

Beginning Investor

A series providing guidance for new investors on how to become successful investors. See AAII.com for the other articles in this series.

Managing Your Portfolio in Difficult Markets

Following a turbulent year in the global financial markets, it's tempting to make changes to your portfolio. This is particularly the case if the value of your portfolio is less now than it was 12 months ago. The best strategy, however, is to not focus on last year's performance, but rather on your long-term strategy.

Focusing on the long term isn't just about how you view your portfolio, but how you manage it. Here are steps you should take to keep working toward your long-term goals.

Avoid Two Common Behavioral Errors

Investors of all levels of expertise and experience often make two behavioral errors: being overconfident in their skills and projecting that the future will be just like the present (or the very recent past).

The first error occurs when an investor believes he has special insight, or at least thinks he knows enough to ignore long-term advice. An example would be moving money out of stocks because you believe a global crash is forthcoming. Doing so assumes you have special insight into the economies, monetary policies and politics of multiple countries. It also ignores the simple fact that most forecasts are wrong.

Projecting the future to be like the present is a behavioral error known as recency bias. Though current economic trends and other global events (e.g., the European sovereign debt crisis) may not change for the better over the short term, the performance of the markets may. More importantly, financial market conditions can change rapidly, often without notice. Think about 2007 for a minute. Attitudes about the direction of housing prices were different at the start of the year than at the end of the year.

Think About Your Time Horizon

Just as recency bias can lead your portfolio astray, so can forgetting about your time horizon. Ask yourself how soon you will need to withdraw money from your brokerage or mutual fund account. While money you will need within the

next two years should be held in an interest-bearing savings account, money you don't need for periods of 10 years or longer should be invested in a combination of stocks and bonds. The reason is that over long term, you need your portfolio to grow in value to offset the deteriorating effects of inflation.

Taking this a step further, if you don't need the money for at least another 10 or 20 years (or even longer), why worry about the short-term movement of the stock market? Over the long term, stocks deliver the highest returns of any asset class.

Rebalance Back to Your Allocation Targets

An effective way to make the ebb and flows of stock prices work for you is to rebalance your portfolio. Rebalancing is the process of adjusting your allocations back to their targets. For example, if your strategy calls for a 70% allocation to stocks, but bonds currently comprise 40% of your portfolio (and stocks 60%), you would move 10% of your portfolio dollars out of bonds and into stocks. This would bring your stock allocation up from 60% to 70%.

Rebalancing does three things for you. First, it ensures that you are actively determining your portfolio's allocation, as opposed to allowing the market to do it for you. Second, it forces you to buy low and sell high—a proven strategy for investing success. Third, it gives you something productive to do when you feel like you need to change your portfolio.

Sometimes, No Change Is Best

Your best portfolio move can often be the one you don't make, especially if you are attempting to forecast the market's direction or move completely into cash. This is not to say you should ignore your portfolio; rather, you should only alter it when there is a clear and rational reason—based on your long-term goals—for doing so.

—Charles Rotblut, CFA, Editor, AAIL Journal