

Avoid Common Mistakes in a Down Market

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Unfortunately, investment markets don't always go up. As a matter of fact, the U.S. stock market has declined about one-third of the time since 1926. Seeing the value of your investments go down can often be emotional, but the markets have produced consistent increases in value over very long periods and through all kinds of challenges. Here are some things to focus on when the inevitable down periods occur.

Keep Cool

Don't let a market slump make you do something you'll regret later or derail your investment program. When the going gets tough, the urge to bail out of stocks can be strong. But panicking can wreck an investment plan faster than anything. Being out of the market won't allow you to keep up with rising costs of living. In addition, repurchasing later may result in a cycle of buying high and selling low. If you haven't developed a long-term investment plan, do it now. If you have, review it to make sure it still reflects your financial goals (see Strategy #13).

Here are some things to consider when markets are rocky:

- ✓ **Communicate with your financial advisor, if you have one.** Financial advisors earn their keep in turbulent times, and a good one will be able to walk you through the holdings in your portfolio and reaffirm your investment strategy.
- ✓ **Do nothing.** Sometimes doing nothing is preferable to action. Try leaving your account statements unopened for a while. When you look at them every three months or so, you may find the account values are higher than you thought, especially if you're adding to them on a regular basis.

- ✓ **Don't watch, listen to, or read too much commentary.** During a downturn, the news media has plenty of disheartening stories. The talking heads and bloggers are there for *infotainment*, not to make you money.
- ✓ **Act less like a day trader and more like legendary investors Warren Buffet and John Bogle.** They see market madness as normal and transitory and take advantage of opportunities in the hard times. Check your stomach for risk. If a big dip invokes too much anxiety, consider putting a larger proportion of your portfolio in less risky assets, like bonds and even cash. But be sure that doing so doesn't jeopardize your long-term goals.

Stick to the Basics

Market turmoil causes investors to question their own judgment and seek different approaches, but the only thing investors really need to do is follow some fundamental principles. Consider the following:

- ✓ **Invest in securities and use strategies you can easily understand and that have withstood the test of time.** The subprime mortgage crisis and the collapse of Enron are examples of strategies that failed because some very smart people couldn't control their complex schemes. Be sure you understand your investments, including risks, fees, and other costs.
- ✓ **Make sure you're well-diversified globally.** The U.S. isn't the only market in the world, and every day we become more dependent on a global economy. See Strategies #39 through #46 for strategies and asset allocations that will make your portfolio less risky.
- ✓ **Use mutual funds and exchange-traded funds.** Unless you have at least \$500,000 to invest and the time and expertise to monitor individual securities closely, you'll be better off with well-chosen mutual funds or exchange-traded funds (ETFs). (See Strategies #20 and #22 for the ins and outs of these investment vehicles.) The value of an individual stock or bond can go to zero, but a mutual fund is usually so diversified that losses are temporary. To reduce risk, limit any single stock or bond to no more than 10 percent of the portfolio. Be conscious of too much overlap in individual securities or in styles of funds in your portfolio. Your advisor or online tools can help you analyze the portfolio.



The 10-percent rule especially applies to employer stock. High concentration in employer stock is one of the most common mistakes made by 401(k) participants. Be aware of how much company stock you hold in all your various portfolios. With your employment and potential retirement benefits already aligned with the fortunes of your company, limiting personal exposure in your company's stock is best.

- ✓ **Keep costs in mind.** High costs are magnified when returns are low. Self-directed investors can minimize costs by using index funds and ETFs. If you need or want an advisor, don't be afraid to ask how the advisor is compensated and about the expenses of the products used.



Uncertain economies and markets make adjusting your portfolio even more important. Many proprietary products handcuff investors by imposing heavy surrender charges or exit fees. Annuities are the most common offenders, but other illiquid investments, such as limited partnerships, can keep you from making the necessary changes.

Be Savvy

Beyond the basics, a smart investor can employ a variety of strategies to cope with adverse market conditions. Give some of these strategies a try:

- ✓ **Pay down debt.** The return on investment by paying off a loan is equal to the interest rate charged — but unlike other investments, the return is guaranteed. Even paying down a mortgage (often considered good debt) may be the best investment you can make in a down market.
- ✓ **Invest for *total return* (the combination of growth and income), not just income.** Down markets often coincide with sluggish economic conditions. Income investors feel the squeeze when rates on CDs and other income investments drift lower and lower. Invest for the highest total return consistent with your risk tolerance and then take distributions as needed.
- ✓ **Continue to invest the same amount of money on a consistent basis, be it weekly, monthly, or quarterly.** By sticking with the program in good times and bad, and increasing the amounts of your contributions when you can, you can build wealth regardless of market conditions.
- ✓ **Automate your savings program.** Participants in 401(k) plans enjoy both automatic investing and dollar-cost averaging, but most financial institutions will arrange similar systematic investing in other types of accounts.
- ✓ **Use target maturity and life-cycle funds.** These *funds-of-funds* provide a complete portfolio rebalanced automatically, ensuring broad diversification and effortless investing.

Take Advantage of the Turmoil

You can't control what happens in the markets, but you can turn market turbulence into opportunities. Consider actions like these during market declines:

- ✓ **Buy more.** A decline in prices means investments are on sale. If you're saving and adding to your accounts, you should be delighted with a down market. You want the value of your holdings to be higher when you retire or when you need them — it doesn't matter so much what they're worth now.
- ✓ **Rebalance your portfolio at least annually.** Market declines can cause your allocations to stray far from your target. To get your portfolio back in line, you buy what's gone down and sell what's gone up. Buy low, sell high.
- ✓ **Harvest your tax losses.** *Tax-loss harvesting* (selling assets in which you have a taxable loss and replacing them with other nearly identical securities) is a great and legal way to take advantage of the tax code. Just be careful to avoid *wash sales* — basically, the IRS will disallow your loss if you buy back the same security within 30 days of selling it. This includes mutual funds. You can, however, buy similar mutual funds; for example, if you sell a large cap value fund, you can buy another large value fund immediately, as long as it isn't the same fund you just sold.
- ✓ **Convert traditional IRAs to Roth IRAs.** When you convert from a traditional IRA to a Roth IRA you must pay the income taxes now. But you won't owe taxes later. If converting to a Roth is beneficial for you, it makes sense to do it when the account balance is lower because your immediate tax bill will be lower.



Don't fixate on income taxes. Fear of paying taxes has prevented more people from taking necessary actions than just about any other reason. If your analysis suggests that selling is required, don't let the tax consequences stand in the way. Besides, with special rates for long-term capital gains, the tax bill may be lower than you think.