

# How to Weather a Stock Market Correction



When stock prices are falling, some investors find themselves trapped in a vicious emotional cycle: fear of losing money often leads to anger, and anger can lead to a quick, poorly planned decision. But investors who have taken steps to prepare their portfolio for occasional market drops generally are better able to manage their emotions when stock prices head south.

A stock market correction is defined as a time when major market indexes drop between 10% and 20%. Declines greater than 20% are considered to be bear markets. In the past 10 years, Standard & Poor's Composite Index of 500 Stocks has experienced a correction several times, and a bear market early on in the new millennium.

## **Sizing Up Your Portfolio**

If confronted with a market correction or bear market, take time to review your portfolio. Are all your investments in stocks or stock mutual funds? Do you own just one stock mutual fund? Have you invested in only a few high-flying stocks?

Remember, all investments involve risk. As a long-term investor, you can afford to ignore short-term price changes. But you can also make the long journey a little more enjoyable by taking a few steps to help protect your portfolio from a drop in stock prices. Here's a short list of some risks you face as a holder of stocks or stock mutual funds, and some ideas about how to reduce the chances that your portfolio suffers a big loss.

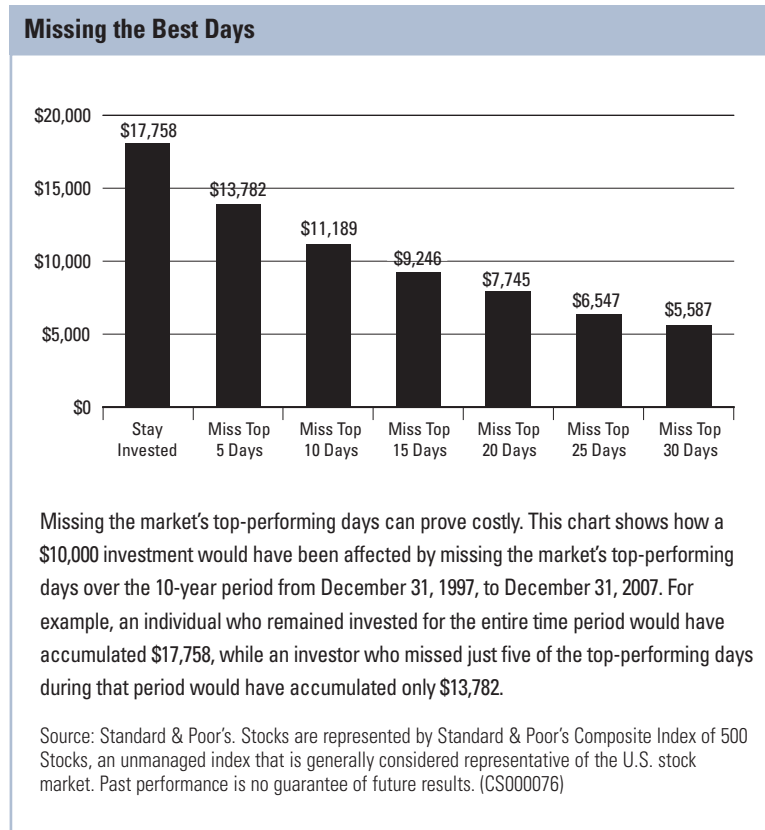
## **Limiting Risks**

Market risk is common to all investments. If stock prices fall, market risk says your stocks or stock mutual funds are likely to drop in price as well. You can reduce market risk to stocks by allocating part of your portfolio to other assets, such as bonds or bond mutual funds and Treasury bills or money market funds.<sup>1</sup> When stock prices decline, it's possible that a rise in your bond or money market investment will help cushion the fall.

Another risk to avoid is underdiversification. If you only own a couple of stocks, you are extremely vulnerable if one suffers a big decline. Experts recommend that stock investors hold at least eight stocks. If one stock falls sharply, the drop will have a limited influence on your portfolio. Also, it's important that each of the eight stocks be in a different industry group. Owning eight computer-related stocks will do you little good when the prospects dim for the computer industry.

Underdiversification is also a risk with mutual funds. If you own only one aggressive growth mutual fund, it's likely to fall sharply if the S&P 500 drops by more than 10%. You can temper the risk by holding a few stock mutual funds with different investment objectives.

