Financial fitness

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Dealing with Stock Market Risk

Essentially, there are two types of risk when owning stocks:
Individual stock risk – what happens to your portfolio when any one stock drops significantly in price?

Market risk – what happens to your portfolio when the market as a whole falls?

"Diversification" – holding many different stocks instead of just a few – helps to mitigate individual stock risk, and as such, is a staple of prudent portfolio management. But it does nothing to offset market risk.

There are two basic approaches for dealing with market risk:
Static – you allocate your assets such that the percentage of stock holdings (i.e. the market risk you are willing to accept) is appropriate for you. This allocation is not influenced by market conditions; it reflects your financial wherewithal and risk tolerance. Determining your appropriate asset allocation was the subject of my June 2014 article: "How Much Stock Should Be in Your Portfolio? Answer These 4 Simple Questions." Such an allocation is generally slow to change.

Dynamic – you modify your stock market exposure as stock market conditions change.

The static approach is the easiest. It's pretty much "set it and forget it" – you make a change only when there's a change in your financial picture. This approach implies that you're always in stocks, to the degree of your asset allocation.

Most investors who have watched their portfolios plummet during steep market declines will tell you that a static allocation is not enough. There are times to be in the stock market. And there are times to avoid it.

The dynamic approach can be implemented two ways: emotionally or non-emotionally. Since 1994, DALBAR's Qualitative Analysis of Investor Behavior has been measuring the effects of investor decisions to buy, sell and switch into and out of mutual funds over both short- and long-term time frames. The results consistently show that the average investor, by virtue of their emotional responses, earns much less than the mutual fund performance reports would suggest. DALBAR found that for the 20 years ending 2014, the average equity investor earned 5.0% per year while the S&P 500 returned 9.2% per year!

Non-emotional approaches use measurable data to trigger the changes in your portfolio's stock percentage. Let me give you some examples, citing the indicators you might use to vary your market exposure:

1. Economic - GDP growth, unemployment rate, CPI, LEI, etc.
2. Fundamental - EPS, profit margins, dividend rates, etc.
3. Valuation - P/E ratios, PEG ratios, P/E vs interest rates, etc.
4. Momentum - Price vs moving averages, volume flows, etc.
5. Behavioral - Congressional (sell when Congress is in session) or "Sell in May"

In summary:
Diversification is good, but only deals with individual stock risk. Static asset allocation, alone, will not protect your portfolio from a down market.

Employ dynamic, non-emotional triggers to reduce stock market exposure in falling markets.

Robert A. "Rocky" Mills is a registered representative with and securities offered through LPL Financial, Member FINRA/SIPC. Investment advice offered through Westlake Investment Advisors, a registered investment advisor and separate entity from LPL Financial.