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Tips for Surviving a Stock Market Correction

For investors accustomed to strong and consistent stock market gains, a period of sustained falling stock prices is not easy to accept. All too often, investors will react to a drop in prices by panic selling or digging their heels in despite deteriorating fundamentals. But more thoughtful investors will see a correction or downturn as an opportunity to review their portfolios and make adjustments where necessary.

Definitions, Please

A stock market *correction* is defined as a time when major market indexes drop between 10% and 20%. Declines greater than 20% are considered to be *bear markets*. If confronted with a significant market decline, how might your portfolio be affected? Here's a short list of some potential risks you may face as an investor in stocks, and some ideas about how to potentially reduce the chance of your portfolio suffering a big loss.[1]

Market risk, common to all types of investments, is the possibility that an investor will experience losses due to factors that affect the overall performance of the financial markets. You can potentially manage the impact of market risk on the stocks you hold by allocating part of your portfolio to other types of assets, such as bonds.[2] In this way, when stock prices decline, it's possible that a rise in your bond investments will help cushion the fall.

Lack of diversification.[3] If you only own a couple of stocks, you are extremely vulnerable if one suffers a major decline. For this reason, experts recommend that stock investors hold more than a handful of stocks. That way, if one stock falls sharply, the drop may have a more limited influence on your overall portfolio. Also, it's important to diversify your stock portfolio among various industry sectors. For instance, owning just computer-related stocks will do you little good if the prospects dim for the computer industry. Keep in mind that diversification does not protect an investor from potential loss.

Volatility, or the degree of variation of returns over time for a particular security or market index, is a consideration, but it generally is not as important to an investor with a long-term time horizon. For instance, someone who is investing for retirement in 30 years should not be too concerned if an investment bounces around from one day to the next. What is important is that the investment continues to perform up to expectations. You can potentially manage the effects of volatility by investing the money you may need in the short term (within five years or so) in a more conservative investment, while choosing to be more aggressive with the money you have earmarked for use in 15 to 20 years.

Liquidity risk is the risk that a given security cannot be traded quickly enough in the market to avoid a loss or to achieve the desired profit. If you invest in a stock that "trades by appointment only," you may get a low price if you are forced to sell the issue on short notice. You may be able to reduce liquidity risk by focusing on large, actively traded companies such as those included in the S&P 500.[4]

Finally, one sometimes overlooked risk is that of falling short of reaching a long-term financial goal. Investing too conservatively may contribute to not reaching an accumulation target. Remember that despite several down cycles, stock prices have historically risen over longer time periods. Past performance, however, does not guarantee future results.

A Healthy Market Decline

It's important to remember that periods of falling prices are a natural and healthy part of investing in the stock market. While professional investors may use a variety of trading tools to hedge their portfolios against a sudden drop in the market, perhaps the best move you can make is managing your overall exposure to the risks discussed above.

Contact your financial advisor today.

[1]Investing in stocks involves risks, including loss of principal.[2]Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.[3]There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.[4]Standard & Poor's Composite Index of 500 Stocks is an unmanaged index that is generally considered representative of the U.S. stock market. It is not possible to invest directly in an index. Past performance is not a guarantee of future results.

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