

SCARY SCENARIOS:

CAN YOU SURVIVE A MELTDOWN?

By Maria Crawford Scott

No matter what the environment, someone is always predicting disaster. The question investors need to address is: What's the real risk I'm facing, and what's the best way to reduce it?

It's not really the meltdown you need to survive. Just the nightmare: As we steam ahead under the power of a raging bull market and strong economic growth, many investors are reliving the Titanic nightmare—they fear we are headed straight for a giant financial iceberg that will sink the markets and send us to the depths of economic ruin.

Investors have lived with similar nightmares for many years, but the look of the financial iceberg has changed over time. For example, in the 1980s, the iceberg was foreign investors, particularly the Japanese, who were thought to be the driving force behind rising stock prices, and who were certain to flee the U.S. markets for one reason or another, causing the market to collapse. Other disaster scenarios in the 1980s featured energy shortages, hyperinflation (since we already had inflation), deflation, the budget deficit, and a host of other crises that would lead to economic ruin of some form or another.

Today's disaster scenarios feature some of the old, and a few newer ones, for example:

- **The Year 2000 Problem** (or, to use the proper disaster lingo updated for today's computer age, the Y2K problem): Many computers have trouble with dates beyond 1999, and the enormous costs of fixing computer software as well as the business interruptions that will occur will trigger a major recession.
- **The Retiring Baby Boomers**: The huge bulge in the population known as the Baby Boomers is reaching retirement age, and when the Boomers retire they will pull their money out of stocks for spending, which will trigger a major decline.
- **The Speculative Bubble**: Today's stock market has been driven to highly overvalued levels by novice investors who don't understand the risks they are taking, and once they do (when the market drops), they will panic and pull their money out, turning a typical market downturn into a full-fledged rout.

DISASTER FORECASTERS

Of course, forecasting "disaster" is somewhat of an oxymoron—if everyone were certain that disaster was imminent, it could be avoided. And that's the problem: investors want to know in advance what unknown event may ruin their financial future. As a result, the "experts" speculate about various scenarios.

From an investor's viewpoint, there are several problems with all of these speculations. First, there is the degree of consensus. Before acting on a disaster scenario, most investors would prefer some "assurance" that the disaster is going to happen. But the more investors believe that a disaster is going to occur, the more likely the markets are already reflecting this prediction.

Second, there is the impact on the markets. Many of the most dire disaster scenarios tend to be simplistic, predicting total collapse in only one area—the stock market, for instance. In reality, if a dire scenario were to unfold, the affects would be complicated, affecting many markets in unforeseen ways.

That's not to say that disaster scenarios don't focus on real investor con-

Maria Crawford Scott is editor of the AAI Journal.

TABLE 1. HOW DIFFERENT ASSETS PERFORMED DURING DIFFERENT ENVIRONMENTS

	Average Annual Return (%)					Annual Returns (%): 1960 through 1997		
	1930s	1960s	1970s	1980s	1990s	Average	Worst	Best
S&P 500	0.0%	7.8	5.9	17.5	16.6	11.6	-26.5 (1974)	37.4 (1995)
Small-Cap Stocks	1.4	15.5	11.5	15.8	16.5	14.7	-31.9 (1973)	57.4 (1976)
Long-Term Gov't Bonds	4.9	1.4	5.5	12.6	10.7	7.3	-7.8 (1994)	40.4 (1982)
Treasury Bills	0.6	3.9	6.3	8.9	5.0	6.0	2.9 (1993)	14.7 (1981)
Gold (Spot Price)	na	na	30.6	-2.4	-4.2	7.7*	-31.6 (1981)	126.5 (1979)
Int'l Stocks (MS EAFE Index)	na	na	9.6	22.7	3.6	12.3*	-23.2 (1990)	69.9 (1986)
Inflation	-2.0	2.5	7.4	5.1	3.1	4.7		

*1970 through 1997; data for prior years is not available or applicable (gold prices prior to 1968 were fixed).

Source: Stocks, Bonds, Bills and Inflation—1998 Yearbook, Ibbotson Associates, Chicago; and Chase Investment Performance Digest—1998 Edition, Chase Global Data & Research.

cerns. But the question investors need to address is: What's the real risk I'm facing, and what's the best way to reduce it?

When the disaster scenario's picture is painted in its bleakest form, the implication that some investors draw is that they should withdraw all of their financial assets from a major asset class (such as stocks), and invest all their savings in a particular asset class (such as cash, gold, or in offshore trusts).

However, that "solution" will only be beneficial if the total disaster actually occurs and if it affects the various asset classes as predicted. And that "solution" can be devastating to an investor's portfolio if the disaster does not unfold as predicted. For instance, anyone who moved heavily to gold in the early 1980s would have seen their portfolio value steadily go down (based on the spot price of gold). And it would have been difficult for such an investor to switch gears several years later, after realizing the "disaster" was not unfolding, and diversify into the stock and bond markets at much higher levels than when he pulled out.

