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CONTINUED THREATS OF TERROR:
Is There A Perfect Hedge?

Though 9-11 has become a distant memory to many, cautious investors continue to keep a watchful eye over their portfolios to determine how they will be impacted in the of event of another devastating event. Some choose to allocate a certain percentage of their assets to very conservative investments that are expected to hold up and even perform well in the immediate aftermath and during indefinite periods of uncertainty. Other stand prepared to invest heavily in more aggressive asset classes, believing that the initial movement in the markets is always exaggerated and numerous opportunities will present themselves.

Granted, given the timing, uncertainty, and magnitude of the actual situation, the investment and economic climate at the time, the resources that may be affected, and the long-term consequences, investors may find it challenging to structure the most appropriate hedge to accommodate every "likely" scenario.

9-11 Revisited

Remember, prior to 9-11, the equity markets were already in a tailspin. While many have chosen to blame the terrorist attacks as a major contributing factor, overvaluation within certain sectors, the dot.com bubble, and ongoing corporate governance issues were already negatively impacting stock performance. The equities markets continued their bearish trend in the days, weeks, months following 9-11. The economy slowed and interest rates moved to lower levels. (Prices of fixed income securities move in the opposite direction of interest rates.)

Fast forwarding to today (almost five years later), many of the major indexes have rebounded considerably. The Dow and S&P 500 indexes recently hit six and five year highs respectively (before giving up some ground over the past few weeks). Even the small-cap Russell 2000 index has moved into record territory. International markets have been among the strongest performers over the past few years. Investors who allocated assets to these classes in the immediate aftermath of 9-11 (and had the patience to wait) have been rewarded.

And Today

The economic and market environments are vastly different today. As mentioned above, despite ongoing concerns surrounding real estate and potential price pressures, the equity markets have moved to higher levels and corporate earnings remain relatively strong. The Federal Reserve has been consistently increasing interest rates (to the detriment of bonds) for the past two years to combat inflationary pressures. A new and untested Chairman has taken over the helm at the Fed, leaving some economists longing for the old (often incoherent) days of Alan Greenspan.

Throughout the year, energy prices have been surging through the proverbial roof as consumers continue to feel the pain at the pumps and in their pocketbooks. Corporate management issues are again in the news as politicos debate the policies and principles of energy execs as their related earnings surge (at the expense of consumers). Gold and other commodities recently set new highs as investors seek out that perceived "natural hedge" in an uncertain environment. The next bubble bursting may very well come in the form of real estate depreciation, particularly given the perceived overvaluation along the West Coast and other major markets.

A Common Sense Approach

Though the times are indeed different today than in 2001, cautious investors would be advised to consider the potential repercussions on the economy and the markets that such a dramatic event could have.

- Initially, panic sets in as individuals worry about future attacks and how they will personally be impacted.
- They grow more cautious in their spending patterns, concerned that a prolonged economic slowdown could affect their jobs.
- In particular, (should another 9-11 like attack occur) travel and hospitality sectors are immediately impacted.
- Should US energy interests be damaged, oil prices might surge and severe inflationary pressures could ensue.
- Since consumer activity accounts for about 2/3 of the domestic economy, the subdued spending could bring many sectors to a temporary halt.
- Corporate profitability could decline (dramatically in some industries) which could lead to job losses and further hinder consumer activity.
- Equity markets decline; fixed income serves as a safe haven.

BUT THEN…

- Rebuilding efforts ultimately (eventually) follow and could lead to strong economic growth in certain regions of the country.
- A sense of patriotism may also ensue as consumers look to buy "Made in America" goods and services.
- Additionally, a "*you can't let the terrorists win*" attitude also often follows as politicos beg their constituents to continue their normal routines and lifestyles.
- As time passes, consumer activity should again resurface and lead to strength in certain affected sectors that may be hurt in the initial aftermath.
- Equity markets eventually rebound.

So What's a Cautious Investor to Do?

Investors should consider that "sleep quotient" when mapping out a strategy for dealing with potentially devastating events. Just how much time do they spend worrying about these developments? How much sleep do they lose running various scenarios around in their head? In actuality, this analysis of one's tolerance for risk should be considered when developing any investment strategy. If that "sleep quotient" is high…If memories of 9-11 are fresh in their minds…

Stay Short And Sweet

Dire times lead investors to seek a flight-to-quality and the safe-haven of short fixed income securities. Treasuries in the one to three year time frame represent the most conservative investment for individuals seeking to hedge some of the risk of another 9-11.

The Golden Rule

Gold has long been considered a strong hedge against challenges faced by the economy and the markets. Despite the recent strong surge in the price of gold, the cautious investors may choose to allocate a small percentage of dollars into metals and other related commodities.

Seek Out Overreactions (or not)

In the months to follow, the cautious investors should follow those markets (and even sectors within those markets) for strong declines and potential overreactions. Five years after 9-11, many markets have rewarded patient investors. When the time seems right and logic prevails, consider investing some of those dollars accordingly.

Then again, if this (portion of the) portfolio is truly for conservative purposes, stay short, sweet, and golden for the foreseeable future.