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How to prepare for a bear v bull rumble

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Mark Atherton examines the best ways to diversify your portfolio and protect your investments in case

The FTSE 100 index of leading shares has fallen by about 600 points in the past three months and, despite a recent rally, is almost 8 per cent below its peak of 7,778 in mid-January. So far the falls represent a correction rather than a crash, but they serve as a warning to investors. Brian Dennehy of Fundexpert, the financial research website, says: “The recent market turmoil may not have heralded the next crash, but one will arrive sooner or later. Given the level of stocks’ overvaluation in the US, falls of 50 per cent or more are quite possible there and around the globe, and you need to be ready.”

So how do you prepare?

Spread your risk

Make sure your existing portfolio is diversified enough to withstand any market shocks. Adrian Lowcock, the investment director of Architas, the multimanager, says: “Hold a mixture of shares, bonds, property, infrastructure and commodities, including gold. You should also aim for a blend of investment styles. If you have a lot of stocks or funds that fall into the ‘growth’ category it would be sensible to have some ‘value’ investments for balance.”

Those without a diversified portfolio should consider moving some money into assets such as gold, commercial property and infrastructure funds (see our experts’ picks above).

Have a cash buffer

This gives you flexibility. When the markets are tumbling you have the consolation of knowing that at least part of your money is not losing value and your cash reserves can be deployed to make purchases when investment opportunities present themselves.

Be ready to sell holdings

Justin Urquhart Stewart of Seven Investment Management, the wealth manager, says: “Look at your portfolio and ask if there are some stocks that you would be happy taking a profit on now. This means you bank some gains and it gives you a cash buffer." He says that selling a stock or fund now doesn't mean goodbye for good. You can always buy back in when the price drops.

Prepare for the worst

Today's stock markets are dominated by computer-driven trading, which means private investors may find it even harder to trade in the next bear market than they did in previous ones. Mr Dennehy says: "Only about 15 per cent of the trading on the US stock market is done by individuals. The rest consists of high-frequency trading by robots, or deals relating to exchange-traded funds [ETFs], which track a particular index. When they rush for the exit it will make previous crashes look like a tea party. Online systems may not be able to cope."

He says you should check whether your online share-dealing service has a phone back-up and what times it operates. If you are planning to sell funds, check at what time in the day the company executes deals. If it does once-a-day deals at 10am and you place your sell order at 10.30am, is your order in limbo for 24 hours?

He says another tool in your armoury should be a stop-loss strategy, designed to ensure that you sell an investment if it loses a certain amount, say 10 per cent, but before it can inflict too much financial damage on you by losing 100 per cent of its value.

He says that all funds are entitled to suspend trading in severely disrupted markets and this could leave investors unable to cut their losses and sell.

He is especially concerned about bond funds, where liquidity is poorer than it was in the crash of 2008, when bond funds were a whisker away from having to suspend trading.

Focus on the long-term

If you have a well-balanced portfolio and are prepared to look many years ahead, you could simply ride out the market storm. Mr Urquhart Stewart says: "You could batten down the hatches, remind yourself that shares go up more often than they go down and simply wait for the market to recover over time. You could take the dividends from your share investments as a useful income if you needed it."

Spot new opportunities

Every bear market throws up bargains and you should be alert to these, says Mr Urquhart Stewart.

"People tend to think of bear markets as gloomy and dispiriting, but they can be exciting times for those ready to look beyond the grim headlines. The key is to stick to the discipline of valuation and seek stocks that start to look very cheap as the market falls. Look also for companies with solid, reliable income streams that maintain or increase dividends."

Make regular investments

One of the best ways to mitigate the impact of sudden share price falls is to drip-feed money into the stock market through monthly investments. That way the falls work in your favour, because your monthly investment buys you more shares when prices are low and fewer when they are high, producing a lower average price.

The discipline of regular investment also helps to protect private investors from the error of buying when markets are high and selling when they are low.

Charlie Musson from AJ Bell, the investment platform. says: "If you had invested £10,000 in the FTSE all-share index 30 years ago, but missed the 10 best days in the market, you would now have a sum worth £69,321. But if you had kept the money invested you would have £129,617."

The experts' picks

Unit trusts

Adrian Lowcock likes three unit trusts: Fidelity Moneybuilder Income, Kames Property Income and JPMorgan Global Macro Opportunities. "The Fidelity fund has a good level of downside protection. The Kames fund invests directly in properties. The JPMorgan fund aims to exploit key global themes such as the Japanese economic recovery."

Ryan Hughes, of AJ Bell, picks Troy Trojan Income, Janus Henderson UK Absolute Return and Royal London Corporate Bond. He says the Troy fund selects high-quality companies. The Royal London fund looks to quality corporate bonds.

Investment trusts

Mr Lowcock picks Personal Assets, John Laing Infrastructure and Finsbury Growth & Income. Personal Assets is dedicated to capital preservation. The John Laing fund takes stakes in infrastructure projects, while the Finsbury trust looks for companies with outstanding brands.

Simon Elliott, of Winterflood Securities picks RIT Capital Partners, Aberdeen Diversified Income & Growth and City of London. He says RIT holds a wide range of investments, and the Aberdeen trust offers a similarly wide spread. City of London is an income trust with a yield of 4.2 per cent.