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How to Play a Market Rally

Stocks Have Surged—but Investors Who Want to Lock In Some Profits Now Need to Do It Carefully

Forget "buy and hold." It is time to time the stock market.

For 10 long years, market rallies have ended badly for investors. Now, with stocks up 15.6% in four months, strategists are beginning to suggest that ordinary investors start dialing back on risk.

That doesn't mean dumping shares willy-nilly. With the Federal Reserve committed to flooding markets with liquidity, it still makes sense to be in equities. But "if you've ridden the market up, you might want to do some trimming," says Steve Shueh, managing partner at Roundview Capital.

Some investors may already be starting. The Dow Jones Industrial Average has given up 2.2% from its Nov. 5 high.

The first step is to disabuse yourself of the notion that it's impossible to time the market. It turns out that sometimes you can. When markets are stuck in a trading range for an extended period, selling into strength and buying into weakness can outperform buy-and-hold investing.

If that sounds like sacrilege, it may be because mutual-fund firms have spent decades persuading you to keep your money in their stock funds through thick and thin so they could collect bigger profits.

Consider an investor with a $1 million portfolio on Dec. 24, 1998, the first time the Standard & Poor's 500-stock index was at its current level. But if the investor had merely held on, he would have seen essentially zero appreciation through Nov. 11 of this year. If that same investor instead had sold one-tenth of his portfolio every time the stock market gained 20% and allocated one-fifth of his cash to the market when stocks fell more than 10%, he would have gained about $140,000, according to a Wall Street Journal analysis.

An approach using broad valuation measures performed even better. One metric, the ratio of stock-market capitalization to gross domestic product, tracks the market's value versus that of the underlying economy. An investor with $1 million on Dec. 24, 1998, who sold 10% at the end of each month when the ratio was above 115% and bought stocks with 20% of his cash when the ratio was below 75%, produced a gain of around $365,000. (The average has been about 91% over the past 20 years.)

Of course, investing success depends greatly on when you start. If you had tried the strategy at the market low of October 2002, for example, you would have come out about the same as if you had bought and held.

Throughout this year the market has traded in a band of about 20%—far away from both its 2007 high and its 2009 low. Stocks gained 15% from Feb. 8 to April 23 on hopes that a robust economic recovery in the U.S. would sustain global growth. By July 2, it had dropped 16% to 1022.58, as disappointing economic data fueled fears of a double-dip recession.

Now stocks are up again—but for how long?

Says Tobias Levkovich, head of U.S. equity strategy at Citigroup Inc.: "Investors should be more willing to hedge."

The smartest way to do that now, strategists say, is to switch from riskier holdings to steadier stocks and dividend payers; to embrace "tactical" mutual funds that can jump in and out of asset classes; and to consider bond funds designed to benefit from rising interest rates.

Dividends

Investors looking for safer stock plays should consider companies that are initiating or boosting dividends, say strategists. Such companies tend to be less volatile than the overall stock market. According to Ned Davis Research, their "beta," a measure of volatility, is just 0.78 versus the broad market, compared with 1.08 for non-dividend payers. (A beta of 1.0 means a stock is as risky as the market.)

Dividend payers may be especially attractive at this stage of the bull market. Whereas non-dividend stocks typically trounce dividend payers during the first leg of a bull run, dividend stocks since 1974 have outperformed by three percentage points during the second leg and seven percentage points during the third, according to Ned Davis Research.

"The biggest headwind for dividend stocks occurs in the very early stages of the bull market, and we're past that in all likelihood," says Ed Clissold, global equity strategist at Ned Davis.

Some dividend boosters in the S&P 500 include Dr Pepper Snapple Group Inc., Time Warner Cable Inc., Starbucks Corp., International Paper Co. and UnitedHealth Group Inc.

Big Tech

The four-month rally has been led by the technology sector: the Nasdaq's 20.4% rise has outpaced the Standard & Poor's 500-stock index's 17.3% jump. Yet the tech sector has a price-earnings ratio of 13.7, only slightly higher than the 13.3 P/E for the market as a whole, according to Thomson Reuters data. Tech also has the fourth-lowest P/E of the 10 major market sectors.

Investors concerned that the rally is overstretched might want to shift away from highfliers and toward the 10 largest tech stocks, which Bank of America Merrill Lynch dubs the "tech titans"—Microsoft Corp., International Business Machines Corp., Apple Inc., Intel Corp., Hewlett-Packard Co., Cisco Systems Inc., Oracle Corp., Google Inc.,

Qualcomm Inc. and Corning Inc.

