Note to Investors: Don't Play Games with Asset Allocation

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For investors, 2008 has been a nightmare. The most widely followed market barometer, the Standard & Poor's 500, is down more than 16%, shrinking the holdings of millions of ordinary people who have put their faith into index-style investing.

Other major U.S. stock indexes have been hammered as well. And although many investors had bet on foreign stocks, hoping that international diversification would soften the ups and downs of their U.S. portfolios, most foreign stocks are down dramatically, too. And a recent rebound in the U.S. dollar, while it boosts Americans' buying power, has undermined their foreign holdings even further.

What are small investors to do in such a climate? Have the rules of the game changed in some fundamental way?

Stocks are still the best bet for long-term investors, offering better returns than bonds or cash, says Wharton finance professor Jeremy Siegel. But with all the turmoil in the financial services industry, he's not betting on quick gains in the S&P 500. "I don't think it will be up this year," he says, adding, however, that the market "is searching for a bottom. All we need is a few weeks of calm to return and I think we will have a very good base for a rally in the market."

Much of the damage to the S&P 500 can be traced to financial stocks. If one were to remove them from the list, then the ratio between share prices and corporate earnings would be a healthy 14 to one -- less than half the level reached during the stock bubble early in the decade. He calls those levels "really very reasonable."

"Nine of the 10 [S&P 500] sectors have higher earnings to date in 2008 than they had in 2007," Siegel says. Moreover, the international economic slowdown has caused prices of oil and many other commodities to fall, reducing the risk of serious inflation. "I really don't' think that's a concern anymore, and that's really important."

Small Investors Should Sit Tight

As in most crises, small investors will do better sticking with their long-term plan rather than pulling money out in a downturn, says Wharton finance professor Richard Marston, who adds that it's just too hard to spot the market's high and low points except in hindsight. He believes the credit crunch could continue to drive stocks down but that investors who move to the sidelines would risk waiting too long to get back in, missing the rebound.

If one plans a long-term asset allocation of, for example, 60% stocks, 30% bonds and 10% cash, the best strategy is to stick with it through thick and thin, he says. That means putting money into stocks when that portion of the portfolio falls below the target, as it has this year for many people. "The most important strategy is to make sure that the long-run allocation is kept intact during market downturns like

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we are experiencing," according to Marston.

Franklin Allen, also a finance professor at Wharton, says investors should steer clear of illiquid assets right now, otherwise they might not be able to get their money out if those investments turn out badly. That obviously includes real estate, which he thinks may fall another 10% to 20%. Even some generally sound holdings, such as municipal bonds, look too risky now because panic in the credit markets could undermine prices or mean a dearth of buyers if one needs to unload.

"If you think you are going to need cash, be careful that you hold liquid assets," Allen says, adding that the traditional rule of thumb still holds: Money should not be held in stocks unless it can be tied up for at least five years. Bank savings are a good place for cash, he notes. But given the risk of bank collapses, investors should not keep more than $100,000 at any single bank, since that's the maximum federal deposit insurance.

Some market followers have argued that popular investment strategies, such as indexing, are not as appealing as they once were. Mutual funds and exchange-traded funds that follow indexing strategies simply buy and hold stocks in an underlying index like the S&P 500, seeking to match the market's gains rather than beat it. Low costs and taxes help boost their returns.

Late in the summer, Dan Wiener, publisher of the *Independent Adviser for Vanguard Investors*, a newsletter for shareholders in Vanguard Group mutual funds, told his readers this had been a "lost decade" for those holding shares in the firm's S&P 500 index fund, one of the nation's largest funds. In August, the index was at its early-2000 level, leaving annualized returns near zero for the decade.

Wiener, who charges subscribers a fee for his advice on getting the most out of Vanguard funds, argued that index investors had been ill-served by the strategy. Specialized Vanguard funds that focus on energy, mining, real estate and some other sectors had trounced the S&P 500, returning over 10% a year during the decade, he pointed out.

