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What to do now: 5 investing mistakes to avoid

Plunging markets can lead to fear, paralysis; emergency savings are crucial

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What to do now?

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With the recession deepening, jobs disappearing and the Dow falling below the 7,000 level for the first time since 1997, many frightened investors are probably wondering if it is time to do something.

But the challenge of "doing something" can be a disaster all its own: You might act rashly and do the wrong thing, or spend so much time being paralyzed with indecision that nothing gets done at all.

To negotiate this dilemma, we asked financial planners across the country for their advice—and initially got some free psychotherapy. "Don't panic" and "be patient" were common refrains, especially for people who have at least five years to go before retirement.

"Historically some of the best periods for stock market returns have been during dismal economic times," says Salt Lake City financial planner Paul Winter. "If your retirement is five, 10 or 20 years from now, what has happened to your portfolio over the past 12 to 18 months is next to irrelevant. All that matters is how your portfolio will perform from today."

OK, then, what to do today? Since some would say the first step to success is simply not failing, we asked planners to pinpoint five mistakes we could avoid:

1) Don't wait it out. Nobody recommends completely cashing out in this market, but if you have a stock portfolio, you probably need to reallocate. "After incurring losses, investors are often reluctant to sell their losers. They cling to the idea that you haven't lost until you sell," says Eric Toya, a planner in Redondo Beach, Calif.

Don't look back, he says. Make sure your equities reflect different asset classes (and include some international holdings), or you can even just play it safe and go toward more index funds, which lower your overall risk. Diversifying now "may increase your odds for success going forward—to recover losses in the near term and make gains in the long term." The immediate bright side: While a few capital losses may sting, at least you're not facing a big tax liability.

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If you want to hire a planner—one who works for fees rather than commissions, or even does by-the-hour services for middle-income clients—check out listings at the National Association of Personal Financial Advisors or the Garrett Planning Network.

2) Don't dump your 401(k). But don't show it too much love, either. If your employer matches your contributions, don't drop that chance for free money. To play it safe, you might consider contributing only up to the company's matching point, especially if you could benefit from a few more dollars in your emergency stash, instead.

It's also a good idea to look at your 401(k) plan with fresh eyes. "Many 401(k)s will have costs of 3 percent or so, and that is a huge drag on your portfolio," says Charles Stanley, a planner in La Jolla, Calif. If that's the case, ask if you can do an 'in-service non-hardship distribution,' where you can still contribute and get matching funds, but do a direct rollover into an IRA. That way, Stanley says, "your returns aren't being eaten up by unnecessary costs."

3) Don't hide behind CDs. "People get scared and dump all their money into CDs," Toya says, "and say they'll keep it there until they 'feel better.' But when are they going to feel better? When other people have gotten better returns elsewhere? "

CDs and other fixed-income products (such as bonds) still have a place in your financial plan, but keep the timelines short, since today's yields are pretty low (often just 1.5 percent).

"You don't want to lock yourself into these yields for the next 3 to 5 years," says Scott Michalek, a certified financial planner in Philadelphia. "Stay one year or less with CDs. If you're investing in bond funds, stay with high-quality short term—an average maturity of less than three years."

4) Don't think outside the box. The dismal market has reignited a love affair with gold, as well as some non-traditional investments that tend to go up when stocks are down. But they're not immune to risk, either.

Don Martin, a planner in Los Altos, Calif., warns against gold coins and bullion in part because there's "due to panic buying, which has made the price of individual gold coins, which have no numismatic value, go up higher than the value of their bullion content." If you want to invest a little money in gold, he says, you're better off buying a gold bullion exchange-traded fund (ETF).

Likewise, he says, watch out for non-traditional or even exotic investments—securities that trade only once a day or not publicly. "For instance," he says, "instead of investing in volatility indexes or oil futures, simply buy some stock in high-quality, oil-producing companies. Get back to basics."

5) Don't favor your mortgage over your emergency fund. While some people might be tempted to overpay their mortgage, perhaps to bring their balances down to real-world levels, your emergency fund should be first in line for any extra cash. Six months' worth of living expenses has long been the conventional-wisdom target, but many experts are now upping that to nine or 12 months, in case someone in your household loses a job.

Planner Craig Carnick in Colorado Springs, Colo., recommends putting that cash in a regular money market account or a CD ladder—a package of CDs that frees up funds with some regularity, like every six months

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over a two-year period. The most important thing is that the account be flexible. “More cash reserves,” he says, “means more ability to withstand unexpected problems.”

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