HOW WILL YOU REACT IN THE NEXT DOWNTURN?

Imagine your portfolio is down 3% from the last time you checked. "No big deal, normal market gyrations" you tell yourself. Other more pressing concerns take your attention elsewhere.

A month later you check again and the portfolio is down a total of 6% since the last peak. Market pundits are speculating but as usual, for every talking head calling for a further decline there is another (just as compelling) suggesting it's an opportunity. "Perfect", you say to yourself, "a chance to get some of my recent cash savings invested cheaper than it was before".

One week later your accounts are down another 5%, the purchases you made a week earlier don't look so smart now and you wish you had the cash back. Big, bold headlines are talking about some unexpected external event no one predicted (except the guest on the talking head programs who is now doing the rounds between the news channels, repeating that he's been predicting this exact event for years). Multiple negative days on the markets are adding up. "Too late to sell now" your internal dialogue groans.

Three days later, spurred on by headlines about margin calls and a hedge fund collapsing from being caught offside, your accounts are down a total of 17% since the last peak. You feel sick to your stomach whenever you check your accounts (which is more and more frequent). "Why didn't I sell out the account, all of the signs were there?" you ask yourself. All of the talking heads are droning on about how obviously due this correction was. The one voice calling for calm and suggesting there is opportunity is dismissed by the others as overly optimistic, out of touch with reality. You know this because instead of checking in occasionally, these channels are now streaming constantly in your home. Your spouse is wondering why you're getting up at 3AM to check on the European trading.

The last time the market had a correction like this, you had very little money invested and therefore very little at stake. It was a show you could watch with detachment, wondering why your older co-workers were looking so stressed. Now that you have a six figure account of your own it doesn't seem so academic. The emotional roller coaster you're on is taking you through the stages of grief: denial, anger, bargaining, depression, and finally acceptance. Towards the end of the depression stage, you stop checking in on your account at all, "why bother, it's always bad news, guess I'm working forever" you tell yourself.

At worst, sometime during the anger or bargaining, you sold out to preserve what you had left. Your internal dialogue convincing you "it's the smart thing to do, let it drop some more then I'll buy back in". You don't, however. The market bounces back a little but your nerves are jittery and the talking heads are calling it a dead-cat-bounce because more bad news is around the corner. Sounds like smart advice. You stop paying as close attention (why should you? You have nothing at stake anymore) and before you know it, half of the loss has been recovered in the market. "I can't buy in now, this is higher than when I sold out!" you tell yourself.

Finally you ask your elderly neighbor how they fared through the market turmoil. You know she has a lot of investments (stocks and bonds) because of previous conversations. "How have you managed through all this turmoil?"

"Turmoil?" she responds, "I just got back from a river cruise and a visit with my grandchildren. I don't pay much attention;"

By the time the market is completely recovered, you've gotten re-invested, but you can't help but think your neighbor, who didn't pay a lick of attention, has fared far better through the correction and recovery than you did both in mindset and money.

FOUR STEP PLAN

This pattern repeats itself with every generation. About every nine or twelve years markets go though some kind of corrective phase, varying in length and severity, always coming from an unexpected direction. In hindsight, however, the correction always looks predictable or obvious. Behavior analysis sometimes refers to this as the Pearl Harbour Effect. Analysis with the benefit of hindsight always shows obvious evidence pointing toward and predicting the event. The analysis ignores or underplays contrary evidence, which was just as compelling at the time, but with the benefit of hindsight it is easy to push aside and ignore.

The first step in dealing with these market corrective phases is understanding they are unpredictable and very difficult to anticipate. The often used phrase "Wall Street predicted nine out of the last five recessions" comes to mind. If you are trying to predict them you will likely do yourself more harm than good.

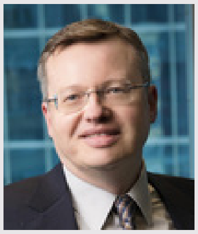
Without any other plan, we will fall into a pattern of being unhappy with our investment portfolio unless it is at a peak.

The second step in preparing for and dealing with market corrective phases is understanding that measuring your portfolio from the last peak will set you up for eventual disappointment. Unless you are at a peak, you are below the last peak. When you are at a peak it doesn't feel like a peak, it feels normal. Not great, not terrible, just normal. You've accidentally built a system where you either feel "normal" or "bad." Find another concrete way to measure your investment portfolio. My favourite is to measure the total amount of dividend and interest income the portfolio is generating. This number tends to be very consistent, increasing when you add new deposits and invest them, decreasing if you make a withdrawal, increasing as the income is reinvested. This way, you feel good as you make a deposit and see the income rise and feel bad if you make a withdrawal, keeping you on track to continue making deposits and seeing the inevitable increase in income the portfolio produces. The market gyrations of a correction don't tend to have a big impact on the income, so it helps to train you to ignore them (like your neighbor).

The third step is having a consistent review plan to keep your portfolio on track. It is easy to think we will have the intelligence and foresight to buy in when the market is down. In reality this is very difficult and stressful to try. A successful alternative is to have a consistent balance you are comfortable with and maintain the balance on a consistent basis. Every six months adjust your stock/bond mix to a predetermined level, understanding you might not hit the exact bottom of the market when you buy equities, or the exact top when you sell. Having a strategy like this keeps you honest and on track, and makes it more likely you will stick with your portfolio through thick and thin, preventing you from selling out at the exact wrong time.

The fourth step is making consistent, regular deposits, if you are still in the saving phase. Rather than trying to guess the best moment to add new funds stick to your regular deposit plan. Human beings are much more likely to feel comfortable making a new deposit when we are feeling good (at a new peak) than when we are feeling bad (below the peak). The only successful way I've found to counteract our inherent self-destructive behavior is to have a contribution plan and stick to it through thick and thin.

Finally, try to understand why your elderly neighbor didn't react. Perhaps it was because she had seen these patterns come and go. She has acquired the wisdom to understand the best reaction is usually no reaction, as long as the dividends are all being paid, don't be distracted. Rather than being consumed by watching the talking heads, immerse yourself in the richness of living your life.



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