But Siegel believes the index-investing strategy remains sound. In an early-September interview, he noted that at the start of 2000 the market was near its peak at the tail end of the dot-com bubble. Comparing today's level to that bloated peak is misleading, he said.

Results look much better if one starts at the post-bubble bottom in October 2002. From then through the end of August the S&P 500 was up about 9% a year. Add dividends and investors made 10.5% to 11% total annual return. "That's a pretty good return," Siegel notes.

In real life, not many investors put all their cash into a single investment on a single date, either the peak or trough, he says. Instead, they add money gradually over time. With steady investing known as "dollar cost averaging," a given sum buys more shares when prices are lower than when they are high, helping to reduce the per-share cost as a holding accumulates. Over time, an investor is likely to do better this way than by trying to judge the best moments to move money in or out of the market.

Siegel points out that the S&P 500 was at 600 in 1995, while it is over 1100 today. Investors who stuck with the index rather than bailing out during the dot-com crisis early in this decade or in the turmoil of the past year enjoyed handsome gains, he notes.

Beware of 'Economic Patterns'

According to Marston, economic patterns are an unreliable guide for those who want to bet on the stock market's peaks and troughs. "In the nine recessions since 1950, the market, measured by the S&P 500, rose at least 30% in the first 12 months once the market reached bottom. In eight of the nine recoveries, the market reached bottom before the end of the recession."

The problem, he says, is that the end of the recession can only be spotted in hindsight -- often many months later. So investors who waited on the sidelines for that signal would have missed the rebound.

And the relationship between the economy and the market doesn't always hold. The most recent recession ended in November 2001, but the S&P 500 did not bottom out until October 2002. Those who used the recession's end as a signal to buy -- assuming they could identify the end as it occurred and not

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later -- would have lost money over the subsequent 11 months.

"The lessons from this are... don't play games with the asset allocation because you will inevitably be out of the market long after the rally begins...and it will be difficult to know when to increase equity positions," Marston says.

Many investors cannot resist the temptation to play the peaks and troughs, Marston concedes, though it's best to try this with only a small portion of one's holdings. Those investors might find some bargains today in classes of stocks that have been badly hammered: foreign stocks in general, especially emerging-market stocks, and small-company stocks.

"Many Americans are significantly underweighted in foreign industrial country and emerging-market stocks, so they should consider adding to those positions," he says. "But be aware that some foreign economies such as Germany and Japan are deteriorating faster than ours, so expect some bumps in the near future."

Siegel, too, believes most American investors don't own enough foreign stocks, which can be purchased most easily through mutual funds or exchange-traded funds. He argues that as much as 40% of an American investor's stock portfolio should be in foreign issues, allowing one to match global stock returns. This very broad diversification can soften the downturns, and global returns may be boosted from the higher growth potential of developing countries, though these returns can be volatile. He also cautions against piling into stocks in regions that have enjoyed big gains in recent years, such as China.

While stocks always pose risks, the dangers may be worse in some other investments, Marston says. Real Estate Investment Trusts, which are like mutual funds that own real estate, "don't seem to have fully priced in the tightening of credit" and may lag stocks in the next recovery. Credit investments such as high-yield bonds, known as "junk" bonds, "are still deteriorating," he says. "Only the very brave are going into distressed assets at this time."

High oil prices have been a key issue in the past year, helping to drive inflation up and threatening to undermine consumer spending, which is key to the U.S. economy and stock performance. Now that oil has fallen below $100 a barrel and gasoline below $4 a gallon, this threat is easing, Siegel says. That leaves trouble in the housing market as the key factor in the economy, and it is not clear when this crisis will end, he adds.

Allen worries that rising unemployment could help to undermine housing prices as more homeowners default on their mortgages -- not a good sign for the stock market because people who feel poorer spend less.

While he, too, would stick with a long-term plan, maintaining the desired mix of stocks, bonds and cash, Allen warns that there is "huge uncertainty" in today's markets. "I think you have to be conservative at the moment, because there are a lot of very difficult times coming up."

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