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Set strategy to deal with uncertainty in investing

Contrary to what many would want you to believe, even on the best of days investing is an imperfect science.

Yet, at the end of every trading session, there is no shortage of commentators and analysts expertly explaining what has happened in the stock market and why. Everything is made to sound so logical, so sensible, so predictable.

Wrong.

Consider several days from a recent week in the market as examples. On Tuesday, October 30th, the market opened decidedly negative after the Government warned of further impending terrorist activity targeting Americans. Not the type of news that gets people out and about. Later that morning, the consumer confidence report was released, and showed that consumer spending was quickly grinding to a halt.

Typically the first areas affected by this tightening of consumer purse strings are luxury items, such as travel.

Understandably, the Dow Jones industrial average was down close to 150 points by midday, with only two equity sectors performing well. One was gold-related stocks, a traditional haven in uncertain political and economic times. The second was cruise lines. Yes, cruise lines. Go figure.

Fast forward to Thursday and Friday of that week, Nov. 1-2, when the widely watched National Association of Purchasing Management index unexpectedly plunged to it's lowest level since 1991, confirming fears that a recession was imminent, if not already here. Add to that a gloomy employment report that showed the largest monthly drop in jobs during the past twenty years.

The market's response? An *increase* in the Dow of nearly 247 points during those two days - not the anticipated reaction to that type of negative news.

Other news certainly influenced the market that week, such as the elimination of the 30 - year Treasury bond. But that's the point. The market and economy move on any given day by a vast number of unknown variables in directions that often make sense only when viewed in retrospect, if at all.

So does a historical perspective help investors make good risk-reward decisions? Yes and no.

Understanding market trends, pricing movements, and past responses can be useful in gaining perspective. But investors who only look in the rear view mirror run the risk of placing too much emphasis on events that have already occurred.

On the contrary, investment decisions designed to optimize future portfolio returns or minimize subsequent losses must be forward looking in nature.

Additionally, while history can provide some guidance as to how an investment or portfolio structure may *potentially* respond to certain economic conditions and market scenarios, the complex dynamic of both the economy and investment markets assures no future situation will exactly mirror one from the past.

The standard security industry warning that "past performance is no indication of future return" is used for good reason. And worthwhile advice it is.

The market dynamics and/or investment strategy that resulted in outstanding results for a given period of time might be completely out of step with current conditions, leaving investors chasing performance that has little chance of being duplicated.

In the current environment, the disclaimer also should serve as a reminder that one should not expect the generally poor equity performance of the past few years to continue indefinitely.

What should an investor focus on to make meaningful investment decisions amidst this uncertainty? Here are three focal points:

■ Establish clear points of reference, such as quantifiable portfolio objectives and comparative benchmarks that remain constant regardless of market fluctuations. Investment decisions then remain grounded and not based on market conditions alone.

For example, if the primary objective of the portfolio is to produce income, quantify the annual amount needed and build your portfolio strategy around that specific target. While changes in interest rates and market conditions will certainly necessitate changes in portfolio tactics, your goal will remain constant and drive your risk-reward decision-making.

■ Many years ago a seasoned pension manager shared with me the investment adage: "Don't take risks you don't have to take". If an annual return of 8 percent accomplishes your objectives, structure your portfolio accordingly and don't swing for the fences. Always make sure you are managing your downside risk.

■ Always view portfolio investment decisions in relative terms, not as absolutes. The risk-reward potential of an investment is best assessed when compared with the alternatives. Likewise, remember that the dynamics of the market will continually change, so comparisons need to be ongoing.

As an example, earlier this year when stock prices were precariously high, the economy was slowing, solid intermediate-term bonds had 7.5 percent yields, and 30 day US Treasuries were paying 5 percent. The relative upside versus downside potential favored shifting some portfolio exposure away from equities and toward fixed income.

Eleven months later, the economy is still slow but showing hints of recovery and stock prices have dropped but continued to hold. The same investment grade intermediate bond now only yields 4.8 percent and 30-day Treasuries currently return 1.8 percent.

In relative terms, the risk-reward benefit may have started to shift back toward the equity side of a balanced portfolio.

Employing these focused strategies in tandem with a defined investment policy will add some logic, some sense, and some predictability to your investment decision-making.

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