MANAGING YOUR INVESTMENTS IN TIMES OF CONFLICT

By Mike McCann, CFP®

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Breaking news of the world's conflicts is available at every turn – on the television, in the papers, on the Internet. Every 15 minutes we can access the latest updates. "Explosions rock Baghdad." "North Korea officially withdraws from nuclear arms treaty." "U.S. forces fired upon in Afghanistan." By the time you read this, undoubtedly more breaking news will have surfaced.

Every report seems to produce volatility in the financial markets, with stock prices reflecting the ebb and flow of the military and political battles. While there are usually multiple factors that affect market movement, the financial press will often assign one explanation for the change, especially in times of geopolitical turmoil. "Stocks slide amid war fears." "Markets tumble with added uncertainty." "Stocks rally with successful campaign."

It's easy to be swept away by the reports, and it's reasonable to worry about the impact the events will have on your investments. But successful investors don't allow this noise to distract them from their plan.

Learning From the Past

Taking a look back, at the markets' history in times of conflict, can help you look forward more clearly and calmly. And remaining focused on a balanced investment strategy – rather than trying to predict the market or pick individual stocks – can help bring stability to your portfolio and ensure long-term success.

Although the war in Iraq and the events leading up to it are somewhat unprecedented, previous international conflicts have certainly impacted America's financial markets.

Such conflicts typically cause an initial drop in the markets, which can last several days or weeks. The Dow dropped 12 percent in the early days of the Korean War, for example, and about 9 percent upon news of the Cuban missile crisis. At the start of the Gulf War in 1991, the market dropped about 4 percent.

Yet, a month after the onset of the Korean War, the Dow rose 9 percent; three months later, it was up 15 percent; and six months later it was up 19 percent. The aftermath of the Cuban missile crisis was even stronger. The Dow was up 15 percent, 21 percent and nearly 29 percent, after one, three and six months, respectively. One month after the Gulf War, the Dow was up 17 percent; three months later it was up 20 percent; and six months later it was ahead 19 percent. (According to reports by *CNN/Money* online.)

Furthermore, this is the fourth time in history that the United States has had multiple-year declines in the market, according the Schwab Washington Research Group (SWRG). They include a four-year decline starting in 1929, a three-year decline starting in 1939, and a two-year decline starting in 1973. In each case the market posted a healthy rebound – of roughly 55 percent, 21 percent and 37 percent, respectively – in the first year following the decline.

Drawing on these parallels, it is foreseeable that a modest rebound will follow the war in Iraq, despite challenges of post-war reconstruction, the continuing threat of terrorism, and other global uncertainties. Prudential Financial analyst Edward Yardeni, in fact, predicts a bullish post-war scenario. In the best case, to which he assigns a 70 percent probability, Yardeni predicts that the economy and consumer spending will grow, as solid productivity gains boost real pay per worker. Home prices will continue to rise, also providing positive wealth effect on consumer spending. Interest rates will remain near current levels, and earnings will recover as profit margins rebound. With the Iraq issue resolved, he predicts, oil prices would tumble, therefore boosting both U.S. and global economic activity.

Still, many investors remain wary. An annual Harris Interactive survey conducted for the Securities Industry Association (SIA) revealed some interesting changes in investment style among investors in 2002. For the second consecutive year, more investors described their investment approach as conservative or very conservative. About half were less willing to take risks to achieve potentially higher gains than they were the year before, and about 42 percent said their main concern in making stock investments is the possibility of losing money. In fact, 30 percent reported taking money out of the stock market because of this concern.

Maintaining a Diversified Portfolio

Despite challenging economic and political times, it's important to maintain a diversified portfolio. That means keeping an appropriate balance of your investments in the stock market. If you're invested in the market, even by a small percentage, your chances of benefiting from a recovery are greater, according to the Schwab Center for Investment Research (SCIR). In the 12 months following the end of a bear market, a fully-invested portfolio has returned an average of 47 percent, the center reports, and if the first six months of the recovery were missed because the portfolio was totally in cash, the return was only 11 percent. (1926-2002, Ibbotson Associates, using the S&P 500 as proxy for the market.)

