Will You Be Prepared When the Market Cools Off?

BY DOMINIC LUCENTE

Markets have cycles, and at some point, the major indices will descend.

We have seen a tremendous rally on Wall Street, nearly nine months long, with the S&P 500, Nasdaq Composite, and Dow Jones Industrial Average repeatedly settling at all-time peaks. Investors are delighted by what they have witnessed. Have they become irrationally exuberant?

The major indices do not always rise. That obvious fact risks becoming "back of mind" these days. On June 15, the Nasdaq Composite was up 27.16% year-over-year and 12.67% in the past six months. The S&P 500 was up 17.23% in a year and 7.31% in six months. Performance like that can breed overconfidence in equities.[1,2]

The S&P last corrected at the beginning of 2016, and a market drop may seem like a remote possibility now. Then again, corrections usually arrive without much warning. You may want to ask yourself: "Am I prepared for one?"[3]

Are you mentally prepared? Corrections have been rare in recent years. There have only been four in this 8-year bull market. So, it is easy to forget how frequently they have occurred across Wall Street's long history (they have normally happened about once a year).[3,4]

The next correction may shock investors who have been lulled into a false sense of security. You need not be among them. It will not be the end of the world or the markets. A correction, in a sense, is a reality check. It presents some good buying opportunities, and helps tame irrational exuberance. You could argue that corrections make the market healthier. In big-picture terms, the typical correction is brief. On average, the markets take 3-4 months to recover from a fall of at least 10%.[4]

Are you financially prepared? Some people have portfolios that are not very diverse, with large asset allocations in equities and much smaller asset allocations in more conservative investment vehicles and cash. These are the investors likely to take a hard hit when the big indices correct.

You can stand apart from their ranks by appropriately checking up on, and diversifying, your portfolio as needed. Thanks to the recent rally, many investors have seen their equity positions grow larger, perhaps too large. If you are one of them (and you may be), you may want to try to dial down your risk exposure.

Do you have an adequate emergency fund? A correction is not quite an emergency, but it is nice to have a strong cash position when the market turns sour. Are your retirement and estate plans current? A prolonged slump on Wall Street could impact both. Many older baby boomers had to rethink their retirement strategies in the wake of the 2007-09 bear market.

Finally, a deep dip in the equity market should not stop you from consistently funding your retirement accounts. In a downturn, your account contributions, in essence, buy greater amounts of shares belonging to quality companies than they would otherwise.

A correction will happen – maybe not tomorrow, maybe not for the rest of 2017, but at some point, a retreat will take place. React to it with patience, or else you may end up selling low and buying high.

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