

Winning Wealth by Dawn J. Bennett

That's no bull: 2007 demands a cautious investor

It's hard not to feel a twinge of optimism about your investment portfolio following the unexpectedly good performance of the major stock indexes in 2006.

The Dow Jones Industrial Average provided a robust 18.84 percent return, including reinvested dividends, and the Standard & Poor's 500 was not far behind at 15.78 percent. The Dow, in particular, provided an extra dose of bullishness by breaking through its all-time high in October and setting records throughout the year's final quarter.

We all have a natural tendency to expect current trends to continue indefinitely. And when the news is mostly good, as it has been lately, it's easy to brush off signs that might indicate otherwise. These signals have been growing more numerous to the point where they're hard to ignore — and lead me to believe that 2007 might be a difficult year.

While investors always should be wary of what's around the corner and position their portfolios accordingly, now it is particularly important to refrain from throwing caution to the wind.

BUBBLES, TERRORIST TROUBLES

Why do I believe caution is in order? The slowdown in home sales and new-home construction is a big concern because it has been such an engine of growth in the past few years.

Some optimists say the worst is already behind us. But the Federal Reserve, which chooses its words very carefully, in December called the slowdown "substantial," a description that should give everyone pause.

Our gross domestic product, which was growing at a robust 5.6 percent annual rate in last year's first quarter, had slowed to 2 percent by the third quarter. Most economists think the GDP will grow 2 to 3 percent this year, below the long-term trend.

The bond market seems to expect that short-term interest rates will fall this year, which would only further confirm the economy is slowing.

All of this plays out against a backdrop of increasing geopolitical uncertainty. The Middle East grows more complicated every day. North Korea is a looming menace. And Russia has shown signs of a retreat into authoritarian ways of the Soviet Union.

We're likely to see a flight to safety this year rather than a continuation of the current bull market. One of the best ways to position yourself for this move is to spread your investments among many asset classes: I tell clients to own around a dozen of them.

Ideally, an investor should have a portfolio of securities that generate a healthy amount of income from interest and dividends as well as appreciate in price. Stock indexes won't always post double-digit gains as they did last year.

In fact, we could be in for a long period of below-average returns. If that's the case, the income portion of your return will take on greater importance.

Among stocks, a well-diversified portfolio should include large-, mid-, small- and micro-capitalization companies. Investors should avoid overweighting or underweighting particular stock sectors, such as utilities or technology companies.

PREPARE FOR MENTAL GAMES

Every sector is cyclical to some degree. If you are a long-term investor, some mental games are required. Your asset classes will all go through ups and downs, and that is normal. Be prepared so you don't panic. The key is to own enough asset classes so that those in the up cycle will more than offset those that are in the down cycle.

Within fixed-income instruments, you should allocate money to short- and medium-term government bonds (with maturities of seven to 10 years) and municipals.

Corporate bonds, because their performance is tied to corporate earnings, might not perform as well as Treasuries and government-backed bonds in an economic slowdown.

Thanks to the foreign demand that showed up in 2006, Treasuries' performance should be steadier this year. Municipals are appropriate only for taxable accounts, not for 401(k) and other types of tax-deferred accounts. Avoid municipals whose tax-free coupon payments are subject to the alternative minimum tax.

At the end of the day, Uncle Sam just might walk home with more than you. Conversely, don't turn your head when a historically well-managed, insured, tax-free municipal, non-AMT bond fund is available for your portfolio. This might be a situation in which Uncle Sam gives more than he takes.

I also recommend a healthy international component, divided evenly between stocks and bonds.

Investors should prepare to capitalize on the rise of emerging-market countries such as India and China, which are poised for many years of growth and middle-class development the way the U.S. was in the 1950s and '60s. Remember, though, an investor benefits from a long-term perspective for the potential positive results.

Certain types of hybrid assets, such as preferred stocks and convertible bonds prove attractive as well.

They are called hybrid because preferred stocks have some bondlike characteristics (a regular cash payment and some protection in bankruptcy), and convertible bonds have some stocklike characteristics because they can be exchanged under certain conditions for shares of stock.

Owning many asset classes provides strong and consistent returns over time. There is no doubt that a portion of such a portfolio will lag at any given point, but it is unlikely your losses ever will be crippling.

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