Volatility risk is a consideration, but it generally is not as important to an investor with a long-term time horizon. Someone who is investing for retirement in 30 years should not be too concerned if the investment bounces around from one day to the next. What is important is that the investment continues to perform up to expectations. You can cut volatility risk by investing the money you may need in the next five years in a more conservative investment. Be more aggressive with the money you earmarked for use in 15 to 20 years.



### Consider Value Stocks

Understanding downside risk is critical. Owning a stock that drops 50% in value can have a devastating impact on a portfolio. The next stock you own would have to climb 100% to offset that initial decline. You can potentially cut downside risk by avoiding stocks that trade with price/earnings ratios above 20. When the stock market does retreat, these expensive stocks often fall the furthest. Look for issues with more reasonable P/E ratios — often called value stocks — that pay solid dividends. Mutual fund investors should look for funds that invest in similar types of stocks.

Finally, investors need to be aware of liquidity risk. If you invest in a stock that “trades by appointment only,” you may get a low price if you are forced to sell the issue on short notice. You may be able to reduce liquidity risk by focusing on large, actively traded companies such as the issues included in the S&P 500. Generally, mutual fund investors do not have to worry about liquidity risk. But if you invest with a small mutual fund company, make sure you understand the rules about withdrawing funds before sending money.

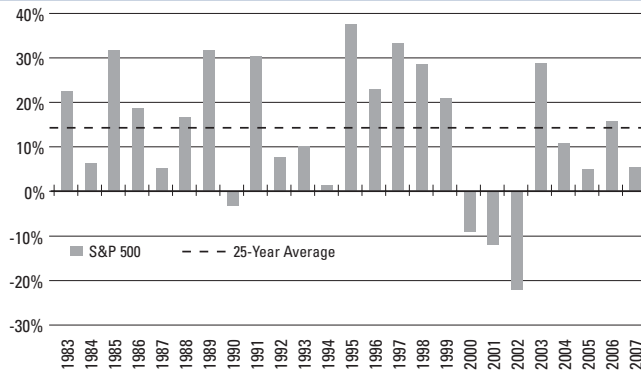
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### Total Annual Returns for the S&P 500<sup>2</sup>



If the prospect of the market falling scares you, consider this chart. In the past 25 years the S&P 500 has recorded only five years of negative returns, and only once has the index finished on the negative side for three consecutive years. Keep in mind that investors cannot directly purchase an index, and past performance cannot guarantee future results.

### A Healthy Market Decline

It's important to remember that periods of falling prices are a natural and a healthy part of investing in the stock market. While some investors will use a variety of trading tools, including individual stock and stock index options, to hedge their portfolios against a sudden drop in the market, perhaps the best move you can make is limiting your overall risk position.

One risk that some investors may be exposed to is the risk of falling short of reaching a long-term financial goal. Investing too conservatively may contribute to not reaching an accumulation target. Remember that despite several down cycles, stock prices have historically risen steadily over time. (Past performance, however, does not guarantee future results.)

<sup>1</sup>An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the fund.

<sup>2</sup>Source: Standard & Poor's. Stocks are represented by Standard & Poor's Composite Index of 500 Stocks, an unmanaged index generally considered representative of the U.S. stock market. Data are for the calendar years from 1982 to 2007. Past performance does not guarantee future results. Individuals cannot invest directly in any index. (CS000142)

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## Points to Remember

1. A correction is defined as a period when major market indexes drop between 10% and 20%, and a bear market is when stocks decline more than 20%.
2. If stock prices are falling, market risk says that your stocks or stock mutual funds are likely to decline as well.
3. Eliminate underdiversification risk by investing in at least eight stocks in eight different industry groups or by investing in a few stock mutual funds with different investment objectives.
4. Volatility risk is a consideration, but the longer your time horizon the less you should be concerned with day-to-day price fluctuations.
5. The downside risk with stocks that have high price/earnings ratios is great. You can limit downside risk by investing in stocks with reasonable P/E ratios and in mutual funds that concentrate on similar issues.
6. Investing in large, actively traded stocks may help reduce liquidity risk. Mutual fund investors should understand the rules of withdrawing funds before sending money.