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Stress-Test Your Portfolio

How to prepare for risks known and unknown

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Mother was wrong: What you don't know *can* hurt you.

Investors nowadays should realize this all too well, as headline-making events are forcing people to expect the unexpected. Unrest in the Middle East and North Africa and disaster in Japan have added to known worries like faltering economic growth and the specter of rising inflation. And there are still eight months to go in 2011.

None of these events has been calamitous for the stock market. But rather than be complacent, investors should take this chance to give their portfolio a stress test: Look at the risks it faces and strengthen any weak spots.

Bernard Baumohl, chief global economist at Economic Outlook Group in Princeton, N.J., advises reviewing each of your holdings, assessing the vulnerability to a potential shock and then making sure you're not overexposed to any one country or sector. And consider liquidity, or how easily you can sell the asset if the need arises.

Too many individual investors, and even professionals, get into trouble by underestimating or ignoring what could go wrong. "Embark on a strategy that will preserve capital in a period of heightened volatility," says David Rosenberg, chief economist and strategist at Toronto-based wealth-management firm Gluskin Sheff. "It's a matter of assessing risk, of identifying opportunities and basically looking at the forest past the trees. It's not about market timing."

Stress tests are no guarantee against losses—2008 proves that—but a periodic

portfolio review at least gives a baseline picture of whether your investments are diversified enough to handle Mr. Market's wild ride. With that in mind, here's a look at some of the biggest risks around, and what you can do to protect your portfolio from them.

Risks You Know You Need to Think About

Inflation and Interest Rates

While the U.S. inflation rate is far from the crushing double-digit levels of 35 years ago, higher energy and commodity costs are taking a toll on consumers and producers alike. The question investors need to ask is how much of this sticker shock is due to speculation. When speculators grab hold of a market, prices can soar rapidly and sink just as quickly. Investors have to weigh that factor against supply-and-demand realities.

Coincident with inflation risk is interest-rate risk. Many market observers are convinced that rates have nowhere to go but up—and soon.

Rising rates reduce the value of existing bonds, especially longer-term issues, bringing pain to bond investors. Already this year, shareholders of long-term government-bond funds and many municipal-bond funds are getting pinched.

Your best bet: Make sure your portfolio is broadly and efficiently diversified. Own U.S. and international stocks, commodities, inflation-protected bonds, real-estate investment trusts and cash, all of which have the ability to withstand inflationary bouts. Cash is king when interest rates rise, as money-market funds and bank certificates of deposit pay correspondingly more. (See "The Best Inflation Hedge?" for more on inflation-hedging mutual funds.)

But don't abandon traditional bonds. Diversification isn't about maximizing return; it's about minimizing risk. That means owning unpopular assets—because you could be wrong. High-quality U.S. and international corporate and government bonds of varying maturities, or bond funds that own these securities, provide you with diversification and lower the risk of a stock-heavy portfolio.

Many bond-market strategists nowadays advise controlling interest-rate risk by shortening a bond portfolio's duration, or sensitivity to rate swings. Bonds that

mature in five years or sooner, for example, don't suffer as much as longer-term issues when rates climb, since once they mature their proceeds can be reinvested at prevailing higher yields. Bond funds don't have maturity dates, but their investment objective is usually stated in the fund's name, and the portfolio's duration is easily found online.

Finally, keep in mind that most assets nowadays are correlated, meaning they move in the same direction, though not to the same degree. In fact, the only global assets now that are truly uncorrelated with stocks, corporate bonds, commodities and precious metals are Treasury bonds, according to Morningstar. If fears of sharply rising inflation and interest rates are unfounded, or when another geopolitical shock spurs investors to seek safety, Treasurys will be in good graces again.

"Some investors might say 'Why invest in bonds right now? Bonds are historically highly valued,' " says Michael Cuggino, manager of Permanent Portfolio, a mutual fund that focuses on preserving capital through holding multiple asset classes, including stocks, gold, currencies and Treasurys. "On the other hand, bonds protect you in deflation, liquidity crises, periods of slower growth. A properly diversified investor will have exposure there, combined with other assets, even if that asset appears to be overvalued."

