

OCTOBER 2, 2008, 2:31 P.M. ET

Lessons From the Market Fall

Successful investing is counterintuitive. Want proof? Consider how some "risky" and "safe" securities have recently performed.

By BRETT ARENDS

You're probably looking at your 401k and other investments right now with alarm. Mutual funds slumped in the third quarter pretty much across the board. Large cap, small cap, international and domestic: Almost everything got pounded.

The Standard & Poor's 500 index has fallen 9% since June 30 and 21% this year. We're not going to waste any time here wringing our hands about the past. One of the most important things investors can do at this point is make sure at least they learn some financial lessons from what has happened.

One of the most important: When it comes to investing, "risk" is not what you think it is. Wall Street doesn't tell you this, but the investments you are told are "safe" may turn out very risky indeed, and the investments you are told are risky may actually turn out not to be.

An example? If I asked you to name areas of the US market that have actually risen during the crises of the past three months, here's two that most people wouldn't pick: Homebuilders, and regional banks.

No kidding. Out in the real world, these two industries are right in the path of the economic hurricane. But on the stock market, you'd think it was all sunshine and pina coladas.

The Dow Jones Home Construction iShare, an exchange-traded fund that tracks homebuilding stocks like Pulte Homes, Toll Brothers, and Lennar, actually rose 26% in the third quarter.

And KBW's Regional Bank exchange-traded fund, which tracks that shell-shocked sector, has soared 34%. What's the reason for this bizarre paradox? Easy. Shares in both these sectors had already collapsed. Everyone had sold out in panic. So because the market thought these sectors were too "risky," they no longer were.

When it comes to investing, risk is a function of price.

By the end of June, homebuilding stocks were down about 75% from their all-time peak. They were in the final leftover bin, in the lowest level of the bargain basement.

History says an industry that isn't going to vanish completely is usually a good investment at these levels.

It's a similar story with the regional banks. At their July lows they were down 68% from their peak. I concede I still wanted to stay away. The shares hadn't fallen as far as homebuilders. They weren't as cheap. And it was impossible to know what you were buying.

Of course if you invest through a broadly-based fund that tracks the sector, you are at least spreading your bets. This is the way to do it.

There's another side to this story. A couple of years ago investors were being pushed into so-called "value" stock funds, which tend to invest in more stable and mature companies with lower growth, higher cash flow, and higher dividends. The argument: They were more "safe" than so-called "growth" funds, which tend to bet on younger, faster growing and more volatile companies.

Result? Value funds, which were supposed to shelter investors from some of the storm, have actually done worse.

Over the past two years, the S & P Growth index has fallen 9%. Value? Oh, 14%. And that includes the gains from those big dividends.

It isn't that the value companies are doing worse in the real world. It's that their share prices got too high. Everybody bought them because they were supposed to be "safe." We saw something similar just last winter, when lots of people reacted to inflation fears by rushing out to buy inflation-protected government bonds. The result? They bid the price of these bonds up so high that people who bought at the peak were, in some cases, locking in no after-inflation return at all.

I pointed out the absurdity – and got waves of angry emails from investors, and financial advisors.

Well, some of those "safe" TIPS have now fallen as much as 13%. Even a broadly based TIPS fund, like Vanguard Inflation-Protected Securities, is down nearly 6% from the peak - and that includes reinvested dividends.

That may not sound like much, but it's quite a fall for an investment that always offered very little upside in return for supposed security.

There was nothing wrong with TIPS per se. It was just the price. Anyone who waited until last month to buy some TIPS, on the other hand, could get a much better deal. What does this mean for you?

Successful investing is counterintuitive. When it comes to the stock market, there is no safety in numbers. And there is no such thing as a "risk free" investment.

Treat conventional wisdom with skepticism. Always be very wary of the most popular and "safest" investments. You may be better off taking a look at those investments that everyone is scared of, and no one wants to touch with a ten foot pole.