FPA
FINANCIAL PLANNING
PERSPECTIVES

HAVE YOU LEARNED YOUR INVESTING LESSONS?

It's baaaccck!

Following three years of gut-churning decline, the stock market is in positive territory again, and strong positive territory at that. In late December 2003, the Dow Jones Industrial Average was over the 10000 mark at a 19-month high, up roughly 23 percent from the first of the year, and the Nasdaq had climbed over 46 percent during the year. In addition, the economy is showing signs of spark.

Investors are growing excited again, though perhaps with a bit more restraint than they showed in the late 1990s. That's to the good. But if the market continues to climb, will investors maintain their restraint? In short, have they learned their lessons from the last bear market?

Invest with a plan. Much of the riskiest investing, overbuying and panic selling during the late 1990s and early 2000s would have been avoided if individual investors had created their own investment plan for achieving *long-term* specific goals such as retirement or a college education. For example, someone who can reach an investment goal by earning a modest average annual return is less apt to jump into higher-risk investments than someone with no plan except to always "go for the highest return."

Smart investors draw up an investment policy statement that specifically outlines realistic return goals, what types of investments they will and won't invest in, what mix of investments, and so on. This IPS serves as a reminder of their goals and strategies, and guides them through market declines and restrains them during boom times.

Stay invested. For some investors, this lesson already comes too late. Panicked investors bailed out of the stock market or drastically cut back, and will likely get back in only after

they're "convinced" that the market is rebounding. Yet missing out on the stock market gains during the early stages of recovery can dramatically reduce returns, and the longer you wait, the more you miss out.

According to a study by SEI Investments of 12 bear markets since World War II, investors who either stayed in the market through its bottom, or were fortunate to enter at the bottom, saw the S&P 500 gain an average of 32.5 percent (minus dividends) during the first year of recovery. Investors who waited at least three months before returning to the market gained only 14.8 percent.

Diversify, diversify. Investors chased hot tech stocks in the late 1990s and got badly burned come 2000 and 2001. The Nasdaq lost 39 percent of its value just in 2001, and another 21 percent in 2002. Investors also overloaded on company stock, frequently with poor results.

Meanwhile, real estate investment trusts, which performed poorly in 1998 and 1999 when stocks were booming, had banner years in 2000 and 2001, performed so-so in 2002, and had an excellent 2003. Bonds also returned well during the bear market. By adhering to your investment policy statement and spreading out your investment portfolio, you usually can reduce risk, minimize losses, and take advantage of the next "surprise" winners.

Hold realistic investment return expectations. As investors painfully learned, those high double-digit annual returns of the late 1990s—one year the Nasdaq jumped 85 percent—aren't *average*. Average annual returns for the past 75 years have been around 11 percent for large-cap stocks and 12 percent for small-cap stocks, and many observers believe stocks will average three to four percent below those averages during the coming decade.

Sleep at night. Investors' tolerance for risk tends to track the market—aggressive when the market is hot, timid when it's down. But risk tolerance should reflect your overall investment needs, investment horizon and how much market volatility you feel comfortable with—regardless of what the market is doing at the moment. Again, a realistic investment plan should keep you focused and help you sleep.

Pay your taxes. After running up big gains in the latter1990s, some investors were reluctant to sell even as the market began to slide because they didn't want to pay large capital gains taxes. Three years of market decline took care of that tax problem for many of them.

Avoid 'rearview mirror' investing. Investors tend to focus on the immediate past. When stocks are booming, investors assume they will always boom. When stocks begin to slide, they fear they will slide forever. Instead, look out the front windshield at the long term.

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