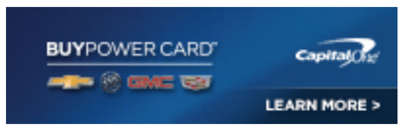
Ad

Safari Power Saver
Click to Start Flash Plug-in

Get There

Is it time to check your exit strategy?



A 4

Advertisement

By Jonnelle Marte October 1 Follow @jonnelle

(Illustration by Chi Birmingham)

Stocks ended the third quarter pretty much right where they started. But it was a white-knuckled roller coaster ride getting there.

The Standard & Poor's 500-stock index eked out a gain of 0.6 percent, marking the seventh consecutive quarterly increase for the index, which was up 6.7 percent this year as of Sept. 30. The Dow Jones industrial average was up 1.3 percent for the quarter and 3 percent since Jan. 1. Even the bond market ended on higher ground, with the

Barclays Aggregate U.S. Bond Index gaining 1 percent for the quarter and 4 percent for the year.

But as they watch markets coast higher, notching record gains even after quick retreats, many investors are wondering: How long can it go up and up? And what will they do if things head south?

"The number one question people need to be asking is 'what is the strategy to get out,'" says Jeff Cutter, adviser and owner of Cutter Financial Group in East Falmouth, Mass., which has about $80 million in assets under management.

Markets may very well keep climbing, but rumbles of trouble from around the world have put investors on alert.

Besides watching the economy at home and wondering about the Federal Reserve's next move, investors have tuned in to dramatic events abroad. After shrugging off crises in Ukraine and Gaza this summer, volatility in the markets has picked up in recent weeks with the U.S. military's engagement in Iraq and Syria and the rise of pro-democracy rallies in Hong Kong.

Investors are also coming to terms with fact that the end of the Fed's bond-buying program could be imminent. Since 2008, the central bank has been snapping up tens of billions of dollars of bonds each month as a way to

Safari Power Saver
Click to Start Flash Plug-in


The Most Popular All Over

THE ATLANTIC

The Real Reason It's Nearly Impossible to End the Cuba...

SLATE

Chat With Dear Prudence

FAST COMPANY

keep to keep interest rates at historic lows, which has lowered the cost of mortgages and auto loans but also constrained returns on savings. They could also tick up short-term interest rates as soon as next year after holding them near zero since the financial crisis.

It's all possible because of growing strength in the economy.

But the stock and bond markets, which have been soldiering ahead for much of the economic recovery, may be due for a shakeup. "There's an old adage: When rates rise something always breaks," says Quincy Krosby, a market strategist for Prudential Financial.

By keeping rates low, the Fed has encouraged people to pile into the stock market — traditionally considered a riskier investment. Now Krosby and others are wondering how markets will hold up without the Fed's intervention.

There's no knowing if the Fed's action will come next spring or not until the fall, or if it will be gradual or sudden. The market reaction, whatever it is, is also impossible to predict — interest rates have never been this low for this long. What does matter, advisers say, is that investors assess the risk in their portfolios and are comfortable with how much they've taken on.

In other words, it's time to check your exit strategy.

This Is Why Facebook Was So Aggressive About...

Assessing risk tolerance

Even if stock markets grow more volatile, few advisers would recommend a take your money and run strategy. Folks who did that during the financial crisis missed out on a bull run that produced staggering gains: From its March 2009 bottom, the S&P 500 is up 189 percent.

Seasonal trends show that the fourth quarter is historically the strongest time of year for stocks, Krosby says, meaning there's a good chance that market gains could keep pace through year's end, even after the Fed halts its bond buying.

Still, people who were planning to shift to a more conservative portfolio this year anyway either because they will be needing the money soon or because they are approaching retirement may as well act now, says Gary Thayer, chief macro strategist for Wells Fargo Advisors. By acting while the market is near new highs, those savers may be able to lock in gains, he says.

Likewise, people with money in stocks that will be needed within five years to cover expenses such as a down payment for a home or a child's college tuition should move it into cash or short-term bonds, says Jim Holtzman, an adviser with Legend Financial Advisors. Even if the market squeezes out gains over the next year, they may not be large enough to be worth the risk of losses on cash needed so soon, he says.

For instance, he recently advised one couple with plans to buy a home in the next two years to move their house fund out of the stock market and into a mixture of floating rate funds, which invest in adjustable-rate loans and short-term bond funds.

Longer-term investors have more of an incentive to stay put, Holtzman says, since they have the time to recoup any losses they might incur over the next couple of years and also have the potential for greater gains in the long run. But they still need to be sure they have enough risk tolerance to stay the course if the stock market collapses. People should ask themselves if they would be able to avoid selling stocks after watching their portfolios drop from $100,000 to $50,000, he says. If the answer is no, people may want to scale back their stock investments.

