Surviving the Big, Scary 'Mega-Bubble'
by Paul B. Farrell

Is there a global mega-bubble about to burst? You sure think so. And you're wondering if there are ways to weather the coming storm.

I gave you a 20-question quiz last month that focused on 20 smaller potential bubbles, asking you to score each from one to five in terms of risk. A score above 50 put you in the mega-bubble camp.

It turns out that this is a real hot-button issue. I received 1,249 responses, three times as many as on any column I've written in eight years. I read every response.

All told, 86% of you scored the bubble risks at 50 or more. And 39% scored between 75 and 100. Only 14% scored under 50.

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one California builder who said he
had "been around for decades."
"Real estate will go back to the
Agricultural Age. Get ready for deflation."

Many of those who responded identified themselves as officers in banks or securities firms, professional financial advisers, corporate executives, federal and state government professionals, mortgage bankers, building contractors and real-estate pros. They scored the bubble risk as very high.

Comments by real-estate pros stood out because the housing bubble is likely to be the lead domino triggering a global economic meltdown. Real-estate respondents from Michigan to Florida expressed almost unanimous concern about this bubble.

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"Warning signs are everywhere," said a New York mortgage banker. "Rates went through the floor, prices to the moon. I sold everything a year ago, paid off debt. The Great Depression will look like a cakewalk."

If you believe a global mega-bubble is near, what's your best strategy? Cash out now, at the top? Sell real estate, stocks too, rent, pay off debt? Then wait patiently until prices drop and buy bargains? That may the best bet for some.

But timing is critical. So is courage. As one reader put it: "The trick is, do I act on it? Back in 1999 I thought of moving my 401(k) to bonds. Didn't. Lost 40-50%. Ouch!"

We can't cover all choices, so I asked two trusted (and very different) experts, a pension-fund manager and an economist, for action-oriented advice.

Plan A: Stay the Course

Ted Aronson's Philadelphia firm, AJOPartners, runs $20 billion of institutional retirement money. He is rare among managers because he disclosed where his personal money is – all in index funds. He has been in the first index fund since it was launched in 1976. His own portfolio beats the market with little rebalancing and no trading.

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Mr. Aronson says that if you have a well-diversified portfolio, cashing out may be costly in the long run: "For good reasons and bad, I'd hold tight. The good include my faith in capitalism and its ability to time this sort of thing. Even if I got out in time, I probably wouldn't be able to correctly time getting back in."

Here's his own family's "weather-the-storm" portfolio of Vanguard Group funds. It includes 40% in domestic-stock funds, 30% in foreign-stock funds and 30% in fixed-income funds, as follows:

The All-American 40%

- 5% - Wilshire 5000 (VTSMX)
- 15% - S&P 500 Stock Index (VFINX)
- 10% Wilshire 4500 Mid/Small Cap (VEXMX)
- 5% Small-Cap Growth (VISGX)
- 5% Small-Cap Value (VISVX)

The Foreign 30%

- 15% Emerging Market (VEIEX)
- 10% Pacific Stock Index (VPACX)
- 5% Europe Stock Index) (VEURX)

The Fixed-Income 30%

- 10% Inflation-Protected (VIPSX)
- 10% High-Yield Corporate (VWEHX)
- 10% Long-Term Treas. (VUSTX)

Plan B: Play New Game

The second expert I consulted, Gary Shilling, is an economist and the author of Deflation: <u>How to Survive and Thrive in the Coming Wave of Deflation</u>, which deals with the impact of falling prices.

He cautions: "There's no such thing as a sure thing, so 100% cash is never appropriate. My recommendation now is 20% stocks, 50% bonds (mainly Treasurys) and 30% cash". His July "Insight" newsletter lists "Investment Themes" to help plan for the deflationary years ahead:

Opportunities to Explore

Dividend-paying stocks. Best bet in era of single-digit returns.
Apartment REITs. More renters as home prices collapse.
Interest rates drop. Treasurys substantially outperform stocks.
Strong U.S. dollar. High productivity builds strong currency.
New savings spree. Spending and borrowing is out; saving is in.

Challenges to Brace For

Domestic stocks. Declines of 40% to 50% in broad market.
Less discretionary spending. Retailers, autos, appliances are hurt.
Financial services. Brokers, bankers, money managers struggle.
'Subprime' lenders. Write-offs on credit cards, mortgage loans.
Home building. Increasing foreclosures and bankruptcies.
Higher risks. Hedge funds, junk bonds, emerging countries.
Global economic slowdown. Deflation goes global in 2006.

Bottom line: If you have a well diversified portfolio and a long horizon, consider riding out the storm. If you don't, please craft one, or get advice about cashing out.

Remember, an overwhelming 86% of your friends see storm clouds dead ahead.

Mr. Farrell is a personal finance and investing columnist for CBS.MarketWatch.com. He is *the author of six books on investing, including The Millionaire Code, The Winning Portfolio and Expert Investing on the Net. Reprinted with permission of MarketWatch, Inc. For more information, please visit MarketWatch.com.*