A sound investment strategy includes a well-diversified portfolio of stocks and other securities. A common pitfall among investors is the urge to commit a disproportionate percentage of funds to an individual stock (IBM, for example, because you inherited the shares from your grandfather) or to try to cash in on certain stocks or industries that may seem hot at the moment (such as defense industry stocks during wartime). Rather than becoming married to individual stocks, investors should commit to an investment strategy that helps them to pick and choose investments and get out when appropriate.

Yet, diversification means more than simply dispersing one's "eggs" into many baskets. The goal is to balance risk and return within your portfolio of investments. The best way to reach that balance is through *strategic asset allocation* based on m*odern portfolio theory*.

Modern portfolio theory explains the benefits of portfolio diversification and demonstrates quantitatively why and how it works to reduce risk. First documented in 1952 by Harry Markowitz, who later won a Nobel Prize in Economics for his work, the theory has become widely accepted by institutional investment managers during the past 50 years. Markowitz was also the first to establish the concept of an *efficient portfolio*. Simply put, if efficient is defined as more output for less input, then an efficient portfolio can be defined as more return for less risk. [Note to editor: If there is space available, we can provide a chart to illustrate this, "What is an Efficient Portfolio?")

So what does all this mean, exactly? Keeping in mind that it's called modern portfolio *theory* and not modern portfolio *absolute fact*, there are ways you can apply this concept to your investment plan.

Begin by infusing as much "fact" into your plan as possible. How old are you? When do you want to retire? What lifestyle do you currently enjoy (measured by monthly expenditures)? From these facts, you can derive additional facts – such as your retirement lifestyle goal, the amount of capital required and consequently your required rate of return.

Next, begin applying theory. Markowitz suggests rate of return can be predicted based on the type (or asset class) of an investment. The risk of an investment can become an objective measure by calculating the *standard deviation* of its past returns. The standard deviation is a statistical calculation that will tell us the likely range of possible returns compared to the average return. In simple terms, you might have an investment that averages 10 percent return with a standard deviation of 8 percent. In this example, most returns will range between 2 percent and 18 percent in any given year.

By analyzing expected returns and corresponding risk for each asset class, we can begin to determine if the required return for your plan is achievable. We can also determine the likelihood of meeting that return. Further, by combining multiple asset classes into your portfolio, we can further reduce your risk, while maintaining expected return. Thus, the portfolio becomes more efficient.

The planning process then becomes subjective, as we work to assess whether you can tolerate the level of risk (standard deviation, uncertainty) required to meet the expected return. Do not minimize the importance of assessing your risk tolerance. Risk assessment is the most important, and most difficult, step. Since sticking to your plan is the biggest determinant of success, it's critical that you choose a plan that you will keep. Taking on too much risk results in anxiety, stress, sleepless nights and ultimately abandonment (and subsequently, failure) of the plan.

Again, bring as many facts into the equation as possible. How did you react to past market losses? Did you sell out, feel anxiety, experience regret? How readily can you replace your portfolio, or where are you in your wealth building cycle – creation, accumulation, preservation, depletion? And how important is your objective? Are you willing to take additional investment risk that may result in the delay of retirement five years if you don't achieve the expected return?

After assessing risk, you must then determine if the expected return in the investments that you are considering with your corresponding risk will meet your needs. If not, it's back to the beginning, to re-evaluate your financial needs and goals.

Staying the Course

Once you've established the best plan for your needs, stick with it – but don't neglect it. Another recent Harris Interactive survey found that approximately 12 percent of investors have never reviewed their investment portfolio, and about 22 percent have not reviewed their portfolio for two or more years.

Even if you tune out the "breaking news" from the financial press and remain committed to your personal investment strategy, your portfolio can still get out of shape over time, due to the outperformance or underperformance of various asset classes and industry sectors. Your personal circumstances also can change over time, which impacts your overall financial plan. Thus, periodic reviews of your plan and rebalancing of your investment portfolio are essential to assure your long-term financial success.