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The Sound Investor Series

Use Time to Manage Market Risk

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May 18, 2005

We have all heard that risk and reward must go hand-in-hand and that investors must accept the risks of investing in the stock market in order to realize decent returns. I agree.

But the stock market has two major types of risk and you don't have to take them both. The first risk, which investors must accept is how well the market actually performs over the long-term, 10 or 20 years. This largely depends on how the economy grows.

The second risk comes from the market constantly bouncing around. This risk is called volatility and can be partially controlled. The key is Time. Keep in mind the Rolling Stones' lyrics "Time, time, time is on my side, yes it is."

One famous investor described the stock market as both a voting booth reflecting short-term public opinion and a scale weighing the long-term performance of companies. The ever shifting opinions' of investors cause the market to bounce around in the short-term, but long-term it correctly reflects companies' performance.

You can reduce the risk of market volatility using three simple "time" based tactics.

1. Hold investments for a long time
2. Buy investments over a long period of time
3. Sell your investments over a long period

First - if you cannot hold investments for a long time, don't buy stocks. My rule of thumb is that investors should buy stocks when they can expect to hold them for at least 10 years.

Second - when you buy stocks; do it over a period of time so that you get the average price. This is called dollar-cost averaging. I know it's not very exciting to aim for getting "the average" and it means you will not be a hero and buy the market cheap. But investing for your future is not a game. For most of us not losing is much more important than winning. Think of this situation - when you retire if someone offered you a fair bet of double or nothing on all your money, would you take it? Of course not, it would be much too risky. Doubling your money would be really nice, but being retired without any money would be horrible. Investing is not a sport; it is a process of accepting considered risks in order to generate reasonable returns.

Third – this tactic is the mirror image of the second - when you sell stocks do it over time. After you retire, start selling a portion of your stocks each year so you get the average price over time, just as you did when you bought them.

Investors using these tactics will largely defeat the risk resulting from short-term fluctuations. The remaining issue is an emergency situation when you are unable to leave all your money invested. This risk can be partially controlled by holding a diversified portfolio. Most people should split their investments between stocks and bonds. In an emergency, if their stocks are way down, they can raise money by selling their bonds. In the next column I will discuss how to decide how much money you should put into stocks and how much into bonds?

There are at least two side benefits to following this advice. First, having a plan to hold your stocks for a long time helps you resist short-term temptations to sell when the market looks bad. All investors have different time horizons for their investments. Know what yours are and stick to them. Second, staying invested allows you to get the benefits of compounding your returns. I will cover this in more detail in the future.

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