Reprinted from the
Lexington Minuteman

COROMANDEL WEALTH MANAGEMENT

March 2020

Dealing with a market meltdown

Navigating the Retirement Maze

"Remain calm! All is well! ALL IS WELL!!!"

- *ROTC Officer Chip Diller, in the movie "Animal House" (1978)*

Over the past several weeks, the stock market has become Forrest Gump's box of chocolates: You never know what you're going to get. As I write this before the open of the markets Monday morning, following a large Federal Reserve interest rate cut today and promises of $1.5 trillion in cash added to the economy, the futures markets have sensed the desperation and plummeted.

A lead-in to today's article might be a variation of Rudyard Kipling's classic poem "If":

"If you can keep your head when all around you are losing theirs…"
Then you'll be an investor, my son."

But you're not reading this article looking for clever aphorisms. You need answers about what to do in the midst of a rout in the financial markets. Thus, let me discuss what prudent investors should do, how to respond to the present situation, and how to position yourself moving forward.

An ounce of prevention

My mantra on portfolio management has been consistent since I entered this profession:

- Make sure that you can sleep at night with what you own, regardless of what the market does. Greater gain means taking greater risks, and if you aren't comfortable with the potential losses, then you need to change your asset mix.
- Estimate your next 3 to 5 years of cash needs, and keep this amount in very low volatility liquid assets: Short-term, high quality bonds; short maturity CDs; money market funds.
- Once a year, rebalance your portfolio to your desired stock/bond allocations. This allows you to lock in some gains, and buy the other asset class at a discount prices, a true "buy low, sell high" approach.

This isn't difficult, but emotions tend to get in the way: procrastination, greed, and projecting past market gains forward. With the huge run-up in the value of US stocks since 2009, it's been easy to ignore rebalancing that would decrease the equity allocation of your portfolio. More stocks, more potential upside. But that also leaves you more vulnerable to market corrections. Make a point to come up with a plan – allocations that have enough long-term growth potential to meet your retirement needs, but won't upset you during market corrections – and stick to it.

Manage your emotions

Controlling your reactions to the market is hard, particularly with record daily gains and losses. The more you are able to control your urge to "do something" with your investments, the better shape you are likely to be in over the long run.

As a financial manager, I don't practice "buy and hold" investing, and periodically make changes to my portfolios. However, for the average non-professional investor who is trying to ensure that they make it to retirement with sufficient assets, sticking with a portfolio plan thorough all of the ups and downs of market movements yields the best results, both to your psyche as well as to your wealth.

If you find that that you can tolerate most market volatility, but get worried when there is a sustained correction, try an approach employed by professional investors to reduce stock exposure in a controlled manor. It's called a "trailing stop loss," and is measured from the price peak of the value of your stock holdings. A loss limit of 20 to 25 percent is a common range to use, as it prevents you from exiting the market during typical fluctuations, but throws the breaker on losses in the case of excessive declines. When your loss exceeds this threshold at the close of the market, the next day you would sell off a percentage of your equity holdings, say half, and put the proceeds into short-term bonds. Plan to reinvest those assets back in stocks once the market has shown a sufficient recovery from its bottom.

From FOMO to FOLE: What to do now

Back in January, I cautioned you not to fall victim to the Fear of Missing Out, or FOMO, when the market was on a steady climb up. I had no clue that the correction would be so soon or so extreme, but in a world of algorithmic computerized trading, markets tend to move a lot faster than they did ten years ago. Now we're in times where the mood has changed to a fear of losing everything (FOLE). Neither mood is rational, and both tend to lead to bad investment decisions.

Let's assume that your equity allocation has grown considerably larger over the past decade due to not rebalancing, and now you are fearful of seeing your retirement assets significantly depleted. Here are several steps to get you in a better position going forward:

1. Determine what stock/bond allocation is appropriate for your age, years to/into retirement, and risk tolerance. (There are many free Web site calculators for doing this.)
2. Adjust your portfolio to this stock/bond split. Do NOT try to second guess what the market will do tomorrow, next week, or the rest of the year. Also, do NOT try to wait to recover any losses from this past month. Mix non-US with US stocks.
3. A year from now, rebalance your portfolio to your target stock/bond allocations.

That's it. Stop losing sleep with every major swing of the market. One newsletter writer refers to this as a SWAN portfolio, one that lets you Sleep Well At Night. So, develop a portfolio plan, stick to it, and ignore the daily market news. You have better things to do with your time than stare at a stock ticker.

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