

# should signs of recovery change your course?



Signs of economic recovery could be tempting you to change your investment strategy. But before you start tinkering, make sure you have the right plan.

## no magic pill

Remember first and foremost that there is no “magic pill”: Don’t approach investing like a dieter trying every fanciful new weight-loss solution. In the end, successfully keeping off the pounds usually comes down to basic diet and exercise improvements, and the best strategy for investing is just as elemental.

“Asset allocation and diversification are arguably the two most effective and readily available risk-management tools that investors can use to help deal with uncertainty,” said Colleen Jaconetti of Vanguard Investment Strategy Group.

It’s a good idea to factor in costs as well. You’ll keep more of what you earn by choosing low-cost funds. This is important because, after all, it will benefit you no matter what the markets do.

## tune in, but don’t overreact

The state of the economy does have an impact on the markets, but not in the way most investors think. That’s why you need a solid plan to guide you.

“Many people believe that the markets respond to economic developments, but in fact markets tend to precede and anticipate economic developments,” said Vanguard economist Roger Aliaga-Diaz. “If you wait until there are tangible signs of economic recovery to determine a portfolio strategy, you’re already late to the game.”

A forward-looking investment strategy requires investors to factor in future uncertainty. This is where diversification and a good asset-allocation strategy are critical.

Right now, emerging markets are leading the global recovery. They are expected to resume their fast rates of economic growth soon. However, investors shouldn’t set their long-term asset allocations solely on the basis of expected growth. Case in point: In a forthcoming research paper, Vanguard finds that the correlation between long-term economic growth and long-term stock returns across various markets is effectively zero.

“The explanation is that equity markets are forward-looking and tend to price in the mainstream economic consensus,” said Mr. Aliaga-Diaz. For example, if an emerging economy is expected to grow faster than the rest of the world, then its stock market would have already priced in that expectation. “The strategy for investing in fast-growing countries should not be as much about economic growth itself, but rather about the price one pays for that growth,” he said.

## check your risk tolerance

How much are you willing to risk for growth?

“Now’s a great time to ‘look before you leap,’” said Ms. Jaconetti, adding that investors often react to market moves instead of planning for them. “The first thing investors should do now is revisit their investment plans and asset allocations. If an investor’s time horizon, risk tolerance, and financial goals haven’t changed, he or she should consider sticking to the strategy.”

If your appetite for risk has increased, it’s still important to avoid performance chasing. While it’s tempting to buy funds in areas of the market that have been doing well lately or to avoid those that haven’t, this approach is generally flawed. It’s like going on an extreme diet: You may like the initial results, but you’re unlikely to sustain them.

## plan instead of reacting

“Trying to outperform the market is a very difficult thing to do over the long run, not just for investors but for professionals as well,” said Ms. Jaconetti. “Vanguard research shows that, historically, the majority of actively managed mutual funds have failed to outperform their benchmarks. A simpler approach for an investor looking to improve returns may be to use broadly diversified index funds and minimize costs where possible.”

A balanced fund can also help provide some diversity with less legwork. “The nice thing about a balanced fund is that, historically, you haven’t generally seen the volatility,” said Ms. Jaconetti. “It’s not that the stock and bond portions don’t go up or down, but if one is up and the other down, you would just see the overall portfolio return on your statement. This view helps people stay invested.”

In addition, she recommends that those in or close to retirement try to build flexibility into their annual spending. “By keeping fixed expenses low, you give yourself the latitude to limit portfolio withdrawals when performance has been poor. That way, poor investment returns are at least partially offset by reductions in spending. This should help preserve the portfolio value and sustain future spending.”

Above all, remember that the market shouldn’t drive your strategy. “You should think about making a portfolio change only if there’s been a change in your circumstances,” said Ms. Jaconetti. “If you were 50–50 in stocks and bonds in 2008 and 2009, you would be almost back where you started now, assuming you stuck with your allocation. But if you switched to 100% bonds or even 70% bonds, you’d still be underwater.”

- All investments are subject to risk. Investments in bonds are subject to interest rate, credit, and inflation risk. Foreign investing involves additional risks including currency fluctuations and political uncertainty. Stocks of companies in emerging markets are generally more risky than stocks of companies in developed countries.
- Past performance does not guarantee future returns.
- Diversification does not ensure a profit or protect against a loss in a declining market.