WEALTH ADVISER

Voices: Kimberly Foss, on Preparing for an Inevitable Market Downturn

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Voices is an occasional column that allows wealth managers to address issues of interest to the advisory community. Kimberly Foss is the chief executive of Empyrion Wealth Management in Sacramento, Calif.

I'm not sure this current market growth is sustainable. With interest rates so low, we know inflation will come back at some point. When it does show its ugly head, it's going to be fast and furious, and advisers need to be prepared.

In guarding against this risk, the best offense is a great defense. That's how I approach it for my clients. Advisers should recommend that clients keep their bond durations short--three years or less. Don't get sucked into the lure of high yield. That high yield doesn't pay you for the duration and the risk you're taking. When the world goes into crisis--and it's not a matter of if, but when--high-yield bonds are going to be the first to default.

The old rule of thumb is that 100-minus-your-age should be your equity exposure. But I recommend adjusting this slightly. For my encore clients, who are between 45 and 65 years old, I recommend only 40% equity exposure--in particular blue-chip stocks with strong balance sheets--and 60% fixed income. The job of fixed income is to keep you at the highest point of the yield curve when interest rates do go up.

Last year, with the S&P gaining nearly 30%, many clients felt great about being exposed to the stock market. The greedy side of human behavior would love to see the market continue upward for another 30% in 2014, but no bull market goes in a straight line. We haven't had a 10% pullback in over two years, which is pretty remarkable. It should come as no surprise to expect such a pullback this year.

Advisers should rebalance allocations frequently, especially when profits are up. Say a client that typically is 50/50 equities to fixed income was more like 60/40 last year. Take that 10% gain and carve it off. Put it back into fixed income. Now you've realized the gain. It doesn't go away when the market goes down.

For advisers, the key is not letting clients make emotional decisions that cause them to bail out of the market. It's easy to get out, but when do you get back in? That puts the adviser in the difficult position of having to time the market. Instead, advisers should try to prep clients to withstand volatility so they have long-term wealth over time.

Additionally, advisers should have a philosophy that they can explain to clients: "This is what we will do if the markets go down." That way you're sending a consistent message. And you're getting rid of what I like to call "hopium": that foolish hope that everything will work out. Hopium is when clients stick their heads in the sand and ignore new and sometimes unpleasant financial realities. That can lead to financial ruin.
