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Taking Advantage of the Downturn

Market Selloffs Are Never Fun. But There Are Ways for Smart Investors to Capitalize

There is no way to sugarcoat the market plunge of the past two weeks—it has been brutal.

The good news is that it isn't forever. And in the meantime, there are ways for investors to take advantage of lower stock prices to pick up bargains, capture tax perks, maximize corporate stock awards and tweak retirement accounts.

The burst of selling that sent the Dow Jones Industrial Average down 4.3% on Thursday continued into Friday, when the average dipped as much as 2.1% before rebounding. All told the Dow has dropped 10.7% since April 29.

Worse, while the stock market might seem to be a better value now, weak economic reports could prompt analysts to start trimming their earnings estimates, weighing down the "e" in the price/earnings ratio.

Yet there are good reasons to expect the market slump to ease, at least in the short term.

Since 1962, the Standard & Poor's 500-stock index has seen 25 corrections of 10% during a bull market—but in only nine of them did the losses grow to 20% or more, according to Birinyi Associates Inc. That means there is only slightly more than a 1-in-3 chance that the market is going to keep cratering.

The selling has been so strong that the S&P 500's "relative-strength index," a technical gauge of momentum, fell to 23.48 on Friday, the lowest since Oct. 10, 2008. That is an indication that the market could be drastically oversold. After all, the number of falling stocks on the New York Stock Exchange on Thursday outnumbered rising ones by 20-to-1, and 98.9% of the volume occurred in stocks that had dropped.

That kind of selling pressure suggests the end of a correction—not the beginning of a bear market, says Jim Stack, president of Investech Research in Whitefish, Mont. During the past 20 years, the S&P 500 has returned 23.7% in the 12 months following a one-day selloff of 4% or more, according to FactSet Research Systems data.

"If the market has topped, it is unlike any market top I've ever seen," Mr. Stack says. "I'm trying to stay objective in the face of all this."

Of course, that doesn't mean investors should close their eyes and blindly purchase stocks. But it does mean that there are opportunities for investors who keep their wits about them and stick to their plan. Here are some ways to capitalize on the selloff.

Look for Bargains

When the market tanks, the selling is often indiscriminate. On Thursday, one of the year's worst-performing stocks, Monster Worldwide Inc. (down nearly 60% in 2011), dropped as much as one of the best, CBS Corp. (up 27%). The upshot: Everything is on sale, and investors should go hunting for bargains.

"On these blowout days, you do well if you're a buyer of stocks and a seller of bonds," says William Larkin, a portfolio manager at Cabot Money Management in Salem, Mass. "This is a good time to play

the counter game."

On Thursday, Mr. Larkin says, he sold Treasuries to buy exchange-traded funds that own large European companies like Nestle SA, Novartis AG and Vodafone Group PLC, which he believes have been unduly punished.

But investors need to be careful, warns Stephen Shueh, a managing partner at advisory firm Roundview Capital in Princeton, N.J. The market could fall another 10% and still be within its historical fair value. He says this is an ideal time for investors to consider the riskiness of their portfolios and decide whether it's time to go shopping among some of the market's safer sectors.

Blue-chip companies seem to be as close to a consensus favorite as the market gets. Mr. Shueh, for instance, has been looking for discounts among high-quality blue chips like Wal-Mart Stores Inc. and Procter & Gamble Co., while David Bianco, chief U.S. equity strategist at Bank of America Merrill Lynch, recommended in note on Friday morning that investors buy the biggest companies in the U.S. "now."

During market slides in the past 10 years, the Dow has dropped about 16% less than the S&P 500, according to Morningstar Inc. data.

Blue chips also are cheaper than other stocks: the Dow's P/E multiple, based on trailing 12-month profits, is 12.2, versus 13.0 for the S&P 500.

"Our portfolio is as blue-chippy as I've ever seen it," Mr. Shueh says. "You're looking for companies with strong balance sheets and solid cash flow."

Many large companies also pay hefty dividends, a nice source of return while investors wait for a better market environment.

"You'll still get knocked around like a boxer in the ring," says Hans Olsen, head of investment strategy in the Americas at Barclays Wealth. "But you get a decent return in the long term that should hold up regardless of what happens here."

Harvest Tax Losses

If your portfolio is too concentrated in one stock, this could be "an opportunity to diversify," says Maria Bruno, an investment analyst at fund giant Vanguard Group. Such investments often involve large capital gains, so selling at a lower price can cut taxes. And you may be able to offset any gains with other losses this year.

The U.S. tax code offers investors many boons. Among them: taxpayers may use losses on one investment to offset gains dollar-for-dollar; "carry forward" losses that can't be used immediately; and use losses to shelter \$3,000 of ordinary income from taxes.

"Taxable-account investors should be loss-harvesting whenever the opportunity arises, not just at the end of the year," says Robert Gordon, an investment tax expert who heads Twenty-First Securities Corp. in New York. His rule of thumb calls for taking losses when an investment drops 15% from its purchase price. Others look at the dollar value of losses.

But investors need to be careful. You can't, for example, take a loss if you buy the same shares 30 days after the sale. Stock option grants and exercises count, as do purchases within an individual retirement account, says Eddie Adkins, a benefits specialist with accounting firm Grant Thornton LLP. In order to preserve the portfolio and catch a rebound, Mr. Gordon often recommends buying a similar stock or related ETF.

