

StrategicPoint of View[®]

PANIC-PROOF YOUR PORTFOLIO

Recession — the dreaded “R” word. It is scary, weighty and anxiety-provoking, but it doesn’t have to be that way. Recessions are part of the normal economic cycle that need not invoke fear or panic. In fact, there are specific steps that you can take to “panic-proof” your portfolio, but the ability to do so requires discipline and the ability to leave emotions out of the process.

Recessions: A Brief History

The definition of a recession is two consecutive quarters of negative growth at the national level. There have been ten recessions since World War II and the most recent one occurred from March to November, 2001, when the dot-com bubble burst. That recession was relatively short and shallow by historic measures, but it hurt — people lost jobs, stocks were weak and businesses were beat up. *The good news is that the US economy will be more than able to survive a recession and so too will you.* Recessions are a natural part of the economic cycle and we should all stop worrying about whether or not one will occur: we will see more recessions and that’s okay.

Take Control and Protect Your Portfolio

So if it is a given that recessions will occur from time-to-time, what can you do to protect your portfolio? Remember panic-proofing does not mean avoiding all losses. It does mean taking action to lessen the chance of loss. The most important thing is to *remain calm and not to panic.*

According to reams of research, the average stock mutual fund investor has not performed as well as the S&P 500 index. The reason is not that investors pick poor funds, but because they purchase and sell at precisely the wrong time, usually as a result of reacting to either fear or greed.

Research firm Dalbar conducted a survey called “Quantitative Analysis of Investor Behavior” which compared the annualized return for the S&P 500 index versus the average stock fund investor from 1986 to 2005. During this time frame, the index returned 11.9%, while investors returned 3.9%. An 8% differential is amazing and it is attributable to the oldest lesson in the investment book: *investors can be led astray by their emotions.*

When investors see prices drop, they are tempted to sell; when asset levels are rising, they pile in. In other words, *average investors consistently sell low and buy high.* You have probably experienced this yourself:

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when stocks make new highs, you tend to suffer from overconfidence and it is hard to trim gains or reduce risk. But as soon as downside volatility grips markets, your anxiety level creeps up, leading you to sell.

You Can Escape This Self-Defeating Cycle

To prevent yourself from falling into the emotional “sell low and buy high” trap that is often exacerbated at the peaks and recessions of the economic cycle, there are **three distinctive steps you should take:**

STEP 1:

Create an investment plan that outlines what you are trying to accomplish.

The plan should incorporate your risk tolerance, including your time horizon for needing to access your money; your feelings about volatility (the ups and downs of the market); and your willingness to accept losses. Only after your goals and risk tolerance have been properly addressed can you successfully manage your money.

STEP 2:

Build and implement an asset allocation plan that allows you to periodically rebalance your accounts.

Asset allocation divides your money among equities, fixed income, real estate, commodities and cash and should not be static. You need to maintain a level of risk that is consistent with your tolerance and then adjust your asset mix to allow for varying levels of volatility and uncertainty in the markets. It is important to keep portfolio models broadly diversified within asset classes and between asset classes to avoid introducing unpredictable levels of risk. A well-diversified investment portfolio is better able to withstand whatever blows the economy delivers and cushions you against unexpected market risks you can't control. Any portfolio shifts should be moderate, not manic.

STEP 3:

Determine whether you and/or your broker/advisor is/are capable of executing Step 2.

Unpredictable market conditions require that managers stay abreast of trends in the economy, reevaluate holdings in portfolios on a frequent basis and invest with an unbiased eye. The particular assets included in your portfolio should shift depending on where we are in the economic cycle. The ability to both buy and sell is imperative, especially during volatile times. Keep your strategy active and monitor your portfolio frequently, making changes as economic and market conditions indicate. Of course, attempting to time the market can be a disaster, but a careful ongoing review of your asset allocation, level of diversification and the strength of your individual holdings can enable you to respond both to changing economic conditions and to the continued appropriateness of any particular asset within your portfolio.

Recession Allocation Tips

If you think the economy is weakening, you should reduce risk exposure. A good place to start is by beefing up your cash position and steering clear of credit risk. Avoid higher risk corporate bonds, especially high-yield bonds and mortgage-backed securities, because these investments have higher default rates than government securities. As the economy weakens, businesses have a more difficult time generating revenues and earnings, which can make debt repayment more difficult and could lead to bankruptcy as a worst case scenario. The amount by which you reduce risk depends on your specific asset allocation plan.

Most will continue to hold some percentage of their portfolios in stocks, but which ones? When the economy slows, many companies fall short of the earnings growth projections. In general, negative earnings surprises are more likely to hit smaller firms that are

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having difficulty finding the financing and customers needed for growth. For that reason, in a recession, investors have generally fared better by sticking to larger, high quality stocks that deliver more predictable earnings and steady streams of cash to run the business and pay dividends.

Historically, the top performing sectors are those with the most reliable source of profits, including: consumer staples (companies involved with manufacturing and selling of food, beverages, tobacco, household products and personal care items) and healthcare and pharmaceutical companies, which tend to produce predictable earnings and revenue in economic declines and often pay substantial dividends. While these stocks can certainly slide in a slowdown, they typically will lose less than their smaller and more economically cyclical rivals.

Of course, every recession is slightly different and our recession allocation tips are general in nature. You will want to do your own homework and select those asset classes and sectors that best fit your personal investment plan.

Annie Was Right... The Sun Will Come Out Tomorrow

Remember, recessions are time limited and yes, it will get better. Your job is to maintain a clear mind as you survey the investment landscape before you. Focus on your long-term goals, manage your risk and you will likely avoid making big mistakes. As Warren Buffett says, "Investors should be brave when others are scared and scared when others are brave." In other words, have the discipline to step away from the crowd and shift away from risky, high-returning investments during times of extreme optimism and have an equal amount of discipline to embrace risk at a time when people are shying away from it to get ahead of the cycle.

"Ugh... This Sounds Hard"

Developing an effective investment management strategy that allows you to take advantage of growth periods and limit risk during recessions is not easy. It requires hard work, discipline and experience. If you are no longer comfortable assuming this massive responsibility or are not sure that your current broker/advisor is delivering what is necessary, then hire a professional who will help you take control of your financial life.

Questions about this article:

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