



Plenty of Dangers Remain For Bear Market Investors

GETTING GOING

By **Jonathan Clements**

February 19, 2002

The worst of the stock-market decline is probably behind us. Now comes the treacherous part.

Ordinary investors have displayed remarkable tenacity since the early-2000 peak for the stock market, sticking with their stocks despite back-to-back losing years. Indeed, investors shoveled more money into stock funds than they withdrew in 17 of the past 22 months.

But even if stocks climb from here, there is still plenty of opportunity for self-inflicted investment wounds.

GETTING EVEN: Cast your mind back to the October 1987 stock-market crash. In that month, panicked investors yanked \$7.5 billion out of stock funds. But in the subsequent nine months, outflows were relatively modest, averaging \$1.1 billion, according to data from the Investment Company Institute, a Washington trade group.

Then, seemingly out of nowhere, investors pulled \$2.9 billion out of stock funds in August 1988, \$3.2 billion in November 1988 and \$2.2 billion in February 1989. What happened? My hunch: Stock-fund investors, who were loath to sell at a loss, had finally gotten back to even, and now they were getting out.

“There are people who will not part with their stocks or mutual funds until they break even, because it’s just too painful,” explains Meir Statman, a finance professor at Santa Clara University in California.

Those who bailed in 1988 and early 1989 paid a steep price for their skittishness. Stocks soared 31.5% in 1989 and went on to generate glorious returns through the 1990s.

Many folds, I suspect, will make the same mistake this time around. They will dump their stocks as soon as they recoup their losses, thus abandoning any chance of earning a decent reward for their stock-market suffering.

STANDING STILL: The roaring 1990s bolstered investors’ confidence, giving them the courage to trade stocks and take risk. But as shares have tumbled, that courage has ebbed away. Reluctant to sell at a loss and fearful that any action might make matters worse, many investors remain frozen in place.

To be sure, overall stock-trading volume has continued to climb, according to WSJ Market Data Group. But the reluctance to act among ordinary investors can be seen in trading activity at San Francisco’s Charles Schwab Corp., where the number of securities trades executed each day averaged 215,200 in January, down 49% from March 2000, when the Standard & Poor’s 500-stock index and the Nasdaq composite peaked.

If you hold a well-diversified investment mix, trading less is probably a smart move. But if you have more than a third of your stock portfolio in any industry sector or more than 10% in any one stock, you need to diversify. Can’t pull the trigger? Try two tactics:

First, narrow your investment choices. “The more options you have, the more frozen you become,” says John Nofsinger, a finance professor at Washing State University in Pullman, Wash. “To the extent that people can narrow their choices, they’re more likely to be able to act.”

For instance, forget scouring the entire mutual-fund industry for the best funds. Instead settle on a large no-load fund company, such as Fidelity Investments, T. Rowe Price Associates or Vanguard Group, and then build your portfolio using only that company’s funds.

Second, if your losing stocks are held in a taxable account, focus on the tax benefits of selling. “This is a chance to re-evaluate your portfolio and make a little money in the process,” says Terrance Odean, a finance professor at the University of Berkeley. “Sell the stocks now, take the tax loss and reinvest the money in mutual funds.”

PLACING BLAME: when stocks were soaring, overconfident investors attributed gains to their own investment savvy. What’s happening now that stocks have tumbled? Folks want to blame their losses on somebody else.

Result: Angry investors are ditching mutual funds and abandoning their broker or financial planner. But some of this smacks of indiscriminate selling.

“We have clients who lost 3% or 4% last year, while the S&P 500 lost 12%,” says Honolulu investment adviser Harry Kasanow. “It’s hard for them to appreciate that they’re doing well.”

Mr. Kasanow says he has lost a few clients who discovered they couldn’t stomach the stock market’s wild gyrations and instead retreated into certificates of deposit and money-market funds. “It’ll be impossible for them to reach their goals in those sorts of investment vehicles,” he fears.

DOUBLING DOWN: While most investors have turned cautious, now that their stocks are underwater, there are some folds who have taken the opposite tack. Like the racetrack denizens who bet their final few bucks on the longest shot in the day’s last race, these investors roll the dice on risky investments in an effort to make back their losses.

Fortunately, this sort of craziness seems to afflict professional traders more than ordinary investors. Indeed, a desperate attempt to recoup earlier losses may have been the undoing of John Rusnak, the currency trader recently blamed for \$750 million in losses at a U.S. subsidiary of Allied Irish Banks PLC.

“You’re more likely double up your bets and increase your risk when it’s somebody else’s money,” Prof. Nofsinger says.

Write to Jonathan Clements at jonathan.clements.wsj.com