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The Sound Investor Series #49

Is Your Portfolio Ready for a Market Correction?

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What will you do if the Dow Jones Industrial Average falls 10% or 20% in the next few months? Will you hang tight and monitor the situation or will you run for the hills?

What if emerging market stocks fall 25% or commodities drop 40%.

I’m not trying to scare anyone, but the tensions in the financial markets are increasing and investors should have a plan of action for different scenarios.

Why are tensions increasing? The short answer is interest rates. Interest rates across the board are higher and that is part of the problem. The other part, which is probably just as important, is that the markets are uncertain of what will happen next. Let’s look at both issues more closely.

Higher interest rates in the U.S. and other major countries push up the borrowing costs for speculators who have poured money into commodities like gold, silver and copper; as well as emerging market debt and equities. These speculators will ignore interest costs when their investments are skyrocketing, but if their investments falter, higher interest rates become another reason to liquidate investments quickly.

Borrowing money cheaply and putting it into potentially higher returning investments is often called a “carry” trade. When investment returns are higher than borrowing costs, the trade is “positive carry” and when interest costs exceed returns it is called a “negative carry” trade. Banks are set up to make money on “positive carry” trades where they borrow from some customers at low rates and lend to others at higher rates.

With the Fed moving short-term interest rates up from 1% to 5% in the last 24 months, more and more “positive carry” trades are in danger of becoming “negative carry” trades.

Another part of the problem is that no one knows what the Fed is going to do – including the FED! After years with the Fed confidently and clearly informing the market what to expect, it now says it is not sure what it will do next. While this uncertainty about the course of interest rates is the “normal” state for the Fed, the market was spoiled by the recent past history of the Fed’s deliberate approach. The markets grew accustomed to the Fed’s certainty and as uncertainty regains its rightful place in investors’ outlook; the market is likely to be more volatile.

We can see this confusion play out over the last few days. Tuesday's economic data, in particular housing starts, provided support to investors believing the Fed was finished raising rates. Then Wednesday's consumer price index was fodder for the analysts forecasting continued rate increases.

Economists explaining the situation are running out of hands as they say rates will be steady on the one hand and on the other hand, rates could go higher. It reminds me of the old joke that there are no one-handed economists.

If rates are pushed higher, at some point, stock and commodity markets around the world may fall and investors need a plan. Some "traders" will try to time the market's fall, but this very difficult and longer term, very few "timers" will be successful.

The problem with "timing" is that no one knows when the market will pay attention to increasing rates or any other information. Rates have been going up for two years and so has the stock market. An old saw on Wall Street – that "nothing matters until it matters" - should be kept in mind.

A more sensible long-term approach is to keep your risk at acceptable levels by having a well thought-out and fully implemented asset allocation plan. This is one of the keys to ride out rough stretches in the market.

Your asset allocation should have investments in both stocks and bonds so you are diversified across asset classes. This lessens your risk and potential loses - as stocks and bonds often move in different directions. Diversification is also important within each asset class. For instance, make sure you are not invested in just a couple of stocks or industries.

Before the approaching storm arrives, investors should rebalance their portfolios as they may have gotten out of line. This won't stop you from losing money if the markets tank, but it may stop you from panicky decision-making, a sure recipe for disaster.

Investors know and expect that markets will move up and down. The key to long-term financial success is to have a good plan and stick to it.

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