If history is any guide, the risk of a total economic or market meltdown is quite small. And that risk must be balanced against the risk your portfolio would face if you were to make radical changes in the allocations and the disaster did not occur. That means you must take a cold, hard look at the alternatives: If

you were to avoid stocks, where would you invest your savings, and how would those investments perform under various scenarios?

THE REAL IMPACT

Many of the disaster scenarios do focus on events that impact the markets in less dramatic ways than the scariest scenarios have predicted. For instance, the savings and loan "crisis" did not sink the economy, but it did affect certain financial institutions. Similarly, the Mexican and Asian currency crises have not led to a worldwide depression, but they have substantially affected emerging markets.

In addition, disaster scenarios tend to focus on events that have primarily a short- or intermediate-term impact on the markets. For instance, the 1981–1982 recession (in which doom-and-gloomers were in full force) resulted in a bear market drop of -26% for the S&P 500 (from the stock market peak to the stock market bottom), but the duration of the bear market was 19 months—a period that must have seemed interminable to stock holders at the time, but of intermediate duration to investors who plan on remaining invested for 20 years or longer.

And, of course, disaster scenarios are diversified—which one do you pick? Each one has its own unique ramifications, some of which are total opposites—hyperinflation

versus deflation, for instance.

Unfortunately, there is no single investment that will do well under all economic environments. Therefore, the best way to reduce these kinds of risks is through diversification: among the major asset classes (stocks, bonds, and cash), within each asset class (for instance, small stocks, large-cap stocks, international stocks) and across time (being diversified over various market environments).

Table 1 provides data on how different asset classes have performed in various decades with different market environments—the deflation of the 1930s, the inflation of the 1970s, the turmoil in the '60s, and the bull markets (and mini-crises) of the 1980s and 1990s. It also provides the best, worst, and average returns since 1960 (since 1970 for gold and international stocks, since data for prior years is not available or not applicable; gold prices were fixed prior to 1968). You can use the data to help judge the risks of certain asset classes in certain environments. For instance, gold did exceptionally well in the inflationary '70s, but has performed miserably during other market environments.

Table 2 provides examples of how the risk of various recent "mini-disasters" could have been reduced.

What about today's disaster scenarios?

Whether or not the Year 2000

Problem results in disaster, it is most likely to be a short-term problem, and the risk can be reduced through time diversification.

The Retiring Baby Boomers disaster scenario is difficult to assess—most of the disaster scenarios paint this as a short-term problem, as if everyone will pull out of the market at one time. But this is unlikely, since Baby Boomers cover a wide age span. In addition, the impact on the markets is unclear, since many investors actually end up investing more total dollars in stocks as they get older and have more assets to invest long-term. Making asset allocation decisions based on this disaster scenario would require long-term predictions of all the various alternatives that would be highly speculative.

The Speculative Bubble is probably

the most-discussed investor nightmare. The best way to reduce this risk is to understand the real risks inherent in stock market investing when you determine your asset allocation mix, so that you do not panic should a major drop occur. And, of course, don't be a speculator yourself and assume returns will continue at high levels—instead, use conservative assumptions.

FUTURE SCARES

Unfortunately, there will always be someone who is predicting disaster. So, how do you judge future scare scenarios? Here are some questions to ask when you hear claims of imminent disaster:

- How “obvious” is it?
- How long is the “disaster” expected to last?

- What market segments would it most likely affect?
- Can the effects of the “disaster” be diversified away, either through time diversification (a short- to medium-term problem) or through investing in various market segments?
- If the suggested “solution” is to avoid a particular market, what are the alternative investments likely to do during the disaster period?
- What happens if the “disaster” fails to materialize—what position will your portfolio be in if you have radically changed your investment allocation due to the coming “disaster” and it doesn't occur?

The real trick is to tune out the Chicken Littles, so that you can get some sleep and avoid the nightmares. ♦

TABLE 2. REDUCING THE RISK OF “DISASTERS”

Past “Disasters”	Time Horizon	Affected Markets	How Risk Could Have Been Reduced
1981-1982 Recession	Short-term	All markets	Time diversification (remaining invested over various market environments)
1987 Market Crash	Short-term	Stock market	Time diversification (remaining invested over various market environments) and diversifying across various market segments
Gulf War	Short-term	All markets	Time diversification (remaining invested over various market environments)
Mexico Currency Crisis	Medium-term	Market segment (emerging international stock markets)	Diversifying into other market segments
Asian Currency Crisis	Medium-term	Market segment (emerging international stock markets)	Diversifying into other market segments
Healthcare Reform Talks	Short-term	Market segment (healthcare stocks)	Diversifying into other market segments
S&L Crisis	Medium-term	Market segment (S&L stocks)	Diversifying into other market segments
Future “Disasters”?	Time Horizon	“Predicted” Markets Affected	How to Reduce Risk
Year 2000 Problem	Short-term	All markets	Time diversification (remaining invested over various market environments)
Baby Boomers Retire	Medium-term	Stock market	Time diversification (remaining invested over various market environments) and diversifying across various market segments
Speculative Bubble	Short- to intermediate-term	All markets	Understand the risks of the various market segments when you determine your asset allocation. Use conservative return assumptions; and use time diversification