Here's an example: Say Ned bought Merck & Co. in January 2010 for \$39.47. Now it is trading more than 15% below that, at less than \$32. He could sell his shares and claim a long-term capital loss of more than \$7 a share that could be used to shelter gains from other asset sales. If Ned doesn't have any gains, he can use a loss to shelter up to \$3,000 of ordinary income from tax.

Assuming Ned likes the pharmaceutical sector, he might immediately buy a similar stock—such as Pfizer Inc.—or a sector fund. Then he would sell the replacement and buy Merck in 30 days. If Ned did nothing and simply waited for Merck to rise again, "he would give up valuable tax savings," says tax expert Robert Willens in New York. Of course, investors should always weigh transaction costs against possible savings, he notes.

Investors should also keep an eye on their time horizon. The tax rate on long-term gains is at a historic low of 15% and is set to rise to 20% in 2013. If you harvest a long-term loss now, repurchase at a lower cost and hold for several years, it is possible to wind up paying more tax. "People really have to do their own math," says Joel Dickson, a tax specialist at Vanguard.

Maximize Stock Options

There are two general types of executive stock options. So-called incentive stock options, or ISOs, often allow for greater capital gains but are rarely issued anymore. "Nonqualified" options—called that because they aren't ISOs—are less tax-favored but much more common.

A market dip is a good time to exercise options, as long as the option isn't underwater and you think the stock will recover.

With nonqualified options, ordinary income tax will be due on the value of the shares as of the exercise date, minus what you pay for the shares, with all future appreciation taxed as a capital gain. If you hold the stock longer than a year, any gain will be taxed at a top 15% rate under current law.

For investors who want to stay in the stock but are strapped for cash, it may be possible to arrange a "cashless exercise" in which profits from some shares are used to buy the stock and pay taxes due.

Grant Thornton's Mr. Adkins is telling holders of ISOs to consider exercising them as well. No regular tax would be due, but an exercise produces income that can trigger or increase the Alternative Minimum Tax. So exercising when the price is lower can be a good move.

People holding restricted shares have fewer choices, because they don't control when the stock vests—which is when taxes are due.

Make Gifts

Any U.S. taxpayer may give another person—not just a relative—up to \$13,000 of assets a year free of gift tax, and there is no limit on the total number of gifts.

For people planning to make asset gifts, a market swoon presents the opportunity to give more. Stocks, mutual funds and ETFs are convenient because they are easily valued and quickly transferred. The giver's cost basis, or the amount paid for the investment, "carries over" to the recipient.

For example: Jane wants to give her grandchild Lucy some Exxon Mobil Corp. stock she bought for \$65 a share in 2009. Less than a month ago, her \$13,000 exclusion would have allowed her to give fewer than 155 shares, but now she could give more than 170. When Lucy sells the stock, she would pay tax on any gain above \$65 per share.

Tweak Your IRA

If the value of your IRA dipped this week, it could be a good time to convert all or part of it to a Roth IRA, a retirement account into which you invest after-tax dollars and get tax-free withdrawals. "I've been getting calls from clients who are trying to figure this out," says Robert Keebler, a CPA and partner with Keebler & Associates LLP in Green Bay, Wis.

The big advantage: Roth withdrawals in retirement are tax-free, and you don't have to make any mandatory withdrawals. Another perk: as of last year, there is no income limit for transferring savings to a Roth from a traditional IRA or employer-sponsored retirement plan.

John Neyland, an investment adviser in Baton Rouge, La., met Thursday with a divorced teacher who plans to retire in three years and is worried about Exxon's falling stock value, since she received 1,500 shares through her divorce settlement in an IRA. He suggested converting the shares to a Roth next week. "It has dropped \$20 a share, or \$30,000, and she's in a 30% effective tax bracket, so she can save \$9,000 in taxes," he says. "She's planning to retire in three years, and tax rates could go up in 2013. It's a no-brainer.

To convert from a traditional IRA to a Roth, you generally fill out a form requesting a transfer. The drawback is that you would owe income tax on the amount you convert for the year in which you do the conversion. (Last year was an exception.) And the move may not pay off unless you can pay the tax using money outside your IRA.

But you would get credit, proportionately, for any after-tax contributions you have made through the years. For example, say you have \$250,000 in IRA assets (\$200,000 in a rollover IRA from a 401(k) and \$50,000 in another account), and the latter contains \$40,000 in after-tax contributions. That means 16% of a conversion would be tax-free.

You also want to be careful "that you don't jump yourself into a higher tax bracket" by doing a Roth conversion, says Vanguard's Ms. Bruno. Say you are near the \$139,350 income limit for the 25% bracket for married couples filing jointly, and you do a Roth conversion. Most of your conversion income could wind up being taxed at the 28% rate instead.

Consider opening a separate Roth for each type of investment you make. That way, you could "recharacterize" any laggards by switching back to a traditional IRA, and would no longer owe the conversion tax, says Ed Slott, an IRA expert in Rockville Centre, N.Y.

If you already converted, and the account balance has fallen, advisers suggest waiting a bit. IRA owners who did 2010 conversions have until Oct. 17 to switch back and erase the tax bill. After that, they would have to wait 30 days to reconvert. "If the market came back in those 30 days, you'd really be a loser," Mr. Slott says.

More important, 2010 converters can spread their payments across their 2011 and 2012 tax returns—but if the assets were recharacterized and reconverted, all the taxes would be due in one year.

If you converted to a Roth this year, there isn't a rush: You have until Oct. 15, 2012, to recharacterize. And you would have to wait until January to convert back to a Roth.

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