



Don't let emotions blur the big picture

Long-term strategy should dictate portfolio

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For the first time in three years, most 401(k) investors can look forward to opening their midyear account statements.

Thanks to the recent 25% stock market rally, as measured by the S&P 500 index, 401(k) account balances are up sharply, providing welcome relief to the pounding most have taken since March 2000.

But how should 401(k) investors react? Could this rally be the light at the end of the tunnel, or is it just the light from another oncoming freight train?

Many surveys that track the general mood of investors reflect these concerns. Interpreting this data has become quite difficult, given the wild, almost schizophrenic changes in investor outlook. For example, in late May, the American Association of Individual Investors registered a 63% bullish reading, a major swing from its 39% level just two weeks earlier.

Still, investor sentiment historically has been a decent predictor of future market direction. A bearish investor sentiment outlook is considered positive news for the direction of the market. That's because when most people are selling, the most likely future direction of the market is up. On the flip side, a bullish investor sentiment reading is considered a negative indicator for the future market direction.

To measure and interpret such investor sentiment, Smith Barney developed a proprietary index they call the "Other PE" where the P is for panic and the E is for euphoria. The index combines the findings from eight

separate sentiment indicators and is designed to give those who follow such things an idea of what attitudes dominate investor thinking at any point in time.

The "Other PE" index flashed its first euphoria signal - a negative - in more than two years in late May. That could spell trouble for this recent rally. While our analysts are quick to point out that a turn in this indicator often leads market shifts by a year or more, there are plenty of other reasons not to get swept away by this most recent market run-up.

Despite concerns about the magnitude of this recent market rally, the bullish view is clearly winning converts these days. Recent tax cuts, tremendous liquidity in our monetary system and extremely low interest rates certainly seem to help build a case for better times - and are clearly swaying investor sentiment indicators.

No wonder 401(k) investors are confused about where the stock market is headed near-term. Here's my suggestion: Don't waste your energy trying to figure it out. In fact, try to disengage yourself from the panic and euphoria inevitably caused by volatile markets. I recommend you focus on bigger-picture issues and your long-term strategy.

If the past three months have taught us anything, it's just how difficult it is to time the market successfully. Proper diversification is your best strategy for, and best defense against, volatile markets.

Anecdotal evidence from indicators such as the Hewitt 401(k) Index, which tracks the activity of some 1.5 million 401(k) plan participants, suggests that

most are standing pat. Whether that's a good thing depends on if those polled were properly diversified from the outset.

Above all, resist the urge to move everything into any single asset class in an effort to make up lost ground. Instead, take a hard look at your retirement portfolio's current asset allocation strategy and ask yourself a few important questions.

1. If U.S. stocks and bonds went nowhere for the next few years, would your current strategy still keep you on track to meet your retirement goals?
2. Are you concentrated in one or two asset classes, or have you "covered the bases" to take advantage of the fact that different asset classes move in and out of favor at different times?
3. Does your allocation reflect your long-term goals or short-term emotions?

Answering these questions and making shifts in your portfolio accordingly is a much better use of your time and energy than jumping on and off the latest investor sentiment bandwagon.

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