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Mutual Funds

7 ways to weather today's volatile market

The stock market this year has been whipsawed by oil prices, economic worries and political concerns. Here are 7 highly effective ways to protect your investments.

By Timothy Middleton

With the stock market bouncing like a pinball in recent weeks, investors' anxiety is growing.

"It seems like (my portfolio) is just not going anywhere or making the income I need to get ahead," a reader told me in an e-mail last week. "I'm ready to cash in and buy real estate."

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Remember, though, that for every frustrated seller in the stock market there must be a buyer. Often, they're the ones getting bargains. James H. Gipson, manager of **Clipper Fund** (CFIMX), has been scooping up shares of **Pfizer** (PFE, news, msgs) as the drug-maker has tumbled nearly 30% amid weaker earnings. That fund, with a solid track record of finding values, has shot up 20-fold since it was launched in 1984.

But how do you make sure you're not the one selling at the bottom or buying at the top? How do you keep from being overcome by today's fear or tomorrow's greed?

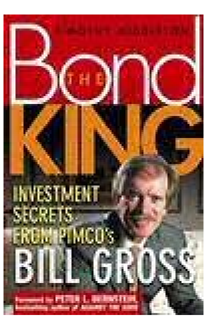
Last week I polled scores of financial advisers for tips on how they're weathering the current market turmoil. With their help, I hereby offer seven highly effective steps you can take to shore up your courage and your portfolio.

Step 1: Embrace lower returns

"We are entering a period of global cooling when it comes to market returns," says Robert J. Schumann of Cambridge Financial Advisors in Gahanna, Ohio. The 20-year bull market in both stocks and bonds during the 1980s and 1990s drove returns to extremes. Both groups are likely to underperform for the next 15 to 20 years.

So if you're used to taking risks and being rewarded, wake up: You may not be rewarded. Therefore, you're foolish to take a lot of risk. The simplest way to reduce risk in a portfolio is to hold a significant fraction of it in cash. Money-market accounts and Treasury bills have essentially zero volatility.

With interest rates rising, you can actually make money on cash. Money-market rates are up to 2.11%. Six-month Treasury bills yield 3.04%. Five-year certificates of deposit yield an average of 4.28%.



Step 2: Diversify broadly

"After reserving sufficient cash, the soundest strategy is to hold many asset classes with low correlation, at the least possible cost," says Adam J. Leavitt, president of Red Rock Financial Advisory in Tulsa, Okla. "Don't wait to structure your portfolio this way."

Investments that don't react to stock-market gyrations, or move the opposite, include bear-market funds like **Grizzly Short Fund** (GRZZX), which was up 10% on the year as of April 20. Funds that invest in real-estate investment trusts have a very low correlation to stocks. **Third Avenue Real Estate Value Fund** (TAREX) is beating the S&P 500 by nearly seven percentage points.

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Elaine D. Scoggins, a financial planner in Tampa, Fla., likes **Gateway Fund** (GATEX), which I wrote about last month. "It has around half the beta of the market and therefore doesn't gain as much in rising markets, but, on a positive note, it doesn't lose as much in declining markets," she notes. This year, it is down 0.9%, about one-fifth the market's loss.

Beta is a statistical measure of a security's volatility in relation to the market. A low beta means that a stock or fund tends to have smaller price swings than the market. So, if the market crashes, a low-beta security will generally suffer smaller losses.

Step 3: Find value

"There are some great funds with betas of 0.8 or less, such as **RS Value** (RSVAX), **Third Avenue Value** (TAVFX), **Artisan Mid Cap Value** (ARTQX) and **Oakmark Equity & Income I** (OAKBX)," says Jeff Feldman of Rochester Financial Services in Pittsford, N.Y.

These are so-called value funds, as is Gipson's Clipper. I wrote about RS Value in the same column as Gateway. Artisan Mid Cap Value has surged an average of 15.8% in each of the last three years, with less volatility than the market itself.

