WHEN MARKETS TURN BAD
THE BASICS REMAIN FUNDAMENTAL

By James B. Cloonan

This year has been an example of the need for diversification across styles as well as industries. While tech stocks have plummeted, micro-cap value stocks are having a very good year. And the entire bear market should emphasize the need for a long-term commitment. Even though my tech stocks have been down for 20 months, I have confidence that three years from now my portfolio will be higher.

One of the problems with producing a monthly periodical such as the *AAII Journal* is that it cannot reflect current events. So investment implications of events such as the tragedy of September 11, 2001, or the crash of October 19, 1987, cannot be covered until 30 to 60 days after the event.

In the October 1987 crash, not doing anything was a blessing, since the market recovered most of the October 19 drop by January of 1988, and 1987 itself turned out to be an up year for the stock market.

Unlike 1987, the events of September 11 occurred in the midst of a very weak market and, importantly, a market that had been weak for well over a year. Yet, as I write this on October 11, the S&P 500 and Nasdaq indexes have exceeded their levels of September 10. That does not mean that stocks will continue up—only that whatever was happening on September 10 will likely continue to happen. And the events of that day will have a long-term economic impact, good or bad, on many individual companies.

While the market averages have recovered the losses due to the September 11 shock, individual stocks have been affected in different ways. This past September is a very obvious reminder that it is wise to diversify across industries. In fact, the entire year has been an example of the need for diversification across styles as well as industries. While tech stocks have plummeted, micro-cap value stocks are having a very good year.

This entire bear market should emphasize another fundamental of investing. Only long-term money should be in the stock market. Long term has many definitions, but I feel safe putting money in stocks that I won't need for three years. And even though my tech stocks have been down for 20 months, I have confidence that three years from now my portfolio will be higher in value than it has been up to this point. A portfolio of 100% tech stocks might well take more than three years to once again see the levels that were attained in February 2000. But that is why we diversify.

The Beginner's Portfolio, AAII's experimental portfolio of smaller, less-followed (by institutions) stocks, is up 14% for the year as of this date, somewhat below its August high. [A description of the Beginner's Portfolio and its performance over the last eight years appeared in the August 2001 *AAII Journal*. The article can be accessed at www.aaii.com.]

In the investment world, you should always keep these rules in mind:

- Diversify stocks across industries, style (growth, value) and company size;
- Don't put money into stocks if you will need it in less than three years (or four or five years, if you are very risk-adverse);
- Stick to your plan.

If you have continual funds to invest, keep investing as the market goes down. If you have an asset allocation program, a falling stock market and rising bond market means that you need to take money out of bonds and invest it in stocks. You needn't do this continually, but adjustments should be made periodically. Of course, the opposite is true when the stock market is rising and the bond market is falling.

The basic rules of investing never change. Their wisdom becomes obvious in hectic markets, but remember them also in the bullish days that eventually will come. ✥

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