Investing: COMMON SENSE FOR UNCOMMON TIMES

BY JOHN GILLIAM

THIS summer, before the bear market and credit crisis morphed into a global financial meltdown, I wrote an article about my terrible decisions in the 2000-2002 bear market. Back then, I rode the market down and threw in the towel with a 50 percent loss — just as the market was bottoming. Then I sat in cash for two years into the next bull market before getting back into stocks. It was a classic, portfolio-decimating case of buy high, sell low and then buy high again. Embarrassed I'd behaved so emotionally, I put most of my retirement assets into a conservative, professionally managed portfolio and promised myself I'd leave it alone.

Then came the deluge of once-unimaginable news: Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, AIG, Washington Mutual, Wachovia — an incredible list of proud American financial institutions — either went under or were taken over. And the Dow kept plummeting, with no end in sight.

With my portfolio down more than 30 percent in one year and still falling, my promise to "leave it alone no matter what" seemed quaint. Had the investing fundamentals underpinning my philosophy collapsed? Was it time to get out of the markets once and for all? Like every investor in America, I was scared, angry and confused.

When Everything Goes Down

The thing that's been so disturbing since the summer is that the prudent investor's best friend — diversification through asset allocation — hasn't worked. Instead of stronger asset classes balancing weaker ones, virtually every asset class has lost serious money. As bad as the U.S. stock market has been, overseas markets — especially emerging markets — have been much worse. Bonds not backed by the U.S. Treasury have also had losses. Real estate continues to be a disaster, while commodities have crashed, admittedly bringing the silver lining of lower gas prices.

"The only thing asset allocation has done recently is make sure you don't do as badly as the worst asset class," USAA Investment Group's Ron Sweet says. "Outside of Treasury securities, there's been no place to hide. That's what happens when you have a credit crisis combined with a recession, a depressed housing market, a financial system meltdown and a global crisis of confidence."

Unraveling the Big, Scary Ball

Before making another big decision about my portfolio, I decided to sit back and unravel the ball of fear. While the "financial crisis" has become an encompassing term for today's ills, it's not that simple. There are several key elements in play, and they have to be considered individually.

The first is the credit bubble that drove the housing boom and the subsequent housing bust that froze the credit markets. The critical factor turning the housing bust into a credit crisis was leverage. Just as homeowners were borrowing against rising home values, banks and hedge funds were borrowing against the inflated value of the mortgage-backed securities on their balance sheets.

As home prices declined and foreclosures skyrocketed, it sparked a second key element that led to the overall crisis: banks and consumers alike scrambling for cash. That reaction created huge holes in bank balance sheets, which is what the government is currently attempting to fix.

A third big problem is the lack of trust between banks. And, again, the government has stepped in and is guaranteeing many types of common financial transactions.

The government's involvement, along with coordinated steps overseas, is designed to unfreeze the credit markets. Further, concrete steps and programs are in place to support the housing market, such as the Hope for Homeowners Act of 2008 and the FHASecure plan.

So does it still make sense to invest in the credit markets? Will bonds resume their traditional role as portfolio balancers and stable income providers? According to USAA's Cliff Gladson, "The losses in the bond market were directly related to the credit crisis. With investment banks and hedge funds liquidating their bond holdings, we've had supply and demand imbalances that have very little to do with the essential element in the bond market — that is, the bond issuers' ability to repay. With the exception of Lehman and WaMu, for example, the other big factor that can impact bonds is inflation, and the good news is that the

combination of global recession with falling energy and other commodity prices will likely wring out whatever inflation exists. Many types of bonds are on sale, especially municipal and corporate securities."

Why the Stock Market Kept Falling

Many people, me included, assumed that the government bailout would have a positive effect on stocks, but instead they just kept falling. USAA's Sweet explains why: "One big reason for the huge sell-off since mid-September — even after the bailout — is uncertainty about capitalism and the capital markets moving forward. There are questions about the banking system and the impact of a less freewheeling capital environment. The market needs to see what earnings will be in the post-crisis world. Once that becomes clear, stock prices should find a new equilibrium that we can build from."

So is it time to get out of stocks and wait until things get better? Warren Buffett doesn't think so. "A simple rule dictates my buying," Buffett wrote in October. "Be fearful when others are greedy, and be greedy when others are fearful."

He continued, "I haven't the faintest idea as to whether stocks will be higher or lower a month — or a year — from now. What is likely, however, is that the market will move higher, perhaps substantially so, well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over."

America the Resilient

As I climb off the ledge of fear, and invite you to join me, does this mean that we should do nothing? Absolutely not, says USAA's Sweet.

"The 1980s and 1990s gave people exaggerated ideas about the stock market, leading to this very humbling decade with its two deep bear markets. People who are nearing or in retirement need to review the risks that they are taking, because they won't have time to make up bear market losses, especially if they are forced to make withdrawals in a falling market."

As for younger investors, Sweet counsels that you should be investing on a regular basis, mostly in stocks, using tax-advantaged retirement vehicles such as 401(k)s and IRAs and educational vehicles such as 529 plans and Coverdell Education Savings Accounts. "Systematic investing is the best way to go, but to make it work you have to keep buying when stocks are cheap...."

John Gilliam is a freelance writer who has written on financial topics for many of America's leading financial institutions including Citigroup, JP Morgan Chase, AIG and USAA.