Because they specialize in distressed stocks, value funds tend to go down less in bad markets; their holdings have already been punished. Due to this characteristic alone, they tend to perform better over very long periods than so-called growth funds, which pay much higher price-earnings multiples and therefore surrender the most shareholder capital in declines.

Step 4: Get on the right side of major trends

"With inflation, commodity prices and oil prices a concern, owning assets that can benefit from this helps offset the risk to other assets," says Mark Gleason, a senior financial adviser with Wescap Management Group in Burbank, Calif.

"For general commodities, including oil, the **T. Rowe Price New Era Fund** (PRNEX) is a good choice," Gleason says. "**Pimco Commodity Real Return Strategy** (PCRDX) has direct commodity exposure."

I discussed both of these funds, and several others, one month ago. Both have a very low correlation to the stock market.

Step 5: Bonds belong

For two years, experts have been warning that bond funds would be slammed by rising interest rates. They haven't been. **Pimco Total Return Fund** (PTTRX), the largest bond fund, returned 5.6% in 2003 and 5.2% in 2004. This year it's up 1.1%.

Aside from cash, bonds are the least volatile investment. Common stocks are prone, in the average year, to price swings of more than 15%. For intermediate-term bonds, the type most suitable for investors (Pimco Total Return is designed to act like these bonds), the potential magnitude of such swings is around 4%.

In classic portfolio design, 40% of the assets are held as bonds and cash and the balance as stocks. **Vanguard Balanced Index Fund** (VBINX), which follows this asset-allocation formula, displays average volatility -- in the range of 8.5%. At the depth of the bear market in stocks, in 2002, the fund declined 9.5%, by far the sharpest loss in its history.

Step 6: Look overseas

Foreign equities performed so poorly in the 1990s, compared with an ebullient domestic market, that many investors abandoned them altogether. But that relative performance has reversed. **American Funds EuroPacific Growth** (AEPGX), the most widely held foreign-stock fund, was up 10.7% in the 12 months ended April 20 and 9.5% in each of the last five years.

"U.S. investors need to get comfortable with international investments," says Kirk Kinder, an investment adviser with Financial Guidance Group of Palm Harbor, Fla. "One, they typically pay higher dividends. Secondly, international equities have a lower price/earnings multiple than U.S. equities."

Small-company foreign stock and emerging markets funds offer even more diversification, both because they're more independent of global economic conditions and because they're more sensitive to local currencies. **Fidelity International Small Cap** (FISMX) has surged an average of 48.4% annually since it was introduced in the fall of 2002.

Step 7: Sell your company stock

"Many people have too much money in one stock, especially their company stock," notes

Warren F. McIntyre of VisionQuest Financial Planning in Troy, Mich. Many 401(k) plan sponsors make the employer match in company stock, and some require participants to hold it at least five years.

McIntyre says his clients are especially loath to sell company stock when its price is depressed, as it's likely to be now. "To reduce the discomfort of making a large change at one time, I recommend that they average-out of the stock by moving a little bit at a time," such as one-twelfth of it per month, he says.

The ultimate goal of this seven-step program is to greatly reduce the risk of investing in domestic stocks, which form the core of most portfolios. The exact proportions you decide upon will be determined by such factors as your age and your tolerance for risk.

The model portfolio I maintain at MSN Money currently has these weightings:

- Domestic stocks, 39.3%
- Foreign stocks, including emerging markets, 25.1%
- Commodities/resources, 7.5%
- Bonds, 10%
- Cash, 18.1%

My personal portfolio, which I don't trade as frequently as I trade the model, has more domestic stocks and less cash than the model. It does have, however, plenty of foreign and natural-resources exposure, and it does conform to the diversification principles I've sketched here.

In a shaky market, diversification is more important than ever.

At the time of publication, Timothy Middleton owned the following securities mentioned in this article: T. Rowe Price New Era and Vanguard Balanced Index Fund.

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