5 steps to help keep your investments on track in any market

Video Transcript

Recorded on March 6, 2015

Featuring:
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Please see important information at the end of this video.

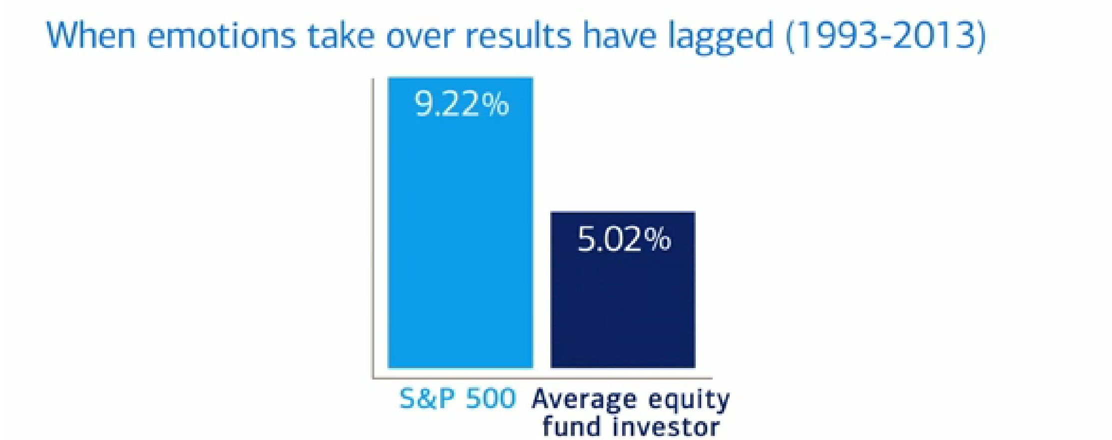
MICHAEL SANTOLI: Hello, I'm Michael Santoli, senior columnist at Yahoo! Finance. I'm here today with Matthew Diczok, managing director, head of portfolio solutions, for Merrill Lynch Wealth Management, and Michael Liersch, managing director, head of behavioral finance and goals-based development for Merrill Lynch, to review specific steps you can take to keep your investments on track in uncertain markets.

Welcome to you both.

Section 1: Emotional investing can hurt returns

Michael, can you talk a little bit about what an investor should be thinking about when the markets change suddenly or become unusually volatile?

MICHEAEL LIERSCH: Well it's always often okay as an investor in times of volatility to do nothing at all — to take a step back so that you don't overreact to markets. Because we know overreaction can actually lead to underperformance or performance lag.



Source: DALBAR: Quantitative Analysis of Investor Behavior, 2014. Annualized returns for 1993-2013. Average equity fund investor, performance results are calculated using data supplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund assets after excluding sales, redemptions and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs. After calculating investor returns in dollar terms, two percentages are calculated for the period examined:

You can see on the chart here how the S&P 500 performed over 20 years on average. And you see the average investor and how they performed in the equity markets annually, on average, over that same 20-year period. And you see this over 4-percent gap, and that's an opportunity for investors to actually take a more disciplined approach, to be less reactive in the face of volatility.

Section 2: 5 steps to help you stay on track

MR. SANTOLI: So Matt, given the human tendency to overreact, what steps can investors take to avoid making the wrong moves or being swayed by emotion when markets get difficult?

MATTHEW DICZOK: We have five action steps that we recommend for investors.

Step 1: Build an emergency fund
First, make sure you're building up an emergency fund. Make sure you have money that is not invested — money set aside for an emergency, for an unexpected cash need.

For instance, assume you haven't set aside the emergency fund. If we enter into a recession and the stock market is down and unfortunately you lose your job, that's probably a bad time to sell stocks to pay your daily living expenses.

Make sure you're building up an emergency fund, ideally six months, at least, to pay your living expenses.

Step 2: Honestly assess your ability to manage market downturns
Second, understand your ability and, more importantly, your willingness to tolerate market downturns.

How have you felt when the market has been down 10 percent, 20 percent, 40 percent? How did you react during those times? Think about your asset allocation going forward. Think about what you have invested in equities. Try to visualize and imagine what you'll do if that's down 40 percent or so. If you can plan for that, you can hopefully stop yourself from making those behavioral mistakes when it does occur.

MR. LIERSCH: That's a great point, Matt. Testing those scenarios before they happen — before you hit that market volatility or that market crisis — can be extraordinarily valuable. Doing that with someone you trust — a friend, a spouse, a partner, so they can tell you how you'll really react when the markets are down —

can be very, very valuable. Making sure that you're not uncomfortable when you invest can be one of the most important things. Because there's nothing worse than being uncomfortable during those difficult times.

