MarketWatch

2011: The Year of Discipline

January 3rd, 2011, 12:00 a.m. EST

TOLEDO, Ohio (MarketWatch) – There is a different type of investor surfacing now than during the midst of the financial crisis in 2008-09.

Then, it was based on pure panic and getting one's assets where they would be continually managed for risk, rather than the buy-and-hold roller coaster that most investors were experiencing. Today's investor is no longer in panic mode, but rather is coming from two very different camps or philosophies.

One group of investors missed much of the severe downturn during the financial crisis, but unfortunately never got back into equities during the dramatic weakness and has watched from the sidelines throughout the impressive rally. These investors are concerned about getting back in just before another collapse after already missing so much of the upside.

The second group of investors is participating in this rally, but has the haunting fear that their investment in every asset-class allocation or momentum success of late will lead to eventual disaster without the right investment disciplines in place.

These investors still have vivid memories of how poorly their asset-allocation models protected their capital in 2008, when nearly every asset class across the globe plummeted in value. The bottom line with both groups of investors is that they are looking at ways to participate and/or ride out this bull market as long as possible, but doing so with a risk-management strategy in place that will protect profits in these volatile selloffs.

Very few of these investors expect a straight-up, back to-the-races market, as they are well aware of the significant headwinds that will face investors throughout 2011 and beyond.

While the U.S. economy is continuing to make decent progress, concerns from housing still being at recession levels to stubbornly high U.S. unemployment cannot be ignored. The biggest selloffs into 2011 will likely occur from headline risk overseas, as the European sovereign debt and banking crisis continues to unfold, and China struggles with the delicate balance of slowing inflation by restraining its economic growth.

Combine this with growing geopolitical risk and the unintended consequence of all the stimulus, and there are plenty of reasons to see why the recent volatility will continue.

On the domestic front, the deteriorating financials of states and municipalities present a formidable obstacle for equity and bond markets. The best way to take advantage of this anticipated volatility in both directions is to utilize selloffs (like we experienced this past summer on double-dip concerns), add cyclical names and utilize rallies to do the opposite — locking in gains in the cyclical highfliers and getting both defensive and selective with any new purchases.

Many investors are just starting to realize the high risk/low return in long-term bonds, and how most cookie-cutter asset-allocation programs and lifestyle funds are guaranteeing mediocre returns or worse with their significant bond exposure as interest rates rise into 2011 and beyond. It will be critical to get more defensive as valuations rise into the year-end rally, as in April 2010 when valuations got ahead of themselves.

This is a great way to participate in the rally without taking excessive risk that often leads investors to the roller-coaster ride of investing with little or no long-term progress. Two years ago, we were buying Apple Inc. (NASDAQ:AAPL) and eBay Inc. (NASDAQ:EBAY) at historic low valuations, and both stocks have dramatically outperformed.

Rather than chase leaders, investors should focus on Microsoft Corp. (NASDAQ:MSFT) or Adobe Systems Inc. (NASDAQ:ADBE) on weakness, as both stocks have both low valuations and expectations on Wall Street with plenty of upside.

This same discipline works in the financial sector. We featured Goldman Sachs Group Inc. (NYSE:GS) and J.P. Morgan Chase & Co. (NYSE:JPM) as our favorite investments for 2009. Investors may wish to focus on Peoples United Financial Inc. (NASDAQ:PBCT) and Hudson City Bancorp Inc. (NASDAQ:HCBK) , as both companies are trading at valuations similar to GS and JPM two years ago, but yielding more than 5%. Unlike bonds that lose principal as interest rates move up from their historic lows, these companies benefit from higher interest rates.

The year 2011 will have similar, albeit still challenging, potential as 2010. There are a number of moving parts, particularly with the Federal Reserve, so investors must stay nimble and continually focus on risk especially as valuations rise.

(Article edited for brevity)