

TIME

Personal Time/Your Money

How to Play a Rotten Market

Don't dump your stocks now, except to diversify. And take heart: turmoil can also create bargains

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Sunday, July 14, 2002

Now what? Stocks have dropped below their post-Sept. 11 panic levels. Since March 2000, nearly \$7 trillion of stock-market value has been destroyed — a chunk of it no doubt coming out of your 401(k). Far from sensing a bottom, sellers kept digging deeper last week, driving the S&P 500 to a level last seen in May 1997. A lot of folks long ago lost the casino's money; whatever they still have in stocks is money they earned on the job. Should you ride out the slide? Or bail out?

Some investors clearly have given up on stocks. A net \$3.2 billion flowed out of stock mutual funds last week, after \$4 billion fled the week before, according to AMG Data Services. This run is the biggest exodus since September — but you probably shouldn't join it. Sell now and you risk selling near the bottom. Most people should sell only to trade losers for more promising investments and to diversify holdings across different industries, with exposure to some large and some small companies as well as to international markets. Make sure that you have some bonds, cash and real estate and that your allocation to stocks is in line with your tolerance for risk and with the time you have remaining before you need cash for, say, college or retirement.

In the roaring '90s, many people lost sight of timeless investing principles; some are still stubbornly clinging to their tech stocks, hoping for a turnaround. They need to adjust. Many stocks are still expensive relative to their expected earnings, and some pros still foresee a cathartic selling spree that will cause the last bulls to buckle. For anyone overloaded in stocks, it's not too late to sell. But don't overdo it. Even Warren Buffett, a technophobe but also a bargain hunter, just found value in at least one battered telecom: Level 3 Communications. Perhaps the biggest risk now, warns Scott Kahan, president of Financial Asset Management in New York City, is that "by hiding cash in the mattress, you miss the recovery. Start now, and plan with what you have."

As a rule, any money you will need in the next three years should be in cash or cash equivalents such as the Vanguard Short-Term Treasury fund. Money needed in three to seven years is best parked in intermediate-term bonds or bond funds. Preferred stock as well as bonds convertible into stock fit here too, offering decent yields and, in the case of "converts," a shot at capital gains if the market shoots higher. Consider the Northern Income Equity fund. Some blue chips now offer dividend yields of 5%. For those in the top tax bracket, short-term tax-exempt municipal bonds and bond funds are a steal today, yielding an after-tax equivalent of 7% plus.

Money needed in 10 years or more should be mostly (60% to 70%) in a well-diversified stock portfolio; if the money isn't needed for 20 years, that's where you should have 80% of your savings.

The rage today is shifting money from stocks into home improvements and second homes. But it's unlikely that residential real estate, which has appreciated sharply of late, will beat stocks over the next decade. Don't overlook foreign stocks, which offer diversification and an added kick from the falling dollar. Consider First Eagle SoGen Overseas. And high-yield bonds, now priced for disaster, should beat stocks over the next few years, in funds such as Regions Morgan Keegan.

Remember: some of the best investment values are found in times of turmoil. Keep putting part of your paycheck into stocks each week through your 401(k), and you'll look smart in five to 10 years.