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Weathering an Economic Storm

It's not always about growing wealth. Sometimes it's about keeping it.

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How do you, your family or your clients survive a tsunami? By not being there when it hits. While advancements have been made to global climate early warning systems, the possibility still exists that a disaster will happen without prior notice. The reality is you will be somewhere. Disaster management publications suggest the solution is not to have all of your valuables or resources with you, wherever you are, just in case you are in the right place at the wrong time.

We are currently experiencing a tsunami in our economy, marketplace and financial system, but we did have advance warnings. We were told by prominent investment professionals for almost a year that this pending correction was going to be one of the worst since the Great Depression. People today are fearful of a total collapse and the word panic is appearing in the media with greater frequency. Why did it take so long for people to listen?

What has surprised me is that the stock market indexes have not fallen further than they have. The S&P 500 index is down almost 21 percent year-to-date as of late September and 26 percent from its 52-week high. Since 1946, there have been 10 official bear markets (defined as a 20% drop in equities). On average, in those bear markets the S&P 500 index has seen a decrease of over 30 percent of the market's value and has lasted for approximately 16 months. The 45-percent decline during the 1973 to 1974 bear market has eerie similarities to this current one. While no one can predict when the market will bottom out, evidence seems to indicate that we still have more downside pain to endure and will need to wait a number of months or even years before the markets fully recover.

Planning Is Key to Security

When planning for a natural disaster, Federal Emergency Management Agency (FEMA) suggests having important legal documents, road maps, fresh water, non-perishable food, with medical supplies in your disaster kit and listening to weather updates. A financial disaster kit needs to include a defined set of objectives, excess cash, a policy of keeping things simple, staying educated on current events and being flexible to make changes when required.

Remain calm to think clearly about your alternatives. If panicked, emotional biases can negatively complicate implementation of the disaster plan. Complaining about the low rates of return on their cash positions, clients demand that their funds be invested, right up to the moment they change their minds to call with concern over the safety of the investments and desire to sell all of their holdings.

You need to guide your clients about when to take risk and advise them against unrealistic expectations. Taking profits and protecting principal — to come back and play again when the odds have improved in their favor — should be thought of favorably, rather than a sign of investment weakness. This action is not about market timing, but deploying tactical reallocation when the winds suggest trouble ahead.

Cash Is King

Always remember that “Cash is King” and that your clients can never have too much liquidity. Just ask Bear Stearns and Lehman Brothers. Banks always want to be your clients’ best friends when they don’t need them, but when approached for assistance in times of trouble, a bank’s response is often “sorry, you don’t qualify.” Now, many of banks are hearing their own words repeated back to them.

Reach out to your clients and show them how not to be alarmed by advising them to:

Focus on objectives. Normal amounts of emergency reserves should cover six months worth of expenses. But these are not normal times. Available balances on home equity loans or credit cards could be reduced or outright closed at the whim of the financial institution. Job security is becoming an increasing concern. Building reserves to cover at least one year of expenses is strongly recommended.

Keep defensive plan simple. Have your clients identify specific short to intermediate term cash-flow needs. Have them identify expenses that will come due as far out as four to seven years. Those funds should be carved out of the portfolio to be invested in safe, liquid, income oriented securities with specific maturity dates laddered to be slightly in advance of when funds are needed. Also, your clients should plan for what might still be unknown. Your clients should not be surprised if they receive a call from a child or close relative who has been negatively impacted by the current crisis.

Delve into short-term deposits. Consider using short-term (one- to three-year) Federal Deposit Insurance Corporation (FDIC) insured certificates of deposits, money market funds with large institutions and possibly GNMA (government guaranteed mortgages) in mutual funds with low-expense ratios. The government has proposed increasing the FDIC insured limits to \$250,000 per account, from the existing \$100,000 threshold. They also recently announced that they will insure the safety of money market funds, for at least the next year. If your clients are in a higher tax bracket, you may want to advise them to consider tax-exempt money-market funds or limited-term tax-exempt bond mutual funds.

Your Clients and Their Asset Allocations

The remainder of the investment portfolio is then available for targeting longer term objectives, like retirement. Even here, I believe one should be conservative and avoid unnecessary losses. A 20-percent decline requires a 25-percent recovery just to be back at breakeven.

If a normal asset allocation plan would earmark 60 percent to 65 percent toward equity holdings inclusive of 20 percent to 25 percent in international funds, a prudent allocation today may reduce these allocations to 35 percent and 10 percent respectively. A monthly or quarterly dollar cost averaging strategy can be established to slowly build these allocations higher, once a sense of stability has redeveloped in the marketplace.

Defensive industry sectors for today’s portfolios may include utilities, medical equipment or consumer staples, with a light sprinkling of biotech, science and technology firms for reasonable growth opportunities. Allocate investment choices to include both small and mid-cap funds, to approximately one-third of the equity allocation. Limit the temptation to look at the stock prices, but do listen to the news or read the business section of the newspapers to keep a pulse on the market’s activities.

Any funds invested in equities or growth-oriented securities need to be committed for the long run, with a recognition that what is happening in the market today is irrelevant to valuations that will exist seven to 10 years from now. That being said, try to keep losses to a minimum, by selling losing investments if specific loss percentages are exceeded and harvest losses (if in taxable accounts) to shelter future gains realized during the next bull market.

Consider using highly rated mutual funds for diversification purposes, that have been in existence for at least three years and have managers with a proven track record that include other bear markets. Choose investments that are appropriate for the specific risk tolerance of the investor, minimizing the chances that concerns over their portfolios will keep them awake at night.

Conclusion

It is often difficult to know when to adjust a client's focus from growing a portfolio to protecting what they have already accumulated. However, it is certainly prudent behavior to take one's foot off the accelerator, backing off from normal driving speed, to carefully navigate the road when signs indicate more storm clouds are above.

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