BRACING FOR THE INEVITABLE BEAR MARKET

After a long run with the bulls, there is an increasing probability the U.S. stock market is treading on bear territory. How should investors prepare?

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Executive Summary

When the market delivers positive returns, it is easy for investors to start thinking the good times will never end. But even during these uptrends, investors should be thinking long-term about how their portfolios are prepared to perform during the next type of market, because it will strike – often with little warning.

This white paper outlines the steps to building a responsive portfolio that's prepared for a variety of market scenarios – good and bad. **There will be another bear market sooner rather than later**, so there's no better time than now for investors to construct a portfolio that's flexible enough to potentially capitalize on a market downturn yet quickly participate when the market rebounds again.

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When the market delivers positive returns, investors often tilt their portfolios toward riskier investments like high-flying equities. It is easy to start thinking the good times will never end, but even during these bull markets it is important to be long-sighted and remember that markets are cyclical.

No matter whether the bulls or the bears currently rule, investors should consider how their portfolios are prepared to perform during the next type of market, because it will strike – often with little warning. This means building a portfolio that may a) reap the benefits of a rising market, b) react in a timely manner to protect assets during a declining market, and c) get off the sidelines quickly when a new bull market begins.

After a historical long run with the bulls, the probability of a correction is increasing. There is no better time than now for investors to ensure their portfolios are ready.

Defining a Bear Market

Most experts agree that a bear market is a downturn of 20% or more over at least 60 days in multiple broad market indexes – such as the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite.

Using that definition, the U.S. stock market has seen 25 bear markets since 1929, lasting an average of 10 months. The average stock market loss was 35% during these downturns, but the losses ranged from 21% (1949) to 62% (November 1931 – June 1932). Today's investors are likely most familiar with the bear markets that brought a 58% decline from 2000 to 2002, and a 57% decline from 2007 to 2009.

What is a Market Correction?

Temporary market declines of 10% or more during an uptrend usually suggest corrective action. The market naturally adjusts to an overvaluation of assets. If the market downtrend lasts less than two months and does not exceed 20%, it is considered a correction, not the start of a bear market.

Bear markets are difficult to predict and can occur due to a wide variety of reasons, such as political events, weak economies, or liquidity issues. A major factor that often turns a market correction (a temporary market decline of at least 10% during a market uptrend) into a bear market is investor sentiment. Investors try to guess what other investors are thinking. If a shareholder thinks others are selling to get out of assets before they lose more value, he or she also sells. Then, the mass sell-off begins, further depressing stock prices.

Though pinpointing the start of a bear market is impossible, they are inevitable. Statistically, we are due for a bear market in the very near future. Historically, bear markets occur every 3.5 years, but the most recent one started in 2007. Since a bear market may be lurking soon, how should an investor prepare?

Developing a Plan

Since bear markets are inevitable and every investor is likely to experience several of them, investors should ensure their portfolios are prepared.

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Mathematics of Declines

Investment Loss	Investment Gain Required to Break Even	Years to Recover Losses
7%	8%	1.1
25%	33%	4.2
33%	50%	6.0
50%	100%	10.3
75%	300%	20.5
90%	900%	34.0

The chart above illustrates the corresponding investment gain and time required to make up an investment loss. For example, if an investor's portfolio were to decline in value by 50%, a return of 100% would then be needed to return to the original value. The time to recover losses assumes a 7% annual return.

During periods of prolonged bull markets, many investors get complacent. Either they have yet to experience a significant downturn or they have forgotten how painful a downturn can be. They abandon the notion of planning for a decline and invest as if the markets will continue to rise. Conversely, other investors are so stung by the last decline that they re-enter the market reluctantly and tardily after fleeing for perceived "safe" investments like cash or gold. These investors miss out on a sizable portion of the eventual upturn. The lesson here is that a portfolio should be flexible enough to potentially capitalize on both bear and bull markets.

Stock market losses can be devastating and life changing, especially for investors with a short time horizon who lack the time needed to make up prior losses during the next bull market. Since they may rely on their investments for everyday living expenses, a catastrophic decline in the stock market can significantly alter their lifestyle.

When a bear market occurs, investors who are unprepared for the downturn may panic and make irrational investment decisions. It is not wise to invest based on emotion. Investors who invest based on emotion may sell everything and convert to cash at or near the market lows, essentially buying high and selling low – one of the biggest blunders of investing. These mistakes are made because they do not have a portfolio they trust to minimize losses during market downturns while still participating in the upside.

