THERE IS NO SAFE PLACE

By Ernie McDaniel

This is sixth in our series of articles taken from my forthcoming book Three Miracles and Seven Secrets and the discussion today is of the third secret-"There Is No Safe Place". While our suggestion that there is no absolutely safe place, not even banks, may sound discouraging, it is also true. Fortunately, if you understand better the potential threats that do exist, you can take steps to reduce overall risk for retirement investments through investments in more than one place.

You can-will you? Please don't forget the important message of the first secret, the subject we addressed two months ago in this column: denial and procrastination. Pretending there's no real problem guarantees there will be no real solution. Today we hope to help you, through providing important information, to "get real".

First, a little more background. In the August issue of Best of Times we discussed the second secret, one involving the value of diversification, the complexity that may accompany it, and the conflicting need for simplification. Today, we refine our understanding of diversification and of risk.

Have you ever considered that diversification makes an investment mistake more likely? The greater variety of investments you have, the greater likelihood at least one of them will go badly. On the other hand, diversification makes the likelihood of a big, catastrophic mistake less likely. Which is your preference, the virtual certainty of little mistakes or the less likely but still quite possible one that destroys your financial future?

I mentioned above that even money in the bank has risks, so let's consider more closely the investment risks of a certificate of deposit (CD). In last month's article we addressed the issues of low interest, taxability, possible exposure to probate and suits for bank deposits. But there are more considerations than this. Do you know when, after what delay, you would be returned your Federal Deposit Insurance Corporation guarantee of $100,000 in case of a bank failure? Are you familiar with the FDIC reserves, at what level they are maintained and what happens if they are depleted? Yes, the government backs the FDIC with its full faith and credit, but where does the government get the money? Well of course, Uncle Sam can print it! But that could cause hyperinflation. End result: you might get your payment later and in dollars that don't buy as much. There is no safe place.

How about the risks of gold? Land? Commercial properties? History is full of booms and busts for virtually every tangible investment you can imagine. Obviously each of these may have its unique advantages. But what about disadvantages, including the risks beyond the obvious danger of boom-and-bust? For example, how do you store gold securely and inexpensively? Experts recommend against the local bank vault-not accessible enough in a crisis, they say. Land and commercial properties must be managed and maintained, and these responsibilities entail risk as well.

To talk about risks of the stock market may be unnecessary after the performance of the first three years of the New Millennium. However, some say the tough times are over for good. We all hope so, but we shouldn't base our investment decisions, our diversification decisions, on hopes. There are many highly respected investment professionals (for example, the septuagenarian Richard Russell of Dow Theory Letters fame, with over forty years of experience) who say that we are presently in a "secular" bear market. They say this longer term downward trend will be interrupted by short-term

rallies, what some call “sucker” rallies, but the negative trend is likely to continue for many years. Before the long-term bear market trend reverses, they observe, the stock market could be reduced from its present level by 50%. Pessimists among them predict much worse!

The bond market? It has its on risks. It can certainly be quite volatile with interest rate changes. When interest rates go up, bonds tend to go down in value, just as they go up when interest rates go down. During tough economic times, there is also an increased risk of default for both corporate and municipal bonds. Bonds are basically loans, and there is the possibility you may not be repaid your money.

Okay, now we have talked briefly about several different kinds of investment and some of their accompanying risks-so how does all this relate to diversification? Diversification can be effective as a risk reduction technique because it is a mixture of not only different kinds of investment but of different kinds of risks, risks that in a sense balance against one another. Thus-and you may need to digest this one a little-increasing one kind of risk can reduce the over all risk of your portfolio. Consider an analogy. Think of two kinds of risks playing tug-of-war, the idea being that they will not both lose. (But, hey, there are no guarantees-the rope may break!)

In summary, while there is no single safe place, there are methods of reducing risk through careful diversification. The chances of “making a killing” are reduced when you are diversified, but so is the risk of being “killed”. Again, as counter-intuitive as it may seem, increasing one kind of risk, and by this, diversifying risks in your portfolio, may reduce total portfolio risk. Risk reduction in our retirement years, thus making those years as secure as possible, is something to which we can all relate. But even diversification fails to absolutely assure against loss. That assurance does not exist.