Retirement

A psychologist's 5 steps to stop panicking about your 401(k); How to keep your focus long term

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In the fall of 2008, when global stock markets were imploding, I happened to be in New York. I switched on the TV in my hotel room and saw financial commentator Suze Orman on Larry King Live. She took calls from the public.

One went something like this:

Caller: Do you think the stock market is going to fall further?

Orman: Yes. I think it's going to go down about another 20%.

Caller: So should I cash out my 401(k) now?

Orman: No!

Caller: But why not?

Orman: Because if you do you'll never get back in.

The Dow Jones Industrial Average DJIA at the time? A little north of 10,000. And over the next 6 months it fell quite a bit more than 20%. By early March it fell below 6,500.

Where it is today? Oh, 31,000. Even after this year's plunge.

Throw in dividends, and if that caller followed Orman's advice she's made about 300% on her money just by leaving it where it was.

Even someone who bought the S&P 500 SPX at the precrisis peak, in November 2007, is up today around 250%.

Markets like these are the ones that can make or break retirement plans: Ordinary, normal, hardworking Main Street Americans' retirement plans. They're the reason so many 401(k) and IRA balances aren't as high as they should be. Turmoil, understandably, scares people away.

Following the latest inflation report shocker, there is now almost universal dread and gloom in the investing world. Bank of America's BAC strategists think the S&P 500 will fall another 20% this year. (The bank's fund manager survey, due next week, should tell a dismal story.) Investment giant BlackRock BLK says the happy days of the last 40 years are now over, and we are back to the era before the mid-1980s: An era of slower growth, higher inflation, and higher volatility. Retired bond king Bill Gross is telling people to move all their money into one-year Treasury notes while runaway inflation gets followed by a recession.

But the real issue for long-term retirement savers isn't what the stock market will do over the next 12 months, but over the next 12 years.

How do we keep our focus on the long-term during all this panic? Sarah Newcomb, the director of financial psychology at investment analysis firm Morningstar Inc., shares some insights. (Newcomb has a Ph.D. in behavioral psychology.)

"When I survey people, I like to ask them how far ahead they tend to think and plan when it comes to their finances: Days, weeks, months, years, decades, or generations," she tells me. "Most people think a few years ahead at most, so we are already at a mental disadvantage when it comes to finances because the best financial decisions are usually made with decades or generations in mind."

Even worse, she notes: At times of stress or panic people tend to focus more on the short-term, not less. "When uncertainty increases, the ability to plan ahead decreases even further. I've heard people who are usually long-term planners say things like, "Who knows what things will be like next year?""

She has a terrific five-point plan to help investors cope:

1. Take stock of your safety net, both financial and emotional. Remembering that there are people who will love you despite financial setbacks can help you calm down and think more clearly.

2. Try to turn each "what-if?" into a "so what?" For example, rather than worry about what I would do if I suddenly lost my job and my savings and my home, I make a plan: I would move in with my mother. I'd spend time with her, collect unemployment insurance, and start to rebuild. I might even pursue a different career track. This makes the "what if?" so much less scary. Would it be hard? Yes. Would it be the end of me? Not by a long shot. As counterintuitive as it might seem, making realistic plans for worst-case scenarios can be very calming. This is the purpose of disability and life insurance as well: to give us and our loved ones a backup in the event of catastrophe.

3. Remember "buy low, sell high"? This is NOT a time to sell, but it's a great time to buy. Look for shares in great companies that were too expensive six months ago but are affordable now. Do your research, of course, but if the company fundamentals are strong, you can buy top quality shares at discount prices.

4. Focus on the things you can control. You have little (if any) power over the markets, world affairs, and global economies. What you can control is your attention (focus on opportunities), your saving, and your spending (dial it down).

5. Remember, you're more than your money. Take time to do the things that make your life worthwhile. Connect with loved ones, grow something, get outside, play with your dog, sleep. If you're emotionally wound up, you're not in a great mental space for making decisions.

I might add: Keep in mind that this crash may be an even better long-term buying opportunity than 2008, because pretty much everything is down. I wrote in 2008 and early 2009 that if you wanted to react to the crash, it was a great time to diversify. The same is surely true today.

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