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Can You Ignore the Stock Market?

Four key steps show you how to make your clients see green.

by Neal Frankle, CFP

Neal Frankle

Last month I wrote about the importance of paying attention to the overall health of the market. Many people wrote to me; they wanted to understand this better. A few people took exception to what I wrote. I thought it might be useful to explain why you and your clients just can't ignore the overall health of the stock market if you want to grow your money safely.

READER NOTE: See results of last month's reader poll on **CPAs Remain Optimistic About 2007 Investment Climate**, interest rates and real estate in the Headlines section of this issue.

Let's use the case of Maggie and Sam to illustrate. They've lost more than $1 million in the stock market since 2000 by "investing conservatively." Their broker assured the couple that buying high-quality mutual funds and holding onto them through rough markets would allow them to grow their money safely. Seven years later, $1 million dollars lighter, with the Dow Jones Industrial Average just getting back to where it was, and the NASDAQ index still 50 percent below its peak, they are worried.

Maggie and Sam's problem is not earning money to fund their retirement dreams. They are smart and successful: she is a heart surgeon and he is a well-heeled attorney. Yet they've lost a fortune, and they can see that no matter how much they earn, it can't possibly offset the damage done by listening to their broker's advice, so they are looking for an alternative. I'll bet you have one or two clients like Sam and Maggie.

These two aren't the only intelligent, affluent investors I've met who are frustrated and frightened by their investment results, and 2000 wasn't the only bear market investors had to endure. Based on 100 years of evidence, a bear market ravages investors every 3.3 years, and the average loss is 27 percent. That's enough to scare anyone. According to the American Association of Retired Persons (AARP), 35 percent of all retirees go back to work after they retire. Could it be because the market cracks and scrambles their nest eggs?

Do you have clients who rely on their investments for retirement income?

I'm reminded of my Uncle Jim, who wouldn't listen to me, and retired in 1999 with $700,000. His plan was to create income from his retirement package and live happily ever after. Interest rates were too low for Jim, so he decided to invest in growth mutual funds to create the income he wanted. By the end of 2002, his $700,000 had dropped in value to less than $400,000 thanks to an inhospitable market. His savings had lost 43 percent of its value. Then, instead of $700,000 working for him, he had $400,000 working for him. That meant a lot less income. Faced with this disturbing reality, Jim sold his beautiful home to buy a small condo and had to go back to work. Jim didn't have 70 years to

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"think long-term" as his broker and other "financial experts" suggested he should. Jim needed that income today.

What can Jim, Sam, Maggie and everyone else do to protect themselves from catastrophic loss in the future? Since we know that a crash comes every 3.3 years on average and the typical loss is more than 27 percent, it is critical for investors to invest only when the risks of doing so are relatively low.

Of course whenever you invest in the stock market you take on risk. However, we know that certain times are riskier than others. Just as you check the weather forecast before you embark on a road trip, I'm suggesting that you check the market's temperature before you hit the financial road.

There are a number of ways you can do this for your clients and yourself. The method I like best is watching the major market indices, such as the Dow, S&P 500 and the NASDAQ.

Four Keys to Stock Market Investment Success

1. **Look for Volume Explosion.** I look for days when the volume explodes. For example, if the Dow trades two billion shares on average, and today the Dow trades 2.2 billion shares, that is a significant increase in volume.

2. **Check Index Prices.** When that happens, I pay attention to what happens to the price of the index. Continuing our example, if the Dow closes higher today to boot, I know that large institutions are falling over themselves trying to buy shares, which means prices are moving up. (Keep in mind that 85% of all the money in the stock market is concentrated in very few hands — those of the mutual funds, pension plans, insurance companies and other financial institutions.)

3. **Search Increases in Traded Shares.** We know that one sign of a healthy market is a big increase in the numbe of shares traded, coupled with the index moving higher. If I see two or more of these strong days, I'm more prone to invest.

4. **Note Higher Volume on Lower Indexes.** If you see the opposite happen (higher trading volume on lower indexes) its time to protect your money — sell and put the proceeds in money market.

This method is not perfect — at times you will get false positives. If that happens, you should change directions. But think of this strategy as an insurance policy. Yes, you might zig when you should zag, but the cost of that mistake is small compared to watching a small loss turn into a catastrophic loss.

The method I recommend (and use for my clients) while not perfect, has done an outstanding job. People who wait for perfection shouldn't leave their homes. Seat belts aren't perfect. Sometimes people get hurt **because** they used them. Never the less, do you want your children in a car without those belts strapped on tightly? Probably not.

Think of "taking the market's temperature" as a seat belt for you and your clients. Friends don't let friends invest without it.

I strongly suggest that you watch the major indices for clues on the market's health before you invest.

Neal Frankle is the author of Why Smart People Lose a Fortune: 5 Steps to Restoring Your Wealth and Sanity. *He helps affluent clients establish and implement a safety-net strategy to protect their wealth. He also helps other professionals, such as CPAs, to do the same thing for their clients.*

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