Building the Right Portfolio

What type of assets should investors hold to give them the best opportunity to minimize bear market losses and maximize bull market returns?

Portfolios should be well-diversified. This strategy works – but it has to be the right type of diversified assets. Traditionally, a diversified portfolio meant a varied mix of stocks and bonds (the conventional approach is 60% stocks and 40% bonds). But the world is becoming increasingly interconnected, which means these asset classes are moving more and more in tandem – especially in bear markets. Traditional diversification does not always control risk.

Thus, now more than ever, it is important for investors to include non-correlated assets such as alternative investments and strategies, whose return characteristics differ fundamentally from traditional asset classes. Due to these distinctive characteristics, these assets tend to move separately from stocks and bonds.

Alternative investments include venture capital, private equity, inverse funds, hedge funds, real estate investment trusts (REITs), commodities, and real assets such as precious metals, natural resources, and art. In

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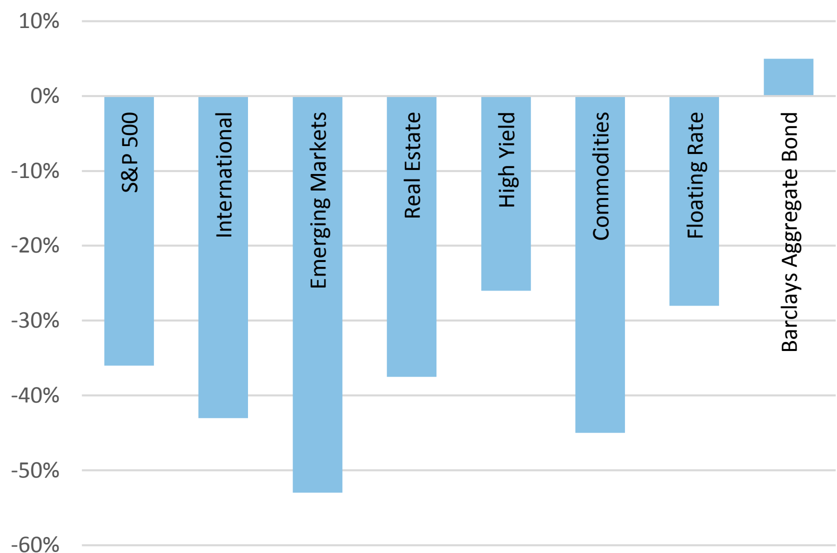
addition, today's mutual funds and ETFs that have the flexibility to invest in these alternative asset classes can behave like an alternative investment.

In the past, alternative investments were difficult for a retail investor to access. They were typically reserved for institutions and endowments, which have used them to improve their portfolio diversification and potentially increase their risk-adjusted returns. But that has changed throughout the last decade. Alternatives are now increasingly available to everyday investors, and the industry is expected to grow to at least $13.6 trillion by 2020.

We believe a portfolio that can best endure and profit from large market swings is one that includes a diversified mix of stocks, bonds, and alternatives. Investors should seek funds that actively manage risk during major market declines, such as funds that control market exposure by shorting or using inverse ETFs, which are designed to increase in value when the market declines.

Conventional diversification wisdom (60/40 stocks and bonds) failed investors in 2008 as markets declined in lockstep[1]

The indices shown are for informational purposes only and are not reflective of any investment. As it is not possible to invest in the indices, the data shown does not reflect or compare features of an actual investment, such as its objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, or tax features. Past performance is not a guarantee of future results.



Data as of 12/31/2008.

Advantages of Active Investing During Bear Markets

Markets are efficient over time, but the conventional buy and hold approach does not work when a bear market hits. For investors with a shorter time horizon, buy and hold losses can be catastrophic.

Over the past ten years, investors have increasingly pursued passively-managed index funds like ETFs in place of actively-managed mutual funds that seek to beat a market benchmark. These index funds may offer lower costs, but what is their value when the market declines? If the S&P 500 Index is down 20%, the fund that tracks that index will also be down 20%, as the fund manager must adhere to the stated objective of tracking a benchmark's return regardless of market direction. These funds do have a place in today's portfolios, as they offer diversification and low cost exposure to equities, market segments, and styles that investors may not otherwise be able to access. However, they cannot protect on the downside the way many actively-managed

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mutual funds can. Therefore, it is important for investors to seek both types of funds to build a well-balanced, responsive portfolio.

