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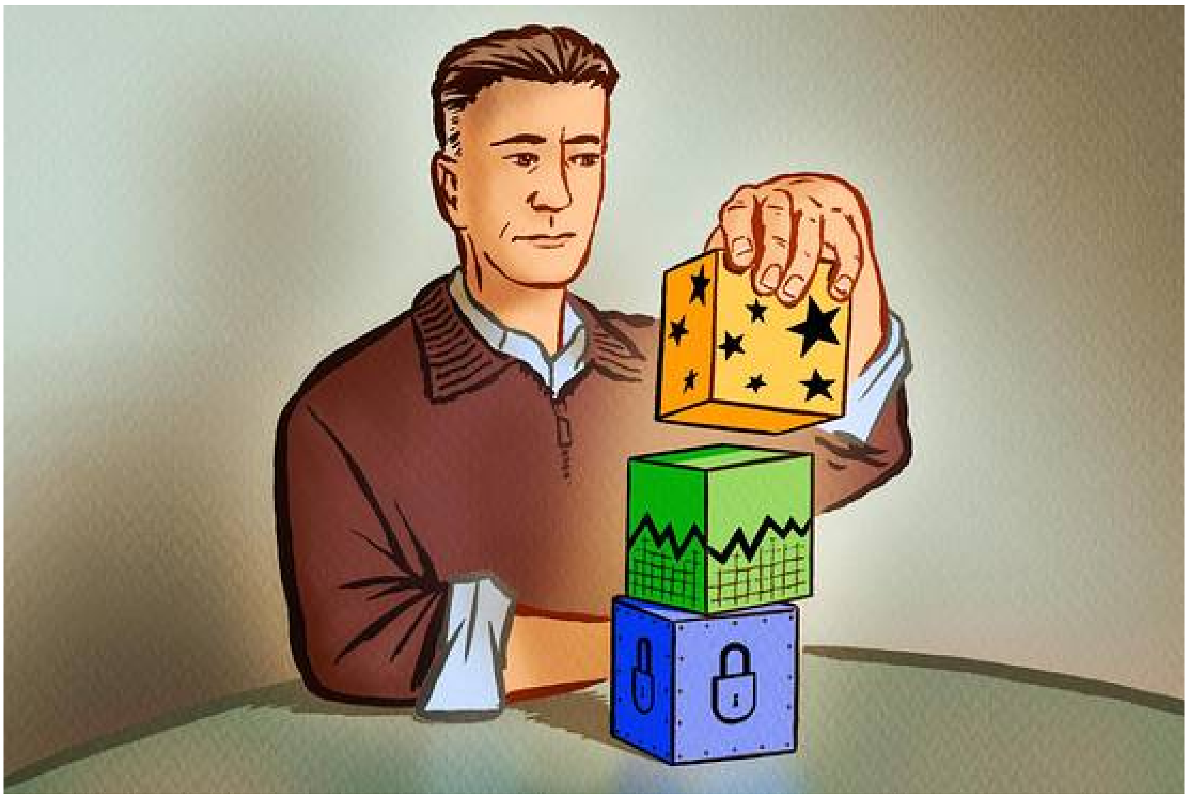
How to Feel Safe in Stocks When the Market Seems Dangerous

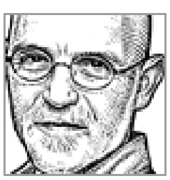
ByJason Zweig



Christophe Vorlet

Every time the stock market jolts up or down, it sends a signal about itself — and about you.

The S&P 500 is on track to swing by at least 1% on seven of the first 10 trading days of 2016 — the most since 2008.



The Intelligent Investor
By Jason Zweig
COMMENTARY

If that turbulence is frightening you, you need to make sure you understand why you own risky assets in the first place.

Almost everyone wants to get richer while minimizing the chance of being wiped out. But the richer investors want to get, the more risks they take in the financial markets.

Concentrating in few holdings or leveraging your results with borrowed money can increase returns. Unfortunately, those tactics also raise the odds of investing ruin.

Investment thinker Ashvin Chhabra points to a different path. Alongside a market portfolio of stocks and bonds, he says, you should hold a “safety” bucket of stable assets, plus an “aspirational” basket of riskier investments.

In research papers and in his book “The Aspirational Investor,” published last year, Mr. Chhabra argues that instead of organizing your portfolio around the markets, you should organize it around your own goals.

Mr. Chhabra is president of Euclidean Capital, a family office in New York. Trained as a physicist, Mr. Chhabra was formerly chief investment officer at Merrill Lynch Wealth Management.

He says a portfolio should achieve three goals: insure your standard of living against severe short-term loss, maintain it over time and improve it. You want a mix of assets that can fund each of those goals no matter what the stock and bond markets do.

To invest for safety, you need cash, short-term Treasury debt and insurance coverage that can buffer sudden shocks. These assets, along with a sensibly purchased home, have a long-term expected return of about zero after inflation. But — unlike stocks and most bonds — they offer little risk of catastrophic loss.

At Circle Wealth Management, a New York-based financial-advisory firm that oversees more than $1.5 billion, some clients have said, “‘I don’t need that [safety] bucket to be so conservative,” says managing partner Maria Chrin. Suddenly this month, “the clients who didn’t want it are glad it’s there.”

The larger your safety bucket, the more risk you can withstand elsewhere.

In your aspirational bucket, blend your expertise with such assets as investment in real estate or a small business. Here, you will likely either crap out or hit the jackpot.

Consider Greg Garville, a retired private-equity executive in the New York area. Lex Zaharoff of HTG Investment Advisors in New Canaan, Conn. helped him implement a goals-based portfolio three years ago.

“Days like these will test the belief that in the long run you can get a 6% to 7% annual return on stocks,” says Mr. Garville, referring to this past week. But the goals-based approach “helps give you the confidence to sustain that belief.”

Mr. Garville’s safety bucket, he estimates, amounts to about 40% of his assets and would cover about six years’ worth of spending if his family had no other source of income — enabling him and his wife to sleep well when the 55% or so of their assets in the stock and bond markets toss and turn.

The final 5% is in an aspirational bucket where Mr. Garville holds four private companies, “leveraging off my experience, knowing that there’s the potential I could lose it all.” One, he says, has generated a 13% annual return; another is likely to lose money; on the other two, it’s too soon to tell.

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“The safety bucket is the foundation for the others,” he says.

Investors with goals-based portfolios are “less likely to feel that things are out of their control” in a falling market, says Michael Liersch, head of behavioral finance at Merrill Lynch Wealth Management.

Katie Nixon, chief investment officer for Northern Trust Corp.’s wealth-management division, says the approach gives “a full line of sight to the tradeoffs in every financial decision you make.” To take more market risk or fund an aspiration, for instance, you must sacrifice some safety.

In general, Mr. Chhabra has written, the approach trades a “slightly lower rate of expected return most of the time” for better protection in the rare event of a severe bear market and at least a hope of long-shot gains.

When investors panic in a downturn and sell stocks or bonds to raise cash, they are trying to use their market bucket as a source of safety — a role “it cannot and should not play,” says Mr. Chhabra.

And if you want to buy on the dips by adding more to your stocks whenever they drop, first make sure you won’t deplete your safety bucket. You might need it.

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