Cutter says that instead of cutting back across the board, he is looking at each industry separately. Using a portfolio of exchange-traded funds that focus on the nine sectors in the S&P 500 stock index, Cutter says he plans to reduce exposure in areas that start to show downward volatility — without eliminating the position.

"We'll never get to a point where we take risk off the table completely because we could be wrong," he says.

That's why some people's exit strategy is to do nothing at all. Falling share prices can create buying opportunities, but only if you're still in the game.

Because the idea of sinking more money into the stock market when prices are falling is terrifying for most retail investors, Krosby says she recommends dollar-cost averaging, which calls for buying stocks at regular intervals no matter where the market is.

That way people can keep putting money to work if stocks climb, and they can buy stocks at more attractive prices if they fall. It also helps to avoid another common investor mistake: People often buy and sell investments at the wrong time, causing them to lock in losses.

Watching interest rates

After roughly three decades of falling interest rates, the market is poised to head in the opposite direction. Or at least that's what it seems like. Market watchers have been calling for a rate hike for years, and they've been wrong many times. Indeed, those investors who acted to protect themselves in the past were burned for acting too soon.

It wasn't until last year that rates on 10-year Treasury bonds, a closely watched benchmark for bond yields, actually increased slightly over the course of the year. That means anyone who bet in 2011 or 2012 that bond yields were going to increase would have lost money. But at this point, weeks before the Federal Reserve is expected to stop buying bonds and months before it is expected to raise short-term rates, the possibility of the rate increase is more concrete, which is could add volatility to the market, analysts say.

Even if the rate increase is gradual, the shift is expected to lead to losses for bond investors.(Bond prices fall as rates increase, and vice versa.) Those investors holding longer-term bonds would see the steepest price declines. For instance, a two-year Treasury security would fall by 0.09 percent if interest rates increased by one percentage point over the next year, while a 10-year Treasury would fall by more than 5 percent, according to an analysis by Wells Fargo.

Investors may try to sell bonds to cut their losses before the Fed acts, a shift that would raise interest rates before the Fed even lifts a finger. But the reaction so far has been the opposite.Treasury yields have fallen further since the Fed began scaling back its bond buying this year– a reminder that it can be impossible to predict how markets will behave.

But doing nothing can also come with a cost, Rusnak says. As bond and stock prices have climbed higher, investors have generally been content with raking in the gains, potentially allowing some markets to bloat. “You want to be ahead of that curve,” he says, “so really now is the time to start working and repositioning.”

One place to start, and a step many investors have already taken, is to cut back exposure to long-term bonds, which would suffer most if rates increased, Rusnak says. The trade-off is that short-term bonds offer the lowest yields, at a time when rates are already near record lows, he adds.

Over the summer, Rusnak also pulled a small portion of the money he had invested in bonds and moved it into cash and global dividend-paying stocks. He is also moving money into floating rate notes, which invest in adjustable-rate loans and have yields that adjust with the interest rate market.

Fixed-income investors will eventually benefit once bonds start offering higher payouts, advisers and fund managers say. Some investors who may have turned to riskier bonds or stocks in search of a higher yield may rework their portfolios once safer assets, like Treasurys, start to offer more attractive payouts. That could bring down prices in those sectors of the market.

John Traynor, chief investment officer of People's United Wealth Management in Bridgeport, Conn., which manages about $5.5 billion in assets, says he cut his allocation to high-yield bonds, which are issued by less stable companies, over the summer out of concern that they had grown too expensive. He moved the money to bonds from companies with stronger credit ratings, where yields are lower but bond prices look more affordable.

Investors may be able to ride out any volatility. Those who own their bonds outright may have to sell them at a loss depending on what happens with interest rates, but if they keep them, they should be made whole when the bond comes to maturity and they're able to collect their principal payments.

Bond fund investors may also see some price volatility, but it could even out after fund managers reinvest the money coming in from maturing bonds into new bonds with more attractive yields.

"So even though they may suffer an initial capital loss," says Catherine Gordon, a principal in Vanguard's Investment Strategy Group, "the higher interest coming in over time will help offset those losses."

(Correction: This story has been updated to correct that the Barclays Aggregate U.S. Bond Index gained 1 percent in the third quarter.)

Read more:

Morningstar downgrades Pimco Total Return fund

How to stay on point with target-date funds

What should you do when your 401(k) match is terrible?

Jonnelle Marte is a reporter covering personal finance. She was previously a writer for MarketWatch and the Wall Street Journal.