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Realize That This Has Happened Before (And Will Happen Again)

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Uncertain economic times come and go. These times can be especially challenging if you aren't prepared for them. No one knows exactly when a major economic event will occur or what it'll look like, but if you're prepared, you stand a good chance of weathering it.

When you're preparing for uncertain economic times, understanding what's happened in the past can help. History provides clues to help you avoid common mistakes made during challenging times. So what kinds of events create uncertain economic times, and what clues do they hold for you today? This strategy takes a look at three types of events that can unexpectedly affect your financial security.

Weathering Major Economic Events

Most major economic events, such as stock market crashes, happen when a normal economic cycle gets out of balance. Have you had the experience of looking forward to an extravagant dinner, and then as soon as dinner arrives, eating until you felt you'd burst? Afterward, you regret indulging and swear you won't do it again, but after a while, you forget the uncomfortable experience and start making plans for another indulgent meal. This is how economic cycles work, too: You see periods of rapid growth often inspired by exciting technological advances. Occasionally, investors overindulge and a bubble develops. Unfortunately, when the bubble bursts, people have to suffer until things even out again.

Stock market bubbles and crashes

One of the most famous bubbles of the last century occurred in the so-called Roaring Twenties, which came to a startling end with the stock market crash of 1929. The overindulgence of credit and spending combined with wild speculation in the stock market led to the Great Depression, which lasted about ten years. Will the U.S. experience another depression like the Great Depression? Who knows, but you can prepare yourself just in case. Here's how to position yourself well:

- **Steer clear of consumer debt.** In the Great Depression, those in debt got hammered when it came time to pay up.
- **Pay your mortgage off as soon as possible.** Minimizing your mortgage debt is also a smart thing to do. Having too much debt — of any kind — puts you in jeopardy if times get really tough and you lose your income, run out of savings, and can't borrow more money.
- **Save for emergencies.** Those with cash set aside are able to roll with the punches.
- **Take advantage of future investment opportunities.** Some people took advantage of lucrative investment opportunities — believe it or not, some people actually prospered during the Great Depression.
- **Develop a broad skill set.** Jobs were extremely hard to come by during the Depression, and those with a wide range of skills had an easier time finding employment.

Although depressions are rare, stock market bubbles and ensuing crashes are not. In fact, since the end of World War II, the United States has had 12 occasions in which the stock market lost more than 20 percent of its value. But take heart; over that same period, the market gained 7,079 percent, in spite of the crashes.

Bubbles are surprisingly similar to each other. Take the dot-com bubble of the 1990s that burst in 2000. As in the 1920s, investors believed that easy riches could be had in the stock market. Internet and technology stock prices soared to dizzying heights until the bubble burst in March 2000 and the party ended. The dot-com bust didn't lead to a depression, but it did do a lot of damage to people's investments. Here's how to avoid getting hurt when a stock market bubble bursts:

- **Maintain a diversified portfolio.** Investors who were seriously injured in the tech wreck had most of their money in dot-com and technology stocks. If you have a diversified portfolio and remain invested for the long term, don't panic when a bubble bursts. Stay the course and let the market work things out.
- **Avoid the next hot investment.** Resist the urge to get caught up in the irrational exuberance of new technology.

Real estate bubbles and crashes

Bubbles aren't limited to just the stock market. The housing bubble started in 2001 as speculators fled the stock market and set their sights on real estate, sending home values up. When housing prices started to deflate, some homeowners found they owed more on their mortgage than their house was worth. As low introductory interest rates reset to higher rates, many homeowners found themselves unable to pay their mortgages. Foreclosures skyrocketed. When the bubble burst, it left a credit crisis unseen since the Great Depression. You'll know the full effects of the 2007–2008 real estate burst when you read about it in the history books. To protect you from a real estate crash, do the following:

- **Don't rely on your mortgage lender or real estate agent to tell you how much house you can afford.** Work out your budget and make sure you can afford the mortgage payment along with associated housing expenses.
- **Put at least a 10-percent (preferably 20-percent) down payment on the home.** Pass on zero–down payment financing. If you can't afford a down payment, you likely can't afford the home.
- **If you don't plan on being in a house for at least five years, don't buy one.** Rent instead. In most cases, breaking even on a home purchase takes at least five years due to the costs involved in buying and selling a home.
- **Avoid using home equity lines of credit for consumer purchases.** Use home equity lines of credit exclusively for emergency purposes.
- **Don't rely on a home equity line of credit as your sole source of emergency funds.** Keep your emergency funds in cash reserve accounts, like savings accounts or money market mutual funds. If, however, you deplete these accounts in a prolonged emergency, you can then turn to your home equity line of credit.

Rapidly rising commodity prices

Not all economic events are caused by speculative bubbles. The Arab Oil Embargo in 1973 forced gas prices to quadruple from 25 cents to over a dollar per gallon. People waited in line for gasoline for hours. The economy slipped into a recession, which led to a nasty decade of rising unemployment and double-digit inflation. Take these steps to prepare for periods of rapidly rising commodity prices:

- Consider economizing your energy use. Ride your bicycle or drive a fuel-efficient car. Invest in energy-efficient appliances in your home.
- Maintain an emergency fund to cover unexpected price increases.
- Purchase staples in bulk.

Standing Strong During Political Events

Political events are often unanticipated and shocking. Assassinations and terrorist attacks can tempt you to panic. Historically, these types of events have caused only short-term economic uncertainty. Take John F. Kennedy's assassination on November 22, 1963. The market lost 3 percent on November 22 as people panicked and sold their stock. However, on November 26, the market not only recovered that tragic day's losses but was actually up 4.5 percent. It pays to stay invested.

The September 11, 2001, terrorist attacks on the World Trade Center and the Pentagon shocked the U.S. The Dow Jones Industrial Average lost 7.1 percent in one day and by the end of the week had fallen 14.3 percent, its biggest one-week point drop in history. Fortunately, the Dow recovered its lost ground in two months. Here's how to stay safe during an unexpected political event:

- **Don't panic.** Knee-jerk reactions will almost always come back to haunt you.
- **Maintain a diversified portfolio.** This is the single best way to weather economic uncertainty.

Witnessing Global Conflicts

You may think that wars would have a negative impact on the economy, but actually, for the most part, the opposite has occurred. World War II was the most costly war in terms of government expenditures and human lives. Gearing up for and supporting the war actually produced a booming economy. The Korean War and the Persian Gulf War had similar effects, although a recession did follow the Gulf War in 1992.

On the other hand, the Vietnam War and the War on Terror have had relatively negative effects on the economy. The Vietnam War lasted for 16 years, and the average return for the S&P 500 during that time period was a dismal 3.91 percent. Likewise, the average return for the S&P 500 for 2001 through 2007 was a depressing 3.02 percent. Here's how to survive long periods of low market returns:

- Don't depend on high investment returns when planning for your retirement or other financial goals.
- Keep investing periodically throughout these periods.
- Include fixed-income investments, such as government bonds and certificates of deposit, in your portfolio.