

Money and You: When markets head south, don't hit the panic button

by Lynn O'Shaughnessy

Ouch. Feb. 27 was one of those days when a pinched nerve would have felt like a relief compared with the pain felt by millions of investors. In just a few hours of trading, hundreds of billions of dollars vanished.

Stock market tantrums, like the one we recently experienced, are painful, but they feel even more excruciating because of the way we're hard-wired. We tend to dismiss our financial successes, while we let our setbacks gnaw at us. If you win \$5,000 after spending an all-nighter in a smoke-filled casino, but you misplace your wallet that contained \$200, you're going to fixate on the lost cash. The same thing happens on those days when the closing bell on the New York Stock Exchange sounds like it's playing a funeral dirge.

When the markets are doing their occasional rendition of "Nightmare on Elm Street," however, it's not the crazed man wielding the ax who should be feared. The worst enemy is more likely to be the folks, horrified at their losses, who are tempted to hit the panic button. During times like this, you want to make sure you don't sabotage your own portfolio. Here are ways to do just that:

- Don't overreact. So your investment accounts probably lost a pint of blood recently. Please keep things in perspective. Suppose, for instance, that your 401(k) and Individual Retirement Account slipped a few thousand dollars in value. Do you think that you're going to remember this February blip when you're ready to retire? Actually, you're probably as likely to remember it as you are to recall what you had for dinner on Feb. 27. Do you really think this setback is going to set back your retirement plans? Hardly.

During times like this, what people often forget is that market swoons can benefit diligent savers. Unless you're already retired, most people should be stashing away money regularly. Those investors will be rewarded when they deposit money into their accounts when mutual funds and stocks have shrunk a dress size or two. When that happens, your new money will stretch further. For instance, recently, I wrote a check for \$1,500 for an index fund in my SEP-IRA. With that money, I bought 73 shares that were priced at \$20.31 each. In the weeks leading up to April 17, which is when 2006 SEP-IRA contributions are due, I will invest more money in this mutual fund. After the recent Wall Street hit, the shares are priced at \$19.53 apiece. So is this such a bad thing? Heck no. I'd rather dump money into mutual funds when they are cheaper. Of course, I want my mutual funds to do well, but my timeline is still many years away.

Rather than adopt this long-term approach, too many investors become paralyzed about whether now is the time to liberate their money or pour more money into the market. You won't have to deal with this unnecessary anxiety, though, if you practice dollar cost averaging. This is what anybody with a 401(k) or 403(b) plan already does. Money is automatically taken out of your paycheck regardless of whether the financial stars are aligned. You can invest the same way with Individual Retirement Accounts or any other savings regimen by having the money automatically directed to these accounts either monthly or quarterly.

- Be diversified. This advice might sound obvious to all but a simpleton, but it's ignored by millions. A diversified portfolio helps keep your nest egg from splatting during rocky times. The Feb. 27 market mowed down a wide swath of victims, from blue chips and small stocks to foreign stocks and debt to junk and corporate bonds. But some investments remained unscathed.

In my own portfolio, the index funds that contain short-term bonds and inflation protection bonds jumped in value. And anybody who owns U.S. Treasuries did just fine as Pavlovian investors rushed to the safety of government debt.

A tragic mistake that so many people make is to judge whether an individual asset class is too volatile. Sure, if you look at an emerging market stock fund by its lonesome, for instance, it will look like the kind of investment only a bungee jumper would appreciate. Do you want your retirement to hinge on a mining company in the Amazon rain forest or a home builder in Malaysia? I sure wouldn't. But that's not the sort of question you should be asking.

The best way to fortify a portfolio is to collect yin and yang investments that react differently to different market conditions. Your goal should be to put together a portfolio that will provide you with the greatest rewards for the amount of risk you're willing to face. That means you should make sure that your portfolio is roomy enough for the overseas firecrackers, as well as those staid Treasuries. The next time the market tanks, you will be happy that you rearranged the furniture.

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