



'Disaster Avoidance' is no accident

by Bill Sherman, Portfolio Manager

It's a wonder that anyone survives their teenage years! Teenagers have a well-known "it won't happen to me" attitude, which sometimes translates into a degree of risk-taking and carelessness that makes adults faint dead away. In fact, we even have a name for this kind of particularly heedless activity — we call it "adolescent behavior."

At its heart, adolescent behavior is an immature refusal to take into account the potentially catastrophic effects of those low probability events which — should they occur — have very high consequences.

Adults sometimes engage in the same refusal to take into account the potentially catastrophic effects of low probability events, too. I watched the 1958 movie "A Night to Remember" on cable TV recently. It depicts the doomed maiden voyage of the Titanic with much greater historical accuracy than the 1997 epic "Titanic." Why did the Titanic sink? Because Captain Smith, under the influence of the domineering ownership of The White Star Line, proceeded full steam into an area of the North Atlantic where icebergs were known to be silently floating. Even though a collision with a massive iceberg was a low probability event, the consequences of such a collision were huge — fatal, as it turned out, to the ship and to 1,503 of her passengers. The captain and the ship's owners wanted performance more than anything — they wanted to cross the Atlantic in record time. They put performance above any consideration of the catastrophic consequence of a low probability event.

We would never do that, would we?

As mature adults, we are used to guarding against life's low probability / high consequence events. We wear seat belts, we insure our cars, houses, and lives. A bad car accident, house fire, or death are all low probability events at any given moment, but we take care to protect ourselves against them simply because their effects, when they occur, have very high consequences.

But how about when it comes to investing?

Unfortunately, most investors are like the Titanic's Captain Smith. Blindly ignoring the consequences of the market's low probability / high consequence events, they steam into the night in pursuit of high returns.

It doesn't have to be this way, for the stock market has a long history from which we can draw numerous conclusions about its own types of low probability / high consequence events, and about how to deal with them.

Among the conclusions are that the market will suffer a significant decline every decade or two or three, leaving investors with half or less of their money. Those that can hang on may eventually see the market rise again after a number of years to regain its former heights. Those who don't have the luxury of "hanging on" for years, however, are left with broken dreams and reduced bank accounts. Many individual investors, particularly those investing for retirement, are in this group.

Another conclusion that can be drawn is that wise and cautious investment management can mitigate or avoid these failures, making the probability of ultimate investing

success much, much higher.

That's why "Disaster Avoidance" is the first goal of the programs I manage here at Portfolio Strategies. Like the ancient dictum to physicians "Primum, non nocere," which says "First, do no harm," I believe that the equivalent dictum for investment managers should be "First, avoid disasters." Disaster Avoidance means employing tactics which will reduce or eliminate the effects of the market's occasional plummets, while still pursuing decent returns. Disaster Avoidance means not taking chances that will eventually catch up to us. Disaster Avoidance means stepping aside when risk is too high. Disaster Avoidance means surviving the trip. Disaster Avoidance means never having to say, "I can't take it any more — get me outta here!"

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'Disaster Avoidance' continued...

Of course, Disaster Avoidance doesn't mean that a losing week, a losing month, or even a losing year is never experienced. Losses are never welcome, but losses that are not disastrous won't prevent an investor from successfully completing the journey. However, losses that are disablingly large, like those suffered by buy-and-hold investors in the 2000-2002 Bear Market, to say nothing of the multi-year recovery periods that follow those losses, should never occur when seeking to achieve the goal of Disaster Avoidance.

Unfortunately, Disaster Avoidance isn't very sexy. A Disaster Avoidance strategy doesn't get much limelight except in dire times, and the powerful attraction of "what's hot" lures many investors away. Almost by definition, a Disaster Avoidance strategy will under-perform the stock market when things are fine.

The Titanic wasn't the only ship in that area of the North Atlantic on the night of April 14, 1912. Two other ships were close by, the Carpathia and the Californian. Both of these ships were operated under the Disaster Avoidance strategy, you could say. Both had stopped dead in the water, trading potential forward progress for safety. Both went on to successfully complete their journeys (taking with them the few Titanic survivors).

As we enter 2005, I know that whatever the market dishes out, we will deal with it using Disaster Avoidance as the guiding principle.

I'm reassured by that, and I hope you are, too. 🍀