IN bull markets, it's wise to guard against thinking that "this time is different" — that stocks will keep rising forever. Sooner or later, the laws of economics reassert themselves. And it's wise to remember that major market declines follow some common patterns, too.

Right now, it's tempting to think that this bear market is so unusual that history's lessons are of little use, and that the types of investments that are weakest now will keep dropping indefinitely. No two market environments are identical, of course, but there is plenty of precedent for the credit crisis of the last 18 months — and for its profound effects on the stock and bond markets.

In fact, you can view the markets' behavior since mid-2007 as a textbook illustration of a statistical pattern uncovered years ago by two finance professors, Lubos Pastor of the University of Chicago and Robert F. Stambaugh of the Wharton School of the University of Pennsylvania. They found that the financial markets are always vulnerable to what they called a liquidity shock — a sudden tightening of credit. Aside from the current crisis, two recent examples are the market conditions during the market crash of October 1987 and the wake of the near-collapse of Long-Term Capital Management in the fall of 1998.

Some types of securities — high-yield, or junk, bonds, for example — are usually more vulnerable than others in such an event. The most immune from liquidity problems are those for which there is always robust demand, so they can be sold anytime without pushing down their prices. As has become abundantly clear over the last 18 months, Treasury securities are a good illustration. At the other extreme are those securities that, without an abundant supply of available credit, become difficult if not impossible to sell at any price.

The professors' research was the focus of this column in August 2001, and their study appeared in the June 2003 issue of The Journal of Political Economy. According to Google Scholar, no fewer than 623 academic articles and studies now cite their study.

This research provides a good template for understanding the last 18 months, according to Lasse Pedersen, a finance professor at New York University who has conducted a half-dozen studies in recent years into the market's reaction to liquidity crises.

In the current crisis, Professor Pedersen said in an e-mail message, "securities with high liquidity risk have done very poorly," just as we should have expected. A good example is convertible bonds, which previous research found to be particularly vulnerable to liquidity shock.

“They have gotten killed,” he wrote.
Though the large body of research into liquidity shocks may offer little comfort to investors who’ve lost so much in the last 18 months, it is an antidote to the argument that history has nothing to teach about the current crisis. The research has found that when liquidity shocks occur, they are so intense that the securities most vulnerable to them predictably provide higher longer-term returns. This happens, Professor Pastor said in an interview, because these securities must compensate investors for the risk of big losses during those shocks.

This doesn’t mean that anyone can predict such shocks with certainty. Instead, according to Professor Pastor, there is a small but significant risk that one could happen at any time — and that investors are deluding themselves if they don’t take that risk into account.

Investors who despair that this credit crisis may never end may therefore be guilty of the mirror opposite of a mistake made earlier in this decade, when liquidity was plentiful. Just as many investors forgot several years ago that another liquidity crisis was destined to happen someday, many may now be forgetting that liquidity shocks don’t last forever.

WHICH securities will perform best after the current credit crisis, and which will fare worst?

According to the research, once a liquidity crisis passes, other factors come to the fore, and securities that have risen in price, like Treasury bonds, are then likely to perform poorly. By contrast, the best performers will be those securities that have lost the most during past credit crises — not just during the current one. Convertible bonds and junk bonds are two obvious categories that should do particularly well, but others, including stocks, should also benefit.

If you can tolerate short-term volatility, you should consider such securities for the long term, Professor Pastor said, even if you’re worried that the credit crisis has longer to run. That’s because it is impossible to predict the exact end of the bear market, and because these investments should provide high-enough returns over the long term to make the risk worth taking.

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