Yes, Virginia,

there is a downside to the market.

How not to lose (your sanity) when the stock market falls

By E. Jeffrey Roof

Investing involves risk. Period. Any financial planner-type will tell you that there are many types of risk associated with investing. Purchasing power risk, interest rate risk, financial risk, etc. However, the risk to which I am referring is generally known as market risk; the gut-wrenching reality that your hard-earned dollars may actually be worth *less* after you've invested them.

Given the kindness of the market (and, naturally, your investment wisdom), this is a reality that many investors have not had to face in a long time. Oh, there have been pockets of negative performance but, until August, nothing in the past several years has come close to an extended broad-based downturn in the market. What steps can you take to preserve both your sanity and some of the wealth you've accumulated when the inevitable occurs?

THINGS TO DO:

Remain focused on your objectives.

If your goal is the long-term accumulation of wealth for retirement, education, independence, etc., having a significant portion of your assets invested in equities probably makes sense and will serve your objectives well. However, understand that a downturn in the market is an expected and natural event. If someone has told you otherwise, better look elsewhere for investment advice.

Yes, stocks have consistently outperformed most other asset classes…over extended periods of time. But short-term fluctuation in stock prices often goes with the territory. If you need the majority of your assets within seven years, you shouldn't be in the stock market. So if you are invested for the long haul, maintain a longer-term perspective.

Diversify your portfolio to control risk.

Diversification typically reduces risk. Do you have high concentrations in one particular sector of the market, management style, or even a single stock? The dramatic appreciation of certain stocks or mutual funds during the past several years may have distorted the intended balance of your holdings. Look for disproportionate weightings and rebalance accordingly.

Utilizing mutual funds is an ideal way to diversify your portfolio. But don't assume all mutual funds have diversification as an objective. Make sure you peek beneath the covers. Funds designed to concentrate their assets in certain industries or geographic regions are generally not the place to be in choppy markets.

Some funds may appear more general in nature but periodically make large sector bets. For example, the Sequoia Fund is a top performing large cap value/blend fund that had 82.7 % of its holdings in financial stocks in early 1998. This is a disproportionate position within a single sector compared to the market as a whole. When the market is mixed, utilize equity funds that have diversified holdings in a broad base of industry sectors.

Keep your management costs down.

Focusing on your cost of investing always makes sense but it becomes crucial when you are looking to preserve assets and return in a less robust stock market. The wallop of that wrap account's 3% load will be much more painful when annual returns dip into single, or even negative, digits. Calculate the net after-expense return of that variable annuity and compare it to alternatives. Paying taxes might not be so bad after all.

Is that mutual fund with the 2% internal expense ratio truly delivering net performance that exceeds a less costly fund with similar objectives? When an equity fund's annual performance is high, many investors tend to overlook the cost of internal fund expenses. However, if that same fund's gross annual return falls to 8%, an internal expense ratio of 2% reduces your return by a full 25%.

Rebalance your asset allocation.

Move to the lower end of any equity range that was set when establishing your overall asset allocation. If you don't know your total stock exposure, its time to do the math. Then reduce your portfolio's total stock exposure to a level that makes you feel more comfortable.

Remember, this game is about the return you get for the risk you take. If you suspect the market's potential performance or your need for return is less than what it was, gradually reduce risk by paring your overall equity exposure.

One caveat. Make sure you monitor the internal equity exposure of any mutual fund you use. If you are reducing your portfolio's equity exposure, and the managers of the mutual funds you're using are doing the same, your actual stock allocation could be much less than you intended. Asset allocation changes should be either at the portfolio or fund level, preferably not both.

Hedging anyone?

For large and sophisticated investors, there exists a myriad of complex hedging strategies. Hedging strategies are usually intended to limit a portfolio's downside potential while preserving existing asset positions. Protective puts, index options, warrants, and other variations of derivative securities can be used. Some work well, some won't, all cost money.

Two rules of thumb for most investors. If you haven't thoroughly examined your other options (no pun intended), don't even consider formal hedging strategies. Two, if you don't thoroughly understand how it works, avoid the strategy. There are some former municipal officials in Orange County, California who undoubtedly agree.

THINGS NOT TO DO:

Panic.

Knee-jerk reactions that run counter to a well-developed strategy typically do more harm than good in managing your portfolio. During the market decline of early October 1987, I received an overseas call from a large institutional client frantically instructing us to, "Sell, sell, sell!" After carefully walking through their recently determined investment objectives, quantifying their probable downside potential, and explaining why now would be the absolute worst time for a wholesale liquidation, the client was able to relax and enjoy the rest of his vacation. And the portfolio ended the year with a very respectable mid-teen return.

Attempting to time the market.

Market timing involves trying to guess when the market has topped or bottomed and then making wholesale shifts in your portfolio weightings. This much different than incrementally modifying your portfolio's equity exposure within a narrow, predetermined range. For market timing to be effective, not only would you need to exit the market at the right moment, you would also have to maneuver a timely reentry. Over and over, history has shown this is a losing proposition.

Letting the market drive your strategy.

Your overall investment objectives and tolerance for risk should determine your decision making, not short-term movements in the market. Unfortunately, the sirens call of a roaring bull market has caused many investors to lose sight of this basic tenet. Similarly, a market downturn shouldn't have you reassessing your well thought out game plan. If your long term financial needs and ability to handle risk have not fundamentally changed, don't let swings in the market dictate your strategic approach.

Buyer beware.

As stock market performance dips, be aware that novel investment products and approaches will surface to take advantage of the investing public's elevated appetite for returns. This is a good time to keep your hand on your wallet. Answer the following questions before considering the latest creative offerings of the financial industry.

First, do you thoroughly understand the concept, as well as all associated risks and costs? Second, is it consistent with your overall investment strategy? Finally, does it pass the 'smell test'? Does it make sound business sense? For instance, if a product's entire premise is dependent on current tax-code, look dubiously at its extended viability. Familiar short-lived examples include limited partnerships and single premium whole life insurance. Likewise, mutual funds, annuities, bonds, or variations thereof, that are paying yields far above the norm are doing so for some underlying reason. Know why.

What's the best overall strategy in a retreating market? At times it's simply reviewing your basics, making minor adjustments, and holding your ground.

Sorry, Virginia, the market doesn't play Santa Claus forever. But fret not… even the Grinch eventually gave back all he took away.

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