

BUSINESS

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401(k) Adviser: Funds should survive crisis

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401(k) ADVISER

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The headlines report we are in the midst of another financial "crisis," this one caused by people defaulting on their home mortgage as interest rates rise and home prices falls.

This sudden rash of defaults has unsettled financial markets and caused a number of financial institutions to report multibillion dollar losses. So what's going on and what should you do to protect your 401(k)?

The heart of the problem is greedy banks and irresponsible home buyers interacting within a system devoid of proper checks and balances. In the past, when a bank offered a mortgage loan, it risked its own capital and took the necessary precautions to ensure its return. But when Wall Street figured out it could package mortgage loans and sell them to investors as "mortgage-backed securities," it transferred the risk of default from banks to investors.

As an illustration of the popularity of this method of financing home purchases, the market value of mortgage-backed securities has grown to more than \$2 trillion. But recent multibillion-dollar losses in these securities also demonstrate that distant investors are not as well-equipped to judge default risk as local banks.

The impact on 401(k) plans of losses in the mortgage-backed securities market can be seen in a number of ways.

First, a small number of bond funds that were heavily invested in the wrong mortgage-backed securities lost money this year. This was a surprise for some unfortunate 401(k) participants who

thought they had invested in a secure bond fund only to find out that their bond fund manager was taking some large risks.

Also, 2007 was only the second year in the past eight that growth funds outperformed value funds. This was largely the result of the subprime mess.

While most stock funds don't hold mortgage-backed securities, they hold shares in companies that are affected by their decline. Those companies most affected are in financial services - banking, insurance and brokerage firms. Because these companies historically trade at low price-to-earnings ratios and high dividend yields, they are most commonly found in value funds, explaining why so many struggled this year.

The long-term effect of the subprime default debacle on 401(k) plan investments will be more difficult to measure. Certainly, the weakness in the housing market and newfound stubbornness of many banks to lend money is slowing the economy. For now, this is bad for the stock market, good for bonds and weakens the dollar.

Yet if the economic slowdown is temporary, as some suggest, the biggest impact of the subprime mess could be the Fed's overreaction. Lowering U.S. interest rates as the world economy expands at a record pace weakens the dollar and raises the risk of inflation at home. We are already seeing the effect of the weak dollar on the price of everything from gold to gasoline.

The first thing to do now is to re-evaluate your current investment allocation.

First, double check the credit quality of your plan's bond offerings.

Next, determine if your portfolio is at least evenly exposed to growth and value

funds. A weak dollar favors international investing, so a long-term 401(k) portfolio should have meaningful exposure to this category.

Finally, evaluate which investments in your plan's fund choices offer an inflation hedge. The best fund types for this task are TIPS bond, commodity index and emerging market equity funds. Now is the time to protect your retirement portfolio against inflation.

No need to panic. While the headlines are calling the subprime default problem a "crisis," the damage to the typical 401(k) investor has been minor.

Remember the ups and downs in past financial markets. In the early '80s, it was Latin American countries defaulting on loans owed to U.S. banks. In the late '80s, it was the savings and loan crisis brought on by junk bond defaults. Then came the collapse of the Russian bond market in the '90s and, most recently, the tech stock meltdown in 2001.

Each of these events was heralded as a financial "crisis," yet the markets adapted and flourished.

Now is a good time to do the same with your 401(k) holdings.

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