That said, not all active funds outperform during bear markets. Rather, investors should seek an actively-managed fund that is poised to participate significantly in markets that offer upside growth, and minimize participation during deep downward movements that can have life-changing consequences for investors. These types of actively-managed funds are generally unrestricted to a specific style box, which means they can "go anywhere" and take long or short positions on any type of asset in any part of the world. This strategy can be particularly advantageous during a bear market, as the fund can go short in an effort to control exposure or use cash to be defensive.

Conversely, some actively-managed mutual funds have a long-only constraint, which means managers can only invest in stocks they believe will rise, while avoiding those they believe will decline. This may sound like an ideal strategy, but the more flexible mandate of long/short funds provides the manager additional tools to attempt to generate returns and manage risk. Funds using a long/short strategy aim to have lower long-term volatility and risk profiles than the overall stock market.

Getting Back Into the Market

Having a solid bear market plan and building a portfolio that is prepared for a downturn reduces the risk that an investor remains on the sidelines when the market eventually rebounds.

Far too often, investors panic and go entirely to cash during a severe market decline, often near the market lows, and then are too nervous to re-enter the market. This is another reason investing in a fund that is focused on both downside protection and upside capture is advantageous. Investors can better prepare their portfolios for all market conditions.

Bear markets are scary, but so is missing out on the upswing. The 25 bull markets since 1929 have sent stocks up an average of 107%. By staying in cash, investors miss the opportunity for gains during a bull market. This strategy of buying high and selling low leads to disappointing investment performance.

Many investors do not have the time, tools, or knowledge to build and maintain a bear market-resistant portfolio. Therefore, investors should seek funds that include strategies to recognize and make adjustments early when bear markets start and end.

Kerns Capital Management, Inc. manages the KCM Macro Trends mutual fund ("KCMTX"), a flexible, opportunistic long/short equity fund without style box restrictions that is free to control its equity exposure with short positions, as well as invest in bonds, alternatives, and foreign investments.

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Investors should carefully consider the investment objectives, risks, charges and expenses of the KCM Macro Trends Fund. This and other important information about the fund is contained in the prospectus, which can be obtained at www.kernscapital.com or by calling 800.945.2125. The prospectus should be read carefully before investing. The KCM Macro Trends Fund is distributed by Northern Lights Distributors, LLC, member FINRA/SIPC. Kerns Capital Management, Inc. is not affiliated with Northern Lights Distributors, LLC.

Mutual funds involve risk including possible loss of principal. The fund may invest in small, less well-known companies, which may be subject to more erratic market movements than large-cap stocks; foreign securities, which are subject to currency fluctuations and political uncertainty; and derivative securities, which may carry market, credit, and liquidity risks. The fund may use leveraging and/or hedging techniques that could fail if changes in the value of the derivative do not correlate with the securities being hedged. The fund may also engage in short selling activities, which are riskier than “long” positions because the potential loss on a short sale is unlimited. These risks may result in greater share price volatility.

[1] Corresponding indexes – S&P 500: Standard & Poor’s 500 Index (an unmanaged composite of 500 large capitalization companies widely used by professional investors as a performance benchmark for large cap stocks.) International: MSCI Europe, Australasia, and Far East Index (designed to measure the equity market performance of developed markets outside the U.S. & Canada, including Europe, Australasia and the Far East.) Emerging Markets: MSCI Emerging Markets Index (captures large and mid-cap representation across 23 emerging markets countries.) Real Estate: FTSE NAREIT All Equity Total Return Index (a free-float adjusted, market capitalization-weighted index of U.S. Equity REITs.) High Yield: Barclays US Corp High Yield Bond Index (index is representative of the universe of fixed-rate, non-investment grade debt.) Commodities: S&P GSCI Total Return Index (a tradeable index for investment in the commodity markets and a measure of commodity performance over time.) Floating Rate: CSFB Leveraged Loan Index (represents tradable, senior-secured, U.S.-dollar-denominated non-investment-grade loans.) Barclays Aggregate: Barclays Capital U.S. Aggregate Bond Index (broad base index used to represent investment grade bonds being traded in the U.S.)

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