Risks You Can't Anticipate

Disasters, War, Political and Economic Upheaval and Social Unrest

Even the biggest geopolitical events—those unlikely "black swans" that cause widespread disruption—typically don't leave a lasting mark on financial markets. For instance, when Asia's fastest-growing economies went into a skid in July 1997, investors scurried for safety. The Dow Jones Industrial Average took one of its worst drubbings ever on Oct. 27, 1997, losing 554 points, or 7.2%, but the index recovered and ended that year up more than 22%.

Even with all the shocks so far in 2011, both the Dow and the S&P 500 posted their best opening three months of the year in more than a decade. "The question I hear more often than not is, 'What is it going to take to break this market?' "

says Ed Yardeni, chief investment strategist at Yardeni Research in Great Neck, N.Y. "The black swans that are out there are pretty scary, but the market has been extraordinarily resilient."

Still, the current troubles in the Middle East and Japan seem more serious than anything the world has faced since the 2007 subprime-mortgage crisis. Japan's disaster disrupts the technology and automobile industries; the Middle East crisis threatens crucial oil supplies.

Your best bet: Add gold and other precious metals, which, like Treasurys, are considered a safe haven. Know that a little bit of gold can go a long way to offset declines in other assets. You can own physical gold via several exchange-traded funds, including SPDR Gold Shares and iShares Gold Trust. (Be aware, though, that if you decide to invest in gold-mining companies, they may perform better or worse than the metal itself.)

"We control risk by owning gold," said Charles de Vaulx, co-manager of the IVA Worldwide and IVA International funds, which each had about 5% to 6% of assets in gold at the end of March. "I know the price of gold is not [as cheap as] what it used to be," he adds, "but there are still risks out there."

Mr. de Vaulx points to such examples as the Middle East and the potential for the U.S. bond market to react violently once the Federal Reserve begins to raise short-term interest rates. "As a hedge against extreme outcomes," he says, "gold makes sense."

More-sophisticated investors can also hedge against volatility by using so-called long-short strategies, which attempt to generate stock-market returns, but with lower risk. Essentially, you bet that some investments will rise while others will fall. These days, such hedge-fund-like strategies are open to retail accounts. Consider Aston/M.D. Sass Enhanced Equity and Wasatch Long/Short. These long/short-category mutual funds, which have low initial investment minimums, have posted S&P 500-beating annualized returns over the past three years.

Risks That Never Go Away

Markets and Companies

Market risk is inescapable, but can be tempered through diversification. The same goes for the risk that a favorite stock in your portfolio could be the next Enron or Bear Stearns.

"The Seven Immutable Laws of Investing," published recently on the website of investment firm GMO, highlights three key risks all investors should understand: valuation risk, or overpaying for an asset; fundamental risk, buying something that turns out to be flawed; and financing risk, using leverage. (To read the article, register and log in at gmo.com/America.)

Before committing your money, says James Montier, part of GMO's asset-allocation team and author of the article, "always insist on a margin of safety." Put simply, don't get carried away. As the U.S. stock market moved fitfully through 2007 and early into 2008, Mr. Montier recalls, "people were acting with no regard to a margin of safety. Everyone was reaching for return and behaving very badly. We knew it wouldn't end well—just not when."

Your best bet: Don't overlap markets or sectors, and avoid concentration in similar stocks and mutual funds. For the stock portion of your portfolio, consider mutual funds that have beaten a market benchmark with considerably less volatility.

For example, a search of the Morningstar database turned up a handful of funds that topped the S&P 500 over the past three years with no more than two-thirds of the market's volatility. Three making the cut: Neuberger Berman Select Equities, CAN SLIM Select Growth and Reynolds Blue Chip Growth.

A Risk You Should Fear

Playing It Too Safe

Of course, one way to avoid risk is just not to suit up for the game. But that puts you in danger of not having enough money in later years, and of missing major market advances.

"What you don't want to do is just focus on the risk and cap your upside," says Harold Evensky, a financial adviser in Coral Gables, Fla. "Returns come in short spurts. If you miss one, you'll never recover it."

Your best bet: If the "sleep at night" factor is most important to you as an investor, then bank any money you might need over the next five years, Mr. Evensky says. That way, you won't be as tempted to unload assets when the going gets tough.

You still might feel queasy when markets gyrate, but that's the point. The late Peter Bernstein, a sage chronicler of financial-market history, once observed that "if you're comfortable with everything you own, you're not diversified."

His advice: "You hate bonds; you ought to own bonds. You hate gold; own some gold. You're scared to death—own stocks because maybe things will have a happy ending."

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