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Sensible investment strategies can help weather gloomy market forces

October has come and gone, which is likely a relief for investors. October gets a bad rap when it comes to the stock market, and perhaps deservedly so: It was October of 1929 when the slide into the Great Depression began in earnest with a 20 percent dip in the stock market. It was also October, in 1987, when Black Monday resulted in the stock market falling over 20 percent in a single day. October of 2008 saw stocks decline 17 percent.

No one knows why, but October has historically been a rough month for the stock market, and this year certainly lived up to that legacy. Maybe it is coincidental, or some changing of animal spirits that occurs in the fall, or any number of other factors. The fact remains, October seems to be the month when bad things happen.

That said, October is not usually the worst month for stock market returns. In fact, since 1926, October has had the fourth-lowest average stock market returns. May, February and September have had lower average returns, but October seems to be the month when really big drops occur.

This year, the S&P 500 fell almost 10 percent from peak to trough during October, marking renewed volatility for stocks. Investors, and the financial media, tend to get skittish when volatility increases, but it is actually very normal. I recently read an article in USA Today that noted that the Dow Jones Industrial Average has experienced 395 drops of 5 percent or more since 1900. Interestingly, there have only been 12 bear markets (periods when the stock market drops more than 20 percent) during that period. So, the market provides an average of three head fakes per year, but really bad events only happen on average every 10 years. Fretting over short-term volatility therefore seems like a waste of energy.

ON INVESTING
Mark Armbruster

That is particularly true when you consider what happens during even the worst bear markets. That is, the market drops, but only temporarily. Unless you have a leveraged or overly concentrated portfolio, a bear market is unlikely to cause permanent damage to your long-term wealth plan. Staying the course, rebalancing into stocks, and realizing tax losses are all strategies to make the most of a down market. Diversification can help minimize losses. And, an actual benefit of a downturn is the ability to buy stocks on the cheap if you are dollar cost averaging into the market.

Despite the fact that stocks have always rebounded from bear markets, staying the course can be an emotional challenge. Unless you are depending on your portfolio to cover current living expenses, a stock market decline should have little practical impact. However, the negative wealth effect from a bear market can weigh on us, and cause us to trade in ways that work against our long-term best interests. Selling at market lows to reduce the pain is the worst thing you can do, as it removes the possibility of participating in the subsequent market recovery, particularly since most of us won't buy back into the market until much of the recovery has already occurred.

Rebalancing your portfolio back into stocks during market declines may seem counterintuitive. After all, who wants to buy more of the asset that just lost a lot of money? However, buying on the cheap makes good sense. Besides, over time, stocks have generated stronger gains than bonds, cash, gold or practically any other liquid asset. So, buying more of them when they are depressed can result in a faster recovery for your portfolio.

Tax swaps are a good way to make the best of a bad situation. Paper losses in your portfolio during bear markets can have real value if you take action. Realizing capital losses by selling can result in a tax benefit. Even if you don't need losses this year, capital losses may be carried forward indefinitely to offset capital gains and some income in future years. So, aggressively realizing losses during a bear market could help minimize taxes for years to come.

Just because you sell stocks for tax purposes doesn't mean you have to be out of the market. In fact, it is best to marry a tax-loss harvesting program with the rebalancing strategy discussed above. For example, assume you have a large-cap stock mutual fund that declines in value by 20 percent. You could sell this fund, realize the loss for tax purposes, and then immediately reinvest the proceeds into another large-cap stock fund. This would allow you to realize the tax benefits of the loss, but also remain fully invested to take advantage of the stock market recovery when it arrives.

Being too aggressive, however, can be a cause for concern. Having too much money concentrated in a single stock or even sector can cause permanent damage, regardless of how successful those strategies can be in rising markets. For example, having most or all of your money in technology stocks seemed like a good idea for the decade of the 1990s, but the tech-heavy NASDAQ Composite

Index took almost 15 years to recover from its downturn during the 2000s. The more diversified S&P 500 recovered its losses in less than seven years. A balanced portfolio of stocks and bonds would have recovered even more quickly.

Diversification is important, even during periods when it doesn't look so hot. While diversifying into anything other than large-cap growth stocks has been a liability the past several years, the future will likely look very different. For example, when the stock market rolled over in 2000, large-cap growth stocks suffered, but other parts of the market held up relatively well. Small-cap stocks, value stocks, international stocks, and real estate companies all fared far better. Today, value and international stocks, in particular, offer far more attractive valuations than large-cap technology shares and will likely hold up better if stocks do end up in a bear market.

With more sensible strategies, stock market losses should not be cause for panic. They are part of investing and they come and go. Acting to avoid these short-term phenomena is usually damaging to your long-term wealth. Rather, accept that they will occur, and use them as opportunities. Indeed, if you are still in the saving phase of your life, buying stocks "on sale" could be a tremendous advantage.

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