5 Things Investors Shouldn't Do Now

Stocks slumped world-wide this week, with U.S. and European markets off more than 5% and the Shanghai Composite Index losing more than 11%. Oil prices also skidded, dropping more than 6%. Traders feared that slowing growth in China, the devaluation of the Chinese currency and the overhang of too much debt could stifle global economic recovery. Here are five things you should know about how not to react.

21 AUG 2015 5:38PM

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1 Don't fixate on the news.

The more often you update yourself on the market's fluctuations, the more volatile and risky it will appear to you — even though short, sharp declines of 5% to 25% are common. The U.S. stock market has, in the past few years, been extraordinarily placid by historical standards. Even the sudden drops of the past few days are well within the long-term norm. Fixating on fluctuations in the short term will make it harder for you to remain focused on your long-term investing goals.

2 Don't panic.

While stocks are certainly not cheap, they aren't wildly overpriced, given today's levels of interest rates and inflation. U.S. stocks are trading at 24.9 times the average of their long-term, inflation-adjusted earnings, according to data from Yale University economist Robert Shiller – down from 27 in February. Over the full sweep of bull and bear markets in the past 30 years, they've traded at an average of 23.8 times adjusted earnings.

3 Don't be complacent.

You should use the latest turbulence as a pretext to ask yourself honestly whether you are prepared to withstand a much worse decline. Did you make it through the epic bear market of 2007-09 without selling all your stocks? Are you extremely well diversified, with plenty of cash, some bonds, and with large and small stocks from markets around the world? Then you can probably weather a further decline. But if you sold in earlier bear markets or you are heavily concentrated in a few stocks or sectors, you should consider raising some cash or diversifying more broadly to protect against the risk that you will take even more drastic action at the worst time.

4 Don't get hung up on the talk of a "correction."

A correction is typically defined as a decline in price of 10% on a widely followed index like the S&P 500 or Dow Jones Industrial Average. The term doesn't have official status, however; until fairly recently, declines of 5% and even 15% or 20% were often called "corrections." A market decline of 10% has no real significance in and of itself. What matters is the outlook for the future; that doesn't depend on whether the market is down 10.2% rather than 9.8%.

5 Don't think you--or anyone else--knows what will happen next.

After a market drop, or at any other time, no one knows what the market will do next. The one thing you can be fairly sure of is that the louder and more forcefully a market pundit voices his certainty about what is going to happen next, the more likely it is that he will turn out to be wrong. Stocks could drop another 10% from here, or another 25% or 50%; they could stay flat; or they could go right back up again. Diversification and patience — and, above all, self-knowledge — are your best weapons against this irreducible uncertainty.

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