Cisco, in particular, may be a better deal now after Thursday's 16% fall.

"When bad news drives these stocks down, it makes them more compelling," says David Bianco, head of U.S. equity strategy at Bank of America Merrill Lynch. He notes that as a group, big tech has gained just 4.0% this year, versus 6.6% for the entire sector, and carries a P/E of about 12.8, versus about 16.7 for the others.

The key advantage big tech outfits hold, says Mr. Bianco, is their strong balance sheets, which should help them boost earnings even if growth slows. "They will issue bonds, buy back shares and acquire other companies," he says. "Large tech will benefit from that."

Go-Anywhere Funds

Investors who wish to take some profits on stocks and redeploy it elsewhere should consider "tactical allocation" mutual funds that allow managers to jump into and out of asset classes at will.

When the stock market trades in a band, as it has for the past decade, these sorts of funds can perform well. According to data from investment-research firm Morningstar Inc. through October, "world allocation" funds have returned 5.08% annually over the past five years and 5.78% annually over 10 years, compared with the S&P 500's 1.73% annualized gain over five years and an annualized loss of 0.02% over 10 years.
Some tactical funds handily beat traditional equity funds during the financial panic. "There were many investors in 2008 and 2009 who were disappointed by how little their fund managers could do to react to or react ahead of what was developing," says Loren Fox, senior analyst at research firm Strategic Insight.

So far this year, financial-services firms have launched 28 world allocation funds, according to Morningstar.

Steven Roge, a portfolio manager in Andover, Mass., has been moving more of his clients' money from traditional equity funds to flexible funds—such as IVA Worldwide Fund, Pimco Global Multi-Asset Fund and FPA Crescent Fund, among others—because of the managers' ability to make swift asset-allocation decisions and their use of derivatives to reduce risks.

"Asset allocation plays such a big part in the return of the portfolio that we could probably add 2% to 3% more in returns with less downside just from the timeliness of the shifts in asset allocation," says Mr. Roge, who estimates that about 40% of his clients' portfolios are in flexible funds, up from about 12% a few years ago.

The Goldman Sachs Dynamic Allocation Fund, launched in January, aims to shift between asset classes based on volatility. If, for example, the volatility of the S&P 500 increases, the fund would pare stock holdings.

"By taking some risk off the table as asset-class risk increases, that potentially sidesteps some of the downward movement in the market," says Theodore Enders, portfolio strategist at Goldman Sachs Asset Management.

Tactical funds can be unpredictable. The $25 billion Ivy Asset Strategy Fund, for example, held an 80% net equity position at the beginning of 2010, then pared it back to 18% at the end of February, only to ramp it up again a few months later. "If you have a fund that's changing its asset allocation frequently, it can be difficult to know how to position the other funds in your portfolio," says Kevin McDevitt, a Morningstar analyst. Note, also, that fees for these funds can be high. The Direxion Spectrum Global Perspective Fund, for example, has annual expenses of 2.55%.

Rising-Rate Funds

A typical move after a powerful stock rally is to sell shares and buy bonds. But with the Treasury markets surging to record highs recently, putting more money there could be even riskier than leaving it in stocks.

The Fed is buying Treasurys now, but not all maturities. When it said last week it would avoid 30-year bonds, their prices promptly tanked. That could be a hint of what's to come once the Fed stops buying other maturities. Its ultimate goal, after all, is to juice the inflation rate. Rising inflation is usually bad for bonds.

Instead of Treasurys, investors should consider "floating rate" funds, which buy variable-rate corporate loans—and therefore collect more money when rates rise. In 2003, for example, when the Fed started raising rates, floating-rate funds gained 10.4% while short-term bond funds gained 2.5%, according to Morningstar.

There are at least 31 open-end funds and 10 closed-end funds to choose from. Morningstar's picks in this category include the Eaton Vance Floating-Rate Fund and the Fidelity Floating Rate High Income Fund, which boast experienced management teams and solid track records.

Warren Ward, a financial adviser in Columbus, Ind., says he is considering the Fidelity Advisor Floating Rate High Income Fund for his clients because of manager Christine McConnell's experience through up and down markets. Another plus: The fund holds a considerable amount of cash, which should allow it to meet any redemptions without having to sell securities, he says.

"If rates rise, floating-rate funds offer investors some protections," says Mr. Ward. "I would like to say go into bonds to get yourself out of stocks, but I think they're more risky right now."

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