

Smart investing in a volatile world

The five-year anniversary of the 9/11 attacks, as well as the fighting in Iraq, Afghanistan, and throughout the Middle East, bring front and center a question on the minds of many investors: How to invest in a volatile world?

Of course, the easiest way to protect your investment dollars from world events is simply to stay on the sidelines. Unfortunately, seeking the safe haven of cash because something *might* happen somewhere in the world that *could* adversely impact your stocks will most assuredly doom your portfolio to mediocre long-term results.

A better approach is to control volatility through proper portfolio allocation and diversification. Indeed, trying to predict the unpredictable is a fool's errand. Better to position a portfolio to weather volatile world events using the following principles:

Diversify across asset classes — Setting a proper mix between stocks, bonds, and cash will go a long way toward modulating portfolio volatility. Of course, the right mix of stocks and bonds for a 30-year-old may not make sense for an investor who is 60. And not all 60-year-olds are alike.

Still, how you combine stocks with bonds and cash in a portfolio is perhaps the single biggest determinant of expected portfolio volatility. A useful rule of thumb for setting your exposure to stocks is to subtract your age from 110.

For example, a 60-year-old may have as a starting benchmark 50% of his assets in stocks (110 minus 60). Now, a 60-year-old who is comfortable with risk and has few financial responsibilities may want to have a larger exposure to stocks, while an extremely risk-averse 60-year-old may want a smaller exposure to stocks.

Remember that it is important to adjust asset allocations over time to reflect shrinking investment time horizons or changes in financial positions.

Diversify within asset classes — Once you've set a proper asset allocation based on your investment time horizon, the next step to controlling risk is making sure you diversify investments within stocks and bonds. This approach is best captured using the concept of investment "style" boxes.

For stocks, you can break down style boxes by size (large, midsize, and small companies), style (growth and value stocks), and geography (foreign stocks and U.S. stocks). On the bond side, you can diversify by type (corporate bonds, high-yield bonds, and government securities) and duration (short-term, intermediate, and long-term bonds).

The idea is to spread your bets among a variety of stock and bond style boxes so that weakness in any one area may be offset by strength in another.

Diversify across time — By making regular investments in the stock market, you can diversify investments across various market cycles. Most importantly, this form of diversification forces you to put investment dollars in the market when stocks are down.

For example, following 9/11, the Dow Jones Industrial Average fell to 8235.81 on Sept. 21 from 10,458.74 on Aug. 7. Investors who abided by time diversification and invested during the decline were glad they did when stocks rebounded in the subsequent weeks and months.

One more way to address this notion of investing in an increasingly scary world is to sprinkle a portfolio with a few quality stocks that have direct stakes in defense and homeland security.