



Recovering from Market Losses

What goes up must come down, and at some point you will experience portfolio losses. There may be occasions when these reverses are significant. Many investors tend to remain in the markets as they decline, even though readily available data is available to suggest alternative courses of action. Even investment professionals sometimes make errors based on some common misapprehensions.

When the financial markets exhibit a strong upward trajectory, the tendency is to pay less attention to risk and more to expected return. When the market corrects, loss averse investors emphasize risk to the exclusion of potential opportunities and tend to hold onto declining stocks for far longer than is warranted.

Historically, this type of "Buy and Hold" tactic is based on the hope that a stock will return to the breakeven point. This hope often keeps investors in stocks that have long since gone south. Unless you have a disciplined plan of action to be activated in the case of market downturns and portfolio losses, you can make serious mistakes--especially in a bear market.

If you're suddenly facing an unpleasant decline . . .

- Don't focus on the loss. Everyone, even the most sophisticated professional money managers, loses money sometimes.
- Don't ignore the losses.
- Take steps to ensure that you don't repeat the same mistakes again.

There is a silver lining to the dark cloud. There are always new opportunities to make money in the market. You have choices, but if you reinvest with the same strategy you're likely to experience a similar result.

Face the consequences objectively

At some point in every market cycle, there will be a juncture at which every decision you might make seems incorrect, or at least far less than ideal. Studies have demonstrated that investors often frame the issue improperly and lose perspective. For example, an investor buys a stock at \$34/share and then watches it decline by 60% to \$20 per share. The average investor will focus on the 60% they have lost rather than the \$20 share that remains.

It is much more beneficial to focus on the \$20 remaining value of the stock and disregard the 60% loss. At the end of each day you hold the stock, you essentially make a decision to reinvest that \$20 of remaining value in the same mistake you made the day before. Take for example investors in Worldcom, who watched the stock plummet from \$60 per share to 12 cents per share. Those investors

who found themselves at 12 cents had made the decision every day to stay with a bad investment rather than get out and look for a more attractive opportunity.

If you find yourself in this situation, ask yourself the following questions:

- Why am I choosing to stick with this stock?
- Is there a better alternative for investing the \$20 that remains?
- Should I be in the market now?
- Am I investing in the right sector?
- How are similar stocks in this sector performing? Have they lost value and gone on to recover?

It's time to take a cold hard look at your investment strategy. Are you sufficiently flexible to change your thinking? Do you have the discipline to accept a loss and move on? Remember that time is money. If you've just lost 60% of the stock's value, then that stock will have to appreciate by 150% simply to break even. It would be a mistake to maintain a bad investment, only to see that another sector or stock has tripled in value over the same period.

What are your options?

Now that you've experienced a loss, what choices do you have? Every situation is unique and any plan of action should involve a consultation with your financial planner. You might consider the following options:

Liquidate the position: this will allow you to clear your mind of the emotional distress that can accompany a loss. If you choose to do nothing, this is likely to serve only as a continuation of an already flawed investment strategy. While you do risk buying back at somewhat higher prices, by not acting you risk missing out on a potentially sound opportunity based on an unfortunate excuse: *I need to see this stock rebound to at least where I bought it before I can sell . . . then I can look at new opportunities.* Starting afresh is the best way to deal with the pressure of a sharp market downturn.

Remain in the position: This is the choice investors most often make, and this decision typically keeps the investor in a constant race to catch up, even as the market recovers. It is seldom the rational course of action to do the same thing and expect different results. Before making any decision, you should ask yourself whether you would buy the stock anew at the current price. If the answer is no, you know what to do.

Compromise: take some proportion, perhaps 50%, of your losing positions and liquidate them. This will offer the chance to redirect at least some assets into better performing areas of the financial markets, whether those be different sectors, bonds, money markets or other asset classes. Refocus and concentrate on making better decisions next time.

Face facts: the best course of action for any investor is to face up to the reality of the situation. Mistakes were made and losses were sustained. Looking backward has no benefit unless you learn from your mistakes. Reassess your financial position and examine your financial goals. How many of these goals can still be met, and how many require readjustment? What are you prepared to do to compensate for the setback? An honest look at the situation accomplishes two very important objectives. First, you are dealing with the situation realistically, meaning that you can build a new strategy on solid ground and go forward. You can also approach the consultation with your financial planner in a disciplined and unemotional manner.

The path to success

A few simple rules can be applied to a long-term investment plan to ensure that you avoid repeating the same mistake.

Manage your risk

Understand the risks involved in any investment, and be aware of your own capacity for bearing risk. Never invest without risk management rules in place, and know at what price you will exit every trade. By establishing an exit price, you may limit your losses.

Follow the money

The market is made up of many sectors. Money flows in and out of these sectors. If you follow sector flows, you will discover that there is always something going up or down, no matter what the major averages or media tell you. Often, the more successful investment managers will tell you that they do not even pay attention to what the major indices do. A disciplined plan and approach will always be in search of opportunity and value—no matter what the market's direction.

Watch the institutional investors

Supply and demand are extremely powerful forces in the market. Institutions make up to 85% of all trades in the market, meaning that these investors drive demand. Watch what they do, follow them, follow the right sectors and be patient.

Work with your financial adviser

Your financial planner is there to help you make important financial and investment decisions that will help you meet your personal financial goals. A planner or adviser can serve as both a source of expertise and as a sounding board. Well-timed, objective advice can help you make rational and informed decisions.

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