Strategies for de-risking investment portfolios during a market crash

By Michelle H Rand – CFA

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Ask an investment advisor what to do when the market crashes, and nearly always the answer is "hang on and ride it out." Selling near the lows is discouraged. But is hanging on always the best strategy, or can major changes be justified while in the midst of a bear market? Sometimes the answer to the latter question is yes.

Humans tend to cycle through several emotions when stocks take a drubbing. The usual progression is:

- **Disbelief.** Investors think initial declines will quickly reverse; braver souls may want to buy more stock at this stage.
- **Stocks decline farther and faster, bringing panic and capitulation.** No one wants to buy anything, and some actually sell.
- **Finally, resignation and acceptance arrive.** Investors begin to think about how to mitigate the effects on their lifestyles of their new, lower portfolio values. This phase ushers in thoughts of working longer, or downsizing.

Anywhere along this continuum, investors may decide they have had enough of stocks. Timid participants entertain this idea at the first emergence of a bear market; others might wait until the worst possible moment, at the nadir of prices. The one common theme is the realization that the pre-crisis portfolio was too risky.

Risk is always with us; it is just not always evident. Misjudging tolerance for risk when a bull market has lasted for 10 years is forgivable. After all, if the worse you have seen recently is a 5% correction, it is difficult to comprehend a decline of 25% even if you experienced something similar in the last bear market. Volatility typically continues after an initial decline, too, becoming something an investor must face for months after a bear market starts.

Likewise, life circumstances can result in an outright change in risk tolerance. Investors are 10 years older than when the last bear market struck. That decade may have brought retirement much closer, calling for a more conservative approach. Ideally, a portfolio gradually positions for retirement over time, but better late than never.

Other viable reasons for changing strategies during a bear market are related to employment. Working for a firm that grants stock options or restricted stock means portfolio risk increases with every award, unless an active offset takes place. A plunge in a concentrated holding of corporate stock can be shocking reminder of vulnerability. Likewise, losing a job can spur a need for cash flow. Even new hires can feel frantic in a sudden recession, as companies adjust to lower demand.

Finally, a major recession often results in dividend cuts in certain sectors. The current recession is hurting payouts at travel companies in particular; the 2008 recession shaved payouts at banks and real estate firms. Declining income from a portfolio might not be tolerable, necessitating changes.

Once an investor has embraced the idea that the old portfolio no longer works, how to proceed?

- **Overcome the feeling that making changes is equivalent to "locking in losses."** The reality is, losses exist whether assets are sold or not. And focusing on losses distracts from the real point of this exercise, which is to rebuild the portfolio with a new strategy that is more enduringly suitable.
- **Recognize that elements of the old portfolio have merit.** Items that produce cash flow can be useful. Watch for companies that sustain and even increase dividends in a bear market; those companies are sending signals of confidence and could be worth holding.
- **Risk reduction often comes with lower returns.** Be prepared to save more to reach the same goals, or make goal substitutions such as local travel versus foreign travel, or one car instead of two.
- **Seek assets that do not move in synch.** During crises, all stocks tend to move together. Portfolio protection can be found with U.S. Treasury securities, cash, and gold. Note that while U.S. Treasuries are "bonds," it's not enough to simply buy a generic bond fund; only U.S.-issued debt offers the kind of safe haven that will buffer values.
- **Consider jettisoning assets that have proven disappointing over long periods of time.** When the landscape is littered with losses on even stalwart investments, taking losses on underperformers is more palatable.
- **When rebuilding the portfolio, take advantage of volatility.** Even in a bear market there will be surges in stock prices when sales can be made. Likewise, disarray in the bond market can offer opportunities to increase income.

- **If you have concentrated, low cost positions,** view the bear market as a perfect opportunity to sell from those, using losses elsewhere to reduce your tax liability.
- **Don't try to change everything at once** unless you're looking for only a slight overall adjustment. It's fine to set a new, less risky goal, and make changes that take the portfolio half way towards its final position, reserving the final push for a less volatile time.

This blueprint for investment strategy changes during a crisis is not "one-size-fits-all" but it can ease the emotional and financial pain on the way to a less risky strategy – one that will help the investor live with future bear markets.