Section 3: What's your risk capacity?

MR. SANTOLI: Michael, what about using one of the many tools we've all seen online that are supposed to help you assess how you might react in risky markets?

MR. LIERSCH: I assume you're referring to these risk tolerance tools that help gauge your willingness to take risks. Those are great. But also considering your risk capacity or your ability to take financial risk given a certain investment objective or goal can be very important too. It's important to consider can you handle that 40-percent market downturn and still meet your investment objective.

You can consider maybe an example — a woman 80 years old. She needs to generate $50,000 in income and she has $200,000 to invest. Now, does she have the capacity to take aggressive risk? Let's imagine that she is an aggressive risk taker. That 40-percent downturn in her $200,000 portfolio could risk her financial future of meeting that $50,000 annual income goal. So even though she is willing to take risk, she may not have the capacity to do so.

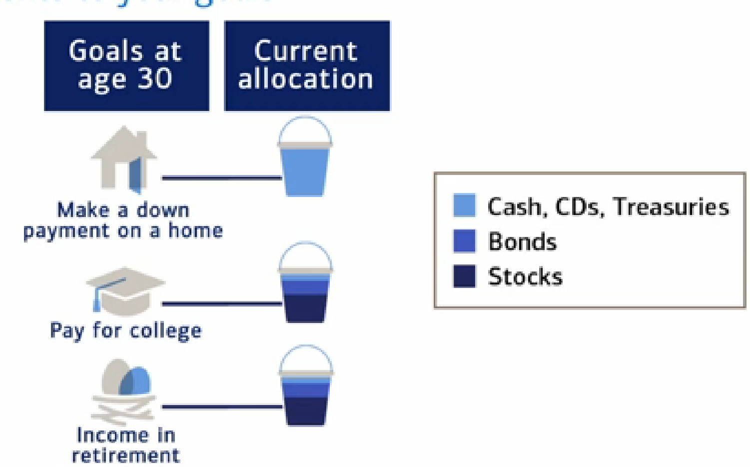
Section 4: Focus on your goals, not the market

MR. SANTOLI: That example makes it clear that it's important to remain focused on some pretty objective goals you have for your investments when you are making these plans. So talk a little bit more about that.

Step 3: Document and share your goals

MR. LIERSCH: Well it gets to our third factor — an idea of documenting and sharing your goals. We believe goals-based investing is the center of the investment process. That idea is really about articulating goals so that you can translate them into the appropriate asset allocation and investment strategy that's right for that goal.

Matching investments to your goals



Source: Merrill Lynch, March 2015.
It is important that you consider your investment objectives, risk tolerance, time horizon and liquidity needs when pursuing your investment goals. For illustrative use only and is not considered an investment recommendation.

You can think about a home purchase, educational goal, retirement — really tying or aligning that goal to the asset allocation is really essential.

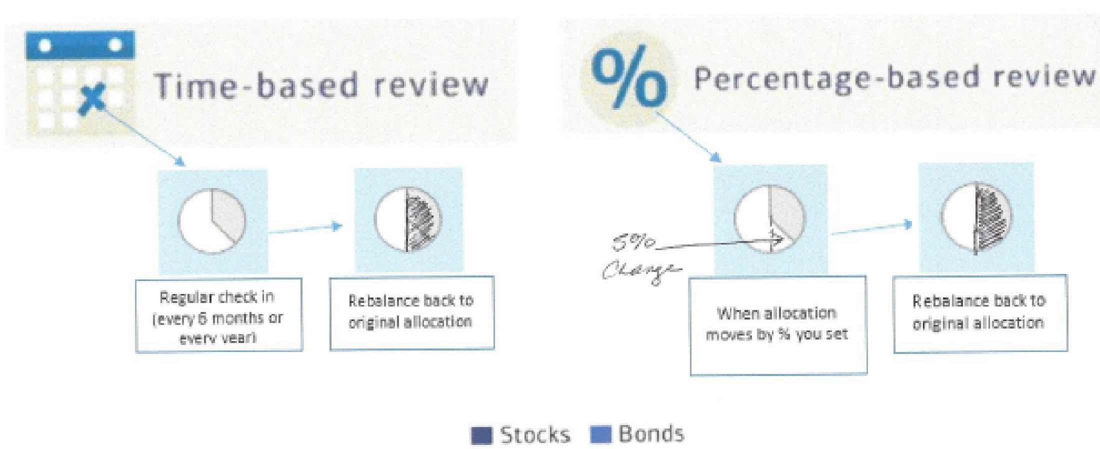
MR. SANTOLI: So, Matt, once an investor does have a pretty good handle on his or her risk capacity and investments goals, what are the next steps to take?

