Saving and Investing in Turbulent Times

When the stock market plummets or you hear the word “recession,” you may begin to question how your money is invested. Maybe you need cash for current expenses, or you’re tempted to sell investments before you lose any more money. There are a number of issues to consider. Here are ways to help you evaluate your options before making a decision.

Ask Questions

What’s your situation?	• Before deciding how to handle your investments, ask yourself…
You are thinking about stopping contributions to your retirement plan because your investments are doing so badly.	• Are your investments diversified, or concentrated in your employer’s stock? • Do you have a sufficient emergency fund? • Did you select these investments as part of an overall plan?
You are retired, or planning to retire, and you planned to sell some investments each year to generate income.	• Do you have savings to cover expenses for a year or two, to give your investments a chance to recover? • Could you return to work, or continue working, in order to delay tapping your investments? • Can you cut expenses so that you need less income?
Your child is starting college, and these investments were intended to pay for college expenses.	• Do you have savings to cover the first year or two, to give your investments a chance to recover? • Can your child attend a less expensive school for the first year or two, or work to pay part of the costs?
The value of your investments has dropped a lot. You’re nervous and wondering if you should sell and put the money somewhere safe.	• What would be the downside of selling now? • How will you feel if you sell, and miss the rebound of stock prices? • How long will it be until you need to tap these investments? • Did you select these investments as part of an overall plan?
A lot of your money is invested in your employer’s stock, through your 401(k), employee stock purchase plan, or stock options and other special programs.	• If the stock value drops and doesn’t recover, how would that affect your overall financial security, your retirement, or other financial goals? • What would happen if you lost your job and the stock lost much of its value at the same time?

Gather Information

To evaluate your options, use the following tools to pull together information about the overall state of your finances.

A **net worth statement** summarizes all of your financial assets (what you own) and obligations (what you owe). For help constructing your net worth statement, see the Net Worth worksheet in Making the Most of What You Have. You can read about the different types of assets and the ramifications of selling or liquidating certain ones. Then review the section, Questions to Ask Yourself.

Your **asset allocation** is the proportion of your savings and investments that are in different asset classes or categories of investments, such as:

- **Cash**: Money that you can easily access, such as savings and money market accounts, money market mutual funds. The value of cash assets is stable and does not fluctuate.
- **Bonds**: Interest-bearing investments that represent a loan to a corporation (corporate bonds) or government entity (such as municipal bonds, US Treasury bills and bonds, savings bonds). The value of a bond fluctuates with changes in current interest rates. On the maturity date, the face value of the bond will be repaid in full.
- **Large cap stocks**: Shares of ownership in larger US companies. The value of stocks changes from day-to-day depending on the performance of that individual company, the state of the economy, and the movement of the overall stock market.
- **Small and mid cap stocks**: Shares of ownership in smaller US companies. The value of these stocks may fluctuate more than the value of larger US companies.
- **Foreign stocks**: Share of ownership in companies in other countries. The most commonly owned foreign stocks are companies in Europe and Asia. **Emerging markets** refers to stocks of smaller countries whose markets are not as well-established, such as many of the countries in Africa, Southeast Asia, and Central and South America.

Mutual funds may belong to any of these asset classes. Some funds fit clearly into one category, but others invest in a variety of asset classes. Target date retirement funds, lifestyle funds, and balanced funds are examples of mutual funds that invest in different asset classes within a single fund.

The allocation of your money across these classes of investments determines the amount and types of risk you face, and how much you will earn from your investments. Risk and return are linked; to have the potential for higher returns over time, you must accept more risk.

Calculate your asset allocation using online tools such as Morningstar's X-Ray (www.morningstar.com > Tools > Instant X-Ray®), software such as *Microsoft Money* or *Quicken*, or tools provided by your mutual fund or broker. Or, you can do it with pen and paper. Add up your investments in each asset class, and divide by the total amount of your investments.

Evaluate

Review your net worth statement to see what cash assets you could draw on in an emergency, how much money is in investments that have restrictions on accessing their value (such as retirement accounts, a business, or real estate), and how your assets compare to your debts.

Compare your current asset allocation with allocations suggested for your situation or risk tolerance. Creating these suggested allocations is not an exact science, so try a couple of different versions to see the range of recommendations you get. You might start by comparing your results from these two online tools with your current asset allocation:

- http://www.smartmoney.com/tools/worksheets/ has a general Asset Allocation tool and one for retirees.
- http://www.ipers.org/calcs/AssetAllocator.html

Conservative portfolios (lower risk) have more money in cash and bonds. Aggressive portfolios (higher risk) have a greater proportion in stocks, especially small cap stocks or emerging foreign markets. Conservative portfolios expect a lower return. They also have less risk of loss and experience less fluctuation in value, compared to aggressive portfolios. If you invest conservatively, you will have to save more to reach your goals. If you invest aggressively, the value of your investments will fluctuate, and there is a chance you could lose money.

