



## Portfolio changes should be made gradually

By MICHAEL J. FRANCIS

### Don't let world events, emotions be your guide for investment decisions

Fear and uncertainty are mortal enemies of the stock market. Just as in early 2000, when greed drove record amounts of money into stocks, today, fear and uncertainty have investors abandoning stocks in favor of bonds.

Before allowing emotions to shift your investment strategy, take a deep breath and consider carefully what history has taught us.

Three years ago, investors didn't want to miss the opportunity of the new economy. Given the upward climb of the stock market, risk seemed of little concern. Today, we are witnessing a new but even more heartfelt obsession with protecting principal.

Yet, many investors don't recognize the similarity of these lemming-like migrations of assets. They just follow the pack. Of course it doesn't help that the financial press feeds on our insecurities and screams at us with headlines designed to generate maximum concern.

So, how do you avoid joining the masses and potentially moving in a direction that's not in your best long-term interests? Understand what's behind current market conditions and learn from other, similar circumstances.

There are lots of fundamental excuses for the poor stock market performance of the past three years. Still, we believe the best explanation is it's payback for the biggest stock market bubble of the modern era.

Today, as investors ponder concerns of war, terrorist attacks, accounting trickery and a shaky economy, their unwillingness to buy stocks is understandable. In our view, however, investors who flee stocks now are not taking into account the possibility for positive change.

To illustrate this point, we have compiled stock market performance data from a number of past crisis periods in U.S. history, as well as past war periods. The data indicate that often, during the years after a crisis, stock market performance is stronger than in the years leading up to one. As famous investor Sir John Templeton noted, "In the stock market, the only way to get a bargain is to buy when most investors are selling."

Of course, that's all well and good for some. But what about those who aren't properly diversified based on their age or newly discovered risk tolerance level? My advice is to plan a gradual divestiture out of stocks and into asset categories whose returns don't correlate with stocks.

The key concept here is "gradual." Those who move too quickly run the risk of being whipsawed by the market - especially if they move into traditional bond funds.

Though bonds may feel like a safe haven after witnessing the past three years of a bear market for stocks, it's not quite that simple. Bonds could be in for their own tough times.

Consider that the Treasury bond yield curve, which plots the yield from bonds with varying maturities, hit a record for steepness in January. This means that short-term interest rates could soon rise to flatten the curve to a more normal slope. If that occurs, money market funds and short-term bond funds will significantly outperform traditional bond funds over the near term.

#### Bonds may not be the answer

It also suggests a real danger of shifting into bonds right now by those who have recently endured losses in stocks. Not only might you continue losing money, but you could also miss the next stock market rebound.

Also, when the market finally does

rebound, remember how the math works. For example, in the last big bear market, Jan. 1, 1973, to October 1, 1974, the U.S. stock market fell 42%, as measured by the S&P 500 index. This was a period of U.S. history we would all just as soon forget: Nixon resigned, the Vietnam War ended ignominiously, gasoline prices skyrocketed, unemployment and interest rates soared, and New York City was on the verge of bankruptcy. Yet despite all that bad news, over the next 26 months, the market surged more than 80%.

Here's the tricky part: Down 42% then up 80% does not net out to a 38% gain for the entire period. When you lose 50%, you must gain 100%, just to get back to even.

This is a difficult time to stay rational, especially when you watch your retirement dollars dwindling with the current market. Try not to make moves purely driven by emotions. Look at the facts. Review your goals.

While following the pack can be comforting, the pack doesn't have your best interest at heart, nor does it have to live with the consequences of your investment decisions.

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#### EVENT-DRIVEN MARKETS DOW HEALTHY AFTER ONE YEAR

Event	Date	First Day	Next Day	Next Week	Next Month	Next Year
Pearl Harbor	Dec. 7, 1941	-3.5%	-2.8%	-1.2%	-0.8%	2.9%
Korean War	June 25, 1950	-4.7%	-0.8%	-2.6%	-4.4%	14.9%
Cuban Missile Crisis	Oct. 23, 1962	-1.8%	3.3%	5.5%	15.6%	33.8%
Kennedy assassination	Nov. 22, 1963	-2.9%	4.5%	5.5%	7.1%	25.2%
Arab Oil Embargo	Nov. 17, 1973	-0.5%	-0.3%	1.0%	-7.4%	-32.3%
Nixon Resignation	Aug. 8, 1974	-1.6%	-1.0%	-6.0%	-13.6%	4.2%
1987 Market Crash	Oct. 19, 1987	-22.6%	5.9%	3.2%	9.0%	22.9%
Gulf War	Jan. 16, 1991	4.6%	0.9%	0.7%	11.9%	24.5%
Asian Financial Crisis	Oct. 27, 1997	-7.2%	4.7%	7.2%	8.8%	16.8%
<b>Average:</b>		<b>-4.3%</b>	<b>1.5%</b>	<b>1.8%</b>	<b>3.0%</b>	<b>12.7%</b>

Source: Consulting Group

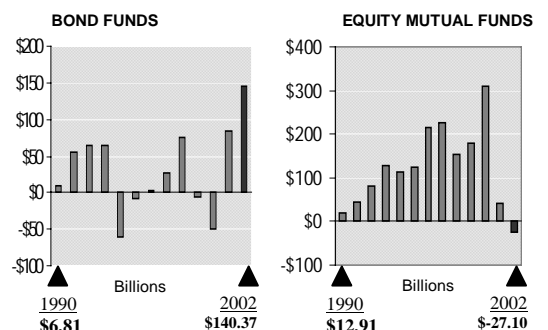
#### WARTIME MARKETS HISTORICALLY, WAR BOOSTED DOW

Event	Dates	Wartime Change	Prior Year	Next Year	Next 3 Years (Annualized)	Next 5 Years (Annualized)
War with Spain	1898	+26.1%	+12.7%	+34.8%	+24.4%	-2.2%
World War I	1917-1918	-18.6%	+0.5%	+25.8%	-14.1%	+0.7%
World War II	1941-1945	+41.3%	-11.2%	+74.9%	+54.1%	+13.1%
Korean War	1950-1953	+19.7%	+34.3%	+28.4%	+90.8%	+13.3%
Vietnam War	1964-1973	+20.4%	+19.3%	-14.4%	-4.6%	-5.3%
Gulf War	1991	+15.2%	-6.8%	+13.2%	+32.9%	+13.9%
Afghanistan War	2001-2002	+10.1%	-14.3%	na	na	na
<b>Averages:</b>		<b>+5.8%</b>	<b>+4.9%</b>	<b>+27.1%</b>	<b>+8.4%</b>	<b>+5.6%</b>

Source: Consulting Group, Dow Jones

#### ECONOMY NET NEW CASH FLOW

While money flowed out of stock funds last year, bond funds saw fund flows increase.



Source: Smith Barney

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