7 Lessons To Learn From A Market Downturn
by Stephanie Powers (Contact Author | Biography)

You can never really understand investing until you weather a market downturn. The valuable lessons learned can help you through the bad times and can be applied to your portfolio when the economy recovers. Listed below are some common investor experiences during tough economic times and the lessons each investor can come away with after surviving the events.

Lesson #1: Evaluate Your Egg Baskets
You're pulling your hair out because everything you invest in goes down. The lesson: Always keep a diversified portfolio, regardless of current market conditions.

If everything you own is moving in the same direction, at the same rate, your portfolio is probably not well diversified, and you could stand to reconsider your asset-allocation choices. The specific assets in your portfolio will depend on your objectives and risk-tolerance level, but you should always include multiple types of investments. (Read *Personalizing Risk Tolerance* to find out how much uncertainty you can stand.)

Taking a more conservative stance to preserve capital should mean changing the percentages of holdings from aggressive, risky stocks to more conservative holdings, not moving everything to a single investment type. For example, increasing bonds and decreasing small-cap growth holdings maintains diversification, whereas liquidating everything to money market securities does not. Under normal market conditions, a diversified portfolio reduces big swings in performance over time. (For more information, read *Diversification: It's All About (Asset) Class*.)

Lesson #2: No Such Thing As A Sure Thing
That stock you thought was a sure thing just tanked. The lesson: Sometimes the unpredictable happens. It happens to the best analysts, the best fund managers, the best advisors, and, it can happen to you.

The perfect chart interpretation, fundamental analysis, or tarot card reading won't predict every possible incident that can impact your investment.

- Use due diligence to mitigate risk as much as possible.
- Review quarterly and annual reports for clues on risks to the company's business as well as their responses to the risks.
- You can also glean industry weaknesses from current events and industry associations.

More often, an investment is impacted by a combination of events. Don't kick yourself over unpredictable or extraordinary events like supply-chain failures, mergers, lawsuits, product failures, etc. (Learn how to find companies that manage risk well in *The Evolution Of Enterprise Risk Management*.)

Lesson #3: Proper Risk Management
You thought an investment was risk-free, but it wasn't. The lesson: Every investment has some type of risk.

You can attempt to measure the risk and try to offset it, but you must acknowledge that risk is inherent in each trade. Evaluate your willingness to take each risk. (See *Measuring And Managing Investment Risk* for information on keeping necessary risk under control.)

Lesson #4: Liquidity Matters
You always stay fully invested, so you miss out on opportunities requiring accessible cash. The lesson: Having cash in a certificate of deposit (CD) or money market account enables you to take advantage of high-quality investments at fire sale prices. It also decreases overall portfolio risk.

Plan ahead to replenish cash accounts. For example, use the proceeds from a called bond to invest in the money market instead of purchasing a new bond.Sometimes cash can be obtained by reorganizing debt or trimming discretionary spending. Set a specific percentage of your overall portfolio to hold in cash. (Learn how to take advantage of the safety of the money market in our *Money Market* tutorial.)

Lesson #5: Patience
Your account balance is lower than it was last quarter, so you overhaul your investment strategy before taking advantage of your current investments. The lesson: Sometimes it takes the market an extended period of time to bounce back.

Your overall portfolio balance on a given date is not as important as the direction it is trending and expected returns for the future. The key is preparedness for the impending market upturn based on an estimated lag time behind market indicators. Evaluate your strategy, but remember that sometimes patience is the solution. (Doing nothing can mean good returns. Find out more in *Patience Is A Trader's Virtue*.)

Lesson #6: Be Your Own Advisor
The market news gets bleaker every day - now you're paralyzed with fear! The lesson: Market news has to be interpreted relative to your situation.

Sometimes investors overreact, particularly with large or popular stocks, because bad news is replayed continuously via every news outlet. Here are some steps you can follow to help you keep your head in the face of bad news:

- Pay attention and understand the news, then analyze the financials yourself. (Read *What You Need To Know About Financial Statements* for help.)
- Determine if the information represents a significant downward financial trend, a major negative shift in a company's business, or just a temporary blip.

- Listen for cues the company may be downgrading its own expected returns. Find out if the downgrade is for one quarter, one year or if it is so abstract you can't tell.
- Conduct an industry analysis of the company's competitors.

After a thorough evaluation, you can decide if your portfolio needs a change. (For more information, read *Do You Need a Financial Advisor?*)

Lesson #7: When To Sell And When To Hold
The market indicators don't seem to have a silver lining. The lesson: Know when to sell existing positions and when to hold on.

Don't be afraid to cut your losses. If the current value of your portfolio is lower than your cost basis and showing signs of dropping further, consider taking some losses now. Remember, those losses can be carried forward to offset capital gains for up to seven years. (For more information, read *Selling Losing Securities For A Tax Advantage*.)

Selective selling can produce cash needed to buy investments with better earnings potential. On the other hand, maintain investments with solid financials that are experiencing price corrections based on expected price-earnings ratios. Make decisions on each investment, but don't forget to evaluate your overall asset allocation. (Read more in *Asset Allocation: One Decision To Rule Them All*.)

Conclusion
Downward stock market swings are inevitable. The better-prepared you are to deal with them, the better your portfolio will endure them. You may have already learned some of these lessons the hard way, but if not, take the time to learn from others' mistakes before they become yours.

Read *Adapt To A Bear Market* to learn how to structure your portfolio to withstand tough economic times.

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Stephanie Powers has worked in the financial services industry since 1995. She uses her experience as a financial advisor to write investment and personal finance articles that educate readers and help them make informed decisions. Her credentials include FINRA securities licenses, an MBA, and experience consulting with individuals and businesses for Edward Jones Investments and Merrill Lynch. Previous experience includes working as a business consultant for American General Insurance and IBM.

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