Step 4: **Build asset allocations based on your goals.**
MR. DICZOK: Michael alluded to it. The fourth step is to make sure that you're taking an asset allocation and mapping it to each of your specific goals, taking your risk tolerance, your time horizon and your liquidity needs in mind.

So for example, if you're thinking about investing for a long-term goal, stocks are usually going to be an important component of your asset allocation while cash is likely to underperform inflation and likely not to grow. If you have a shorter-term goal, obviously you're going to want to be less invested in stocks or perhaps not invested in stocks at all. So make sure again that your asset allocation is matched to each one of your specific financial goals.

Step 5: Revisit your portfolios regularly and rebalance when needed
The fifth thing we want to make sure investors do is a process that we refer to as "rebalancing." So as an example, if you've invested in 50 percent stocks, 50 percent bonds for a particular goal, make sure you're periodically checking in over time and seeing if you're still 50/50.

There are two systematic ways we think investors should think about this.



First, you could just rebalance on a time-based method — every six months, every one year, check in, get yourself back to 50/50. It helps you systematically sell high and buy low.

Another way you could do it is just on a percentage basis. So again, with the 50/50 example, if you get to 55 percent equities, 45 percent bonds, you sell 5 percent of your equity portfolio and you rebalance.

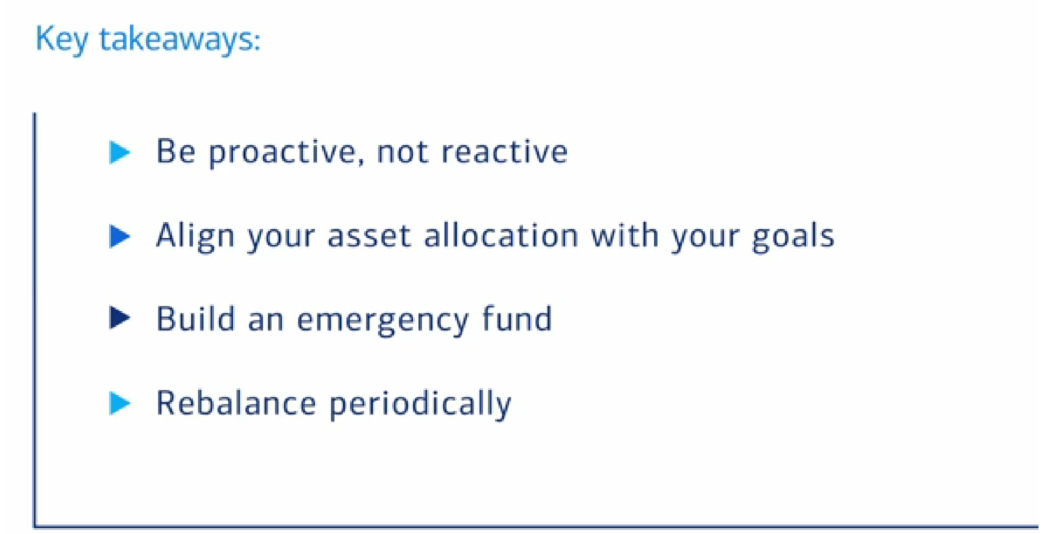
It really doesn't matter which method you choose. Just make sure you choose one method and stick with that method.

We do have to caution that you need to weigh how often you want to rebalance versus any fees, trades, or commissions you need to pay to do that. We have a lot of information on this at **merrilledge.com/changingmarkets**.

MR. LIERSCH: I really think that's an important point and that highlights how goals-based investing is really at the center of our investing process — this idea of rebalancing in the context of goals. It really highlights the need to avoid attending to that 24/7 news feed that comes in and may generate fears and confuse the investor between what true process-driven, goals-based driven, rebalancing is versus that idea of overreaction to markets.

Section 5: Key takeaways

MR. SANTOLI: How about some final thoughts? Michael what are your main takeaways for an investor?



MR. LIERSCH: So the first one is be a proactive investor, not a reactive one. The second one is really this idea of investing according to goals and making sure your asset allocation is mapped to those goals so the money does the job it needs to do.

MR. SANTOLI: And Matt?

MR. DICZOK: Before you think about the money you're going to invest, set aside the money you're not going to invest. Have your emergency fund. Once you've articulated your goals and have your asset allocation, then make sure you rebalance periodically to keep that asset allocation to help you reach your goals.

MR. SANTOLI: Thanks, Matt and Michael, for your insights today. I appreciate it. I invite you to learn more about what you can do right now to make your investments more resilient to changing markets by visiting merrilledge.com/changingmarkets.

This is Michael Santoli. Thanks for watching.