

## After the Dust Settles

The nation's banking system has probably never been through a storm quite like this before. So far, the tempest has swallowed some of the most familiar and enduring names on the financial map — Bear Stearns, Lehman Brothers, Merrill Lynch, Fannie Mae, Freddie Mac, and AIG — and the crisis has not yet run its course. Many other institutions are exposed to the complex array of mortgage-backed securities. They face further write-downs and losses as the housing slump produces a growing volume of delinquencies and foreclosures.

For investors, it's been particularly unnerving. As of September 15, the S&P 500 was down 18.8% for the year and off 23.8% since its high of 1,565 in October 2007. Financial stocks, which once represented the largest sector in the index, have been especially hard hit. Financials are down 35.1% for the year, 47.5% since the peak of the market, and 50.3% since the sector hit its high in June 2007. The impact of these declines on individual investment or retirement portfolios will be significant, and many shell-shocked investors have already bailed out or taken refuge in savings accounts or money market funds.

But as history has shown, markets have a way of springing back. Just days after some of the worst news hit, a relief rally sent the market soaring, with the S&P 500 gaining nearly 8.5% in two days, helping recoup some of its earlier losses. Since 1982, the S&P 500 has risen at an average rate of nearly 9% per year. This is particularly meaningful since the time span includes four actual bear markets, or periods in which the S&P 500 suffered short-term price declines of 20% or more before rebounding.

Perhaps most important is that, despite the fiscal trauma, the core of the financial system has held. Commitments by even the most injured brokers and insurance companies are being routinely sustained. Trades are being completed on time. Insured bond values are being upheld. Futures, options, and swap contracts are being honored. And central banks around the world have agreed to pump whatever liquidity might be necessary into global markets to protect the interests of innocent trade counterparties.

To be sure, the storm is not over. The economy remains weak. Retail sales appeared slower than expected in August. At the same time, previous estimates for June and July were shown to be overly optimistic. Meanwhile, inflation rose to 3.6% over the most recent 12-month period despite the fall in oil prices. And housing — the essential source of the current financial woes — has yet to recover. But at times like these, it is important not to panic and to maintain a long-term perspective. No one can predict where the market will go from here, but if nothing else, the current crisis has shown the resilience of the financial system and the importance of keeping an eye on fundamentals.

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## Portfolio Strategies

What does this ultimately mean for investors? You may want to consider the following options:

**Avoid panic selling or other emotional decisions.** Selling during a market trough could put you in a position of missing out on a subsequent upturn. Historically, stocks have demonstrated an ability to produce strong gains in the months immediately following an economic recession, although past performance is no guarantee of future results. Since 1950, in the first 12 months following the low point of a bear market, the S&P 500 gained an average of 28.66%. If an investor missed the first six months of the recovery, the gain was reduced to 10.28%.

**Review your sector allocations for new investments.** In volatile times, it is generally considered unwise to make major changes in the balance of a portfolio since the odds of getting hit with unfavorable sales prices are increased. What is more, investors who might sell out of a sector or an asset class at market bottoms may put themselves in the unenviable position of missing the benefits of the market rebounds that often follow drops. However, for long-term investors in regular savings programs such as employer-sponsored retirement plans, it is possible to adjust the allocation for new investments without incurring that risk.

**Consider positioning for a prospective rebound.** Some experts believe that the financial sector still has some distance to fall, and it will continue to do so until all of the potential losses from the subprime meltdown have been identified. Others believe that the bulk of market damage may have already occurred. They see the potential for a fairly near-term rebound in the sector, one that would be driven by the cumulative effect of current rescue measures and the proposed transfer of bad real estate loans to the U.S. Treasury. If you side with those who believe the bottom *is* near, you might even want to consider increasing your allocations to this hard-hit sector. Of course, no one can precisely predict future market movements. But some investors have been able to benefit in the past from the judicious use of available information to take carefully measured risks.

*A special note for retirement plan participants: As a general rule, IRA holdings and employer-sponsored retirement plan assets are held in special trusts that are designed to keep them safe for participants even if the trustee itself were to fail.*