CONSULTANT'S CORNER

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Investors encounter rough ride in markets

A recent Barron's article suggested many investors might be feeling a bit like Bart Simpson traveling with his parents. "Are we there yet, are we there yet, are we there yet…?"

But the journey investors wish to end is the current downward trip of the stock market.

The desired destination? A point where declining equity prices reach a bottom and can again begin to appreciate in value.

After a positive start in January, the market ended the first quarter notably on the negative side. The Dow Jones Industrial Average was down more than 8 percent, the Standard & Poor 500 Index was off about 12 percent, and the Nasdaq Composite fell more than 25 percent. All this followed the year 2000, when all three indexes finished in the red.

Are we at the end of the recent market slide? It depends who you ask. Some analysts are very positive and point to indicators suggesting a market rebound.

One indicator is the relative price of stocks vs. bonds. The Federal Reserve Board interest rate cuts designed to stimulate the economy also decrease the yields of bonds and other fixed income investments, making the potential upside return of stocks more attractive. And the decline in stock prices during the past year does make stocks much cheaper today relative to the cost of bonds.

But also remember that some analysts viewed last April's market drop as only a minor correction and predicted a market turnaround in May, then July, then August… Other market optimists stubbornly held "the old rules don't apply" view of market valuation despite evidence to the contrary.

Consider that Yahoo stock was still a recommended "buy" last year even when priced at $186 a share. It currently trades at about $16. You get the point.

In contrast to the optimists, some market observers remain steadfastly negative, believing the current market has a long way to fall before rebuilding begins. They note the economy has cooled and corporate earnings are being pared. Layoffs and slowdowns are in the news daily.

The month will undoubtedly bring mixed economic data and a new round of profit warnings from a wide range of companies.

However, market naysayers also believed we were at the beginning of a prolonged drop in the market in October of 1987 when the Dow plummeted below 2,000 after flirting with then an all time high of 3,000-plus.

Fears of stock overvaluation and impending fallout were also heard when the Dow first topped 4,000 in 1994, then 5,000 in 1995, and 6,000 in 1996.

Even after a few chaotic weeks in March, the Dow closed the month at 9,878. Again, you get the point.

To add to the confusion, an investor can be exposed to these contrasting opinions 24/7 by media personalities seemingly intent on entertaining their audience by taking them to alternating states of panic and euphoria. In reality, market performance will most likely remain somewhere between nirvana and Armageddon.

To help keep a perspective on the market's downside, it is important to remember that economic slowdowns and market downturns are a natural part of our free market economy and are by no means unusual.

For example, excluding present, the S&P declined into bear market territory nine times since 1949. The average drop in the S&P during these periods was 27 percent and the average length was approximately 15 months.

Likewise, Neil Davis Research reports that the Dow declined 15 percent or more on 51 separate occasions from 1900 to 2000. Each drop lasted an average of seven months and occurred on average about once every two years. Statistically speaking, the recent downward market move has been somewhat overdue.

While you can't control what the market does, you can control what the market does to your portfolio. What can be done during periods of uncertainty to help you weather the storm?

Basic strategies still apply; such as avoiding the temptation to time the market by jumping in or out of stocks entirely and not letting short-term market dips unduly influence your long-term investment policy.

Additionally, here are a few tactical moves to help temper future portfolio volatility and downside risk.

▪ Understand your portfolio's market risk.

Many investors do not realize that nuances in their portfolio's structure can dramatically influence how that portfolio responds to market changes. Measuring these nuances can provide valuable insight as to a portfolio's potential vulnerability to movements in the market.

One such measurement is a portfolio's beta coefficient. Simply put, beta measures a portfolio's sensitivity to market movements, both up and down. In essence, the volatility of the portfolio is compared to the volatility of an appropriate market index.

Assuming there's a high correlation with the index, a portfolio beta *greater than* 1.00 indicates that portfolio's return is more volatile than the market in general, while a beta that is *less than* 1.00 indicates less volatility.

Consequently, it would not be surprising for a portfolio sporting a high beta of 1.50 (relative to the S&P) to conceivably return -15% last year when the index return for the period was -10.14%.

▪ Cash is king.

Having extra cash in a down market is always attractive, even for a publicly traded company. As the economy slows, leveraged companies carrying high debt often will be the first to suffer, since lower corporate revenues will make supporting that debt a greater burden.

Stocks of firms that consistently produce positive cash flow and maintain low debt-to-capital ratios are typically better positioned to sail through stormier times.

▪ Truly diversify your portfolio.

Unfortunately, many investors discovered last year that merely owning a variety of stocks or mutual funds does not constitute equity diversification. If the securities are concentrated in the same types of industries or even respond in the same way to moves in the economy or market, the downside protection of a truly diversified portfolio evaporates.

Even at the stock market's high water mark in March 2000, the relative weighting of technology sector stocks in the S&P 500 was only 33 percent. Given the popularity and appreciation of technology stocks and like-oriented mutual funds at the time, many investors had portfolio concentrations in the tech sector far exceeding this benchmark level.

Whether that exposure was created intentionally or not was of little consequence as the market turned negative and the tech sector was hit hard, driving a highly concentrated portfolio well below market-level returns.

A more prudent approach in a downward market is to consciously reduce areas of portfolio exposure to at least benchmark level, particularly when that sector is suspected to be overvalued relative to the market.

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