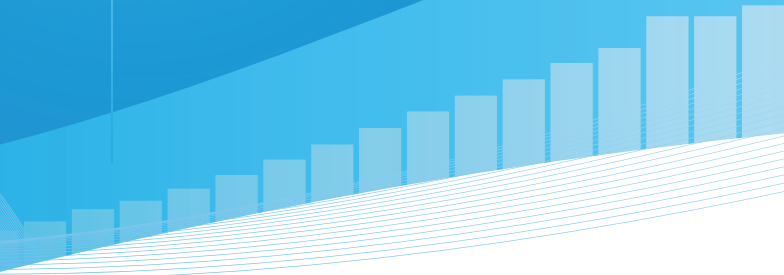


# The Importance of Financial Defense

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# The Importance of Financial Defense

by David Scranton

The great Alabama coach “Bear” Bryant once said, “Defense wins championships,” and you can bet every great coach in every sport has shared that same philosophy. Just think about some of the great sports dynasties, teams that won championships year after year: The Green Bay Packers under Vince Lombardi, the Boston Celtics under Red Auerbech, the Yankees under Joe Torre... You could go on and on. All of these teams knew how to score, yes, but they all started with the premise that a strong defense made their offense better. Strategically, they knew how to win games, but they focused first on strategies that ensured they wouldn't lose games.

Why is that same approach so critical when it comes to your finances and, in particular, saving and investing for retirement? Well, it's simply because when you're talking about your “life savings,” losses can potentially have a huge impact on your life! How huge? Well, consider the fact that if you have all or most of your investments in the stock market and your portfolio loses 50 percent of its value, you need to regain 100 percent of it in order to break even; that takes time, and depends on the market not dropping again.

The fact of the matter is, this very thing has happened to domestic investors in the US twice in the last 14 years. From the beginning of 2000 through March 2003, the stock market, based on the Standards & Poor's 500 Index, dropped almost 50 percent. It took until October 2007 to recover. That means it took approximately three years for the market to drop by nearly 50 percent and then four-and-a-half years to make a 100 percent gain and get back to where it was some seven-and-a-half years earlier. Then, lo and behold, it dropped again, and this time it again took roughly seven years to recover to its previous high. So: two drops of approximately 50 percent or more and subsequent rebounds in the last 14 years.

**Time is Money**

So, let's go back to the question: "how huge" an impact did all this have on investors oblivious to the importance of financial defense (and who may, in fact, still have most of their money in the market despite those two major drops)? To see the real impact, we have to look further than just the fact that these investors have twice had to re-double their lost gains, and have experienced virtually no portfolio growth over this entire period; we also need to consider the amount of time that has elapsed.

For an investor to recover from a 50 percent loss with a 100 percent gain over, say, 10 years, he would have to average 7 percent a year over the length of that recovery period. By the same token, to make the recovery over 7 years, he would have to average about a 10 percent average growth rate. So in that sense those investors from March 2003 to October 2007 were lucky because they made that 100 percent, break-even gain in only 4-and-a-half years, which represents an annual average growth rate of 16 percent. That sounds pretty good until you factor in a little thing called inflation. Over the last 14 years, investors lost approximately 25 percent of their buying power due to inflation. That means what was worth a dollar 14 years ago was, by the end of last year, worth only 75 cents.

But let's go further and factor in something called "lost opportunity cost." Whether we're talking 4 years, 7 years or 13, consider the fact that investors waiting and *hoping* to regain stock market losses over all that time could have been earning money elsewhere. For many parts of the 2000-to-2007 period we're talking about, for example, those investors could have had their money in FDIC-insured bank CDs that were averaging somewhere between 3 and 5 percent annual returns.

The point is that when you add inflation to lost opportunity cost, it's pretty easy to see that those investors so relieved when their portfolios finally regained their original value over the course of several years, *really* recover or break even. They did, in fact, experience losses, and depending on what alternative investment options they might have pursued, those losses might have been significant.

## **Two Questions**

So, with two major drops of 50 percent or more having occurred in just the past 14 years (one of them in conjunction with this country's worst economic downturn since the Great Depression) investors today – especially those at or near retirement age – need to consider two questions: 1) Is another major drop possible? And 2) If it happens, how huge an impact might it have on you?

Regarding the first question, an in-depth analysis of stock market history clearly suggests that a third major drop in the wake of the previous two is not only possible within the next 10 years, but actually probable. As for the second question, it depends, of course, on how much attention you're paying to financial defense in your own portfolio right now. But to give an idea of the potential personal impact on someone utterly ignoring financial defense, let's take a worst case scenario:

Let's say a gentleman who retired in 2000 stayed invested in the stock market and started to draw income. Let's assume his portfolio value is \$1 million, and he's drawing \$50,000 per year. We said before that from 2000 to 2007, the market dropped by 50 percent and then recovered. So that's a net result of zero growth over seven years – which means that if this retiree was taking out \$50,000 a year over that time, he would have taken \$350,000 out of the portfolio. With zero growth, that simple math says he would have had \$650,000 left seven years later in the year 2007. Unfortunately, however, the impact would have been far worse.

That's because in the years when the stock market dropped and he still needed to take out his \$50,000 per year, his investment advisor or mutual fund company had to liquidate more shares in those years to give him that same amount of income. As a result, this poor retiree cannibalized the fund, and by the time the market came back in 2007, he might only have had \$500,000 or less left invested – half of his original portfolio or not even that!

### **Misguided Optimism**

It may seem surprising to think that an investor such as the one in the example above might remain committed to a "buy and hold" strategy in the stock market even

after an experience like that, but it's not uncommon. Part of the reason is human nature; some people are hard-wired to be optimists, which is an admirable quality, but can have its drawbacks where investing is concerned. But the main reason even people who've been badly impacted by financial losses continue to ignore or short change financial defense is that much of the financial services industry does likewise.

One reason is that a lot of people in the industry are salesman first, advisors and educators second, and their first priority is to move product. Obviously it's easier to move products that are "sexier" and well known, and in their case that means stock-based products. For a salesman, the stock market is the path of least resistance, the easiest sell. (Coincidentally, it also happens to be the one with the best potential to earn him high fees and commissions over the long run.)

The main reason so many brokers and advisors virtually ignore financial defense, however, is simply that much of the financial world is in the business of selling optimism. It starts, not surprisingly, with Wall Street, whose CEOs and shareholders have a vested interest in keeping you invested in the markets, and know you're more likely to stay invested if you're optimistic and believe the market is forever on the upswing. From there, a majority of brokers and advisors fall dutifully into the role of becoming "stock market cheerleaders," stubbornly urging you to hold on and trust in a long-term market rebound – even when there's an overwhelming amount of historical evidence out there to suggest that our current secular bear market cycle still has a long way to go, and that another major drop is probable.

So, how can you get started on building a financial strategy with a solid defense that Vince Lombardi would have been proud of? Simple: by contacting a qualified financial advisor who specializes in the universe of non-stock market alternatives designed to generate income through interest and dividends. This is income you can spend if you're retired, or that you can reinvest in order to grow your portfolio organically, or "the old-fashioned way," with far less worry over damaging losses that could impact your life and sideline your retirement plans.