In general, the sooner you will need your money, the more conservatively you should invest. The longer it will be before you need your money, the more aggressively you can invest. The value of stocks is unpredictable in the short term. Over longer periods of time (i.e, 5, 10 or 20 years), stocks have historically given better returns than bonds or cash.

You may decide that your current asset allocation is too risky or too conservative for your situation. The process of bringing your allocation back to the desired percentages is known as rebalancing. It can be accomplished by buying and selling existing investments, directing new money into underweighted asset classes, or selling investments in an overweighted asset class to generate income.

Your asset allocation will show you whether you're appropriately diversified across asset classes. But also check to see that you don't have more than five to 10 percent of your money invested in any single company – including your employer, and that your investments are not overly concentrated in any single industry.

Consider

After evaluating your net worth, your asset allocation, there are still several points to consider before taking action.

- **Income taxes**: You can buy and sell investments within a retirement account without tax consequences. But if you sell an investment at a profit that's in a taxable account, you will have either a taxable gain to report on your income taxes, or a loss that you can use to offset other gains or, with certain limitations, regular income. For more information, see IRS Publication 550, Investment Income and Expenses (http://www.irs.gov/pub/irs-pdf/p550.pdf).
- **Missed opportunities**: When stock prices begin to recover, they often increase in price very rapidly. If you have sold your investment and plan to re-invest when things are safer, it's likely that you will miss out on those substantial gains. If you sell investments now, especially if you use the money to cover current expenses, you may be compromising your future financial security.
- **Transaction costs**: For certain types of investments, there are fees for purchases or sales, penalties for taking money out or closing accounts. Examples include:
  - Commissions or broker fees for buying or selling stocks and bonds.
  - Loads for purchasing certain mutual funds (A shares), or back-end loads for selling them before a certain number of years have passed (B shares).
  - Surrender charges for taking money out of annuities before a certain number of years have passed.
  - Early withdrawal penalty taxes for taking money out of retirement accounts before age 59 ½. For rules and exceptions, see *Rules for Taking Distributions from Tax-Deferred Retirement Plans* at http://www.ace.uiuc.edu/cfe/retirement/takingdistributions2007.PDF.)
  - Frequent-trading fees: Some retirement plans impose fees on investors who exceed the allowed number of transfers. Certain mutual funds assess a charge if you transfer money out too quickly. Check your plan documents or mutual fund prospectus.
- **A single transaction versus a series of smaller ones**: If you decide to buy or sell substantial amounts of any one investment (for example, to reduce the amount of money invested in your employer's stock, or to rebalance after major shifts in stock or bond prices), the costs, if any, may be lower if you do it all in a single transaction. But selling a set number of shares or transferring a set dollar amount from one investment to another on a regular schedule over a period of time removes the risk that you'll buy or sell the entire amount at the exact worst time.

Take Action – Or Not

With all this information in hand, you're probably ready to take action. You might decide to:

- Rebalance your investments to match an asset allocation with an appropriate level of risk.
- Dollar-cost-average out of a major holding to achieve better diversification.
- Increase the amount of money held in "cash" so that you have an adequate emergency fund.
- Liquidate investments to generate cash you'll need in the next year or so.
- Do nothing. After evaluation, you may conclude that the best course of action is to stick to your current investments and wait for the market to recover.

Get Help If You Need It

You may feel overwhelmed with these decisions. Or you'd just like a professional to check that your plan of action won't have any unintended consequences. A financial planner, accountant, or other professional may be the answer. For help finding a financial professional that best meets your needs, see *Choosing a Financial Professional* at http://web.extension.uiuc.edu/financialpro/.

For Additional Information

Beginners' Guide to Asset Allocation, Diversification, and Rebalancing, U.S. Securities and Exchange Commission, http://www.sec.gov/investor/pubs/assetallocation.htm.

The Plan Well, Retire Well Blog: Saving and Investing Your Money, University of Illinois Extension, http://web.extension.uiuc.edu/countrysidecenter/blogs/eb141/index.html.

Choosing Investments, in *Plan Well, Retire Well: Your How-To Guide* (anonymous registration required), www.RetireWell.uiuc.edu.

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