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Taking Stock by Nino Boezio

Should We Worry About Terrorism When We Invest?

In dealing with a number of major investment clients the past couple of years, an issue that often comes up is what to do if something really bad happens. A serious terrorist event can send equities down as much as 30 percent in a short period of time. (Al Qaeda regularly boasts about the devastating new attacks it is planning.) Economic confidence can be shaken very quickly. And despite interest rates being already quite low, there is not much room to take them lower (if required) to further stimulate the economy.

Should we worry about a significant terrorism event ever happening again, is there a way to safeguard or mitigate against it or should we behave as though it will not happen? I have had some interesting conversations with investment advisors and portfolio managers that highlight some of the thinking that exists in the marketplace.

1) We have to invest as though it is business as usual. We cannot remain crippled in our decision making because we fear the worst may happen again. It may not, and if we do behave as though it may, we lose out on investment opportunities and thus suffer regardless.

2) It is, or should be, understood by investors that when something cataclysmic happens, all bets are off. These events should, to a large extent, be considered unusual circumstances that are outside the portfolio manager or advisor's control. One has to give investors the best advice possible, react with the best information available and try to address all of the client's needs and concerns as currently identified.

3) Whatever takes place, we may have to learn to live with it. We may need to adapt. We, as a society, should try to get used to it. The markets will adjust too.

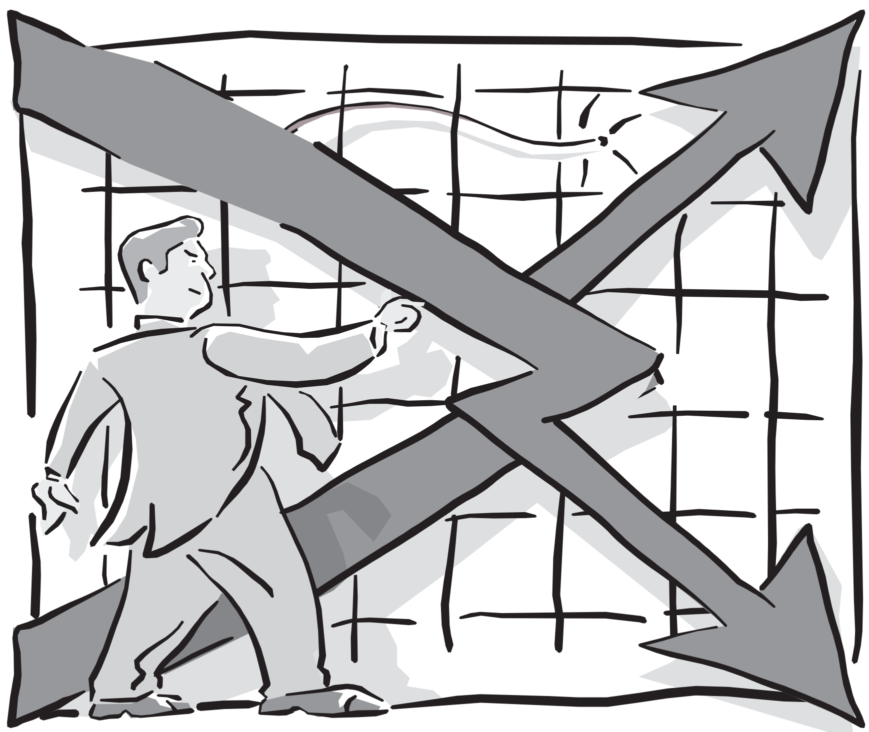
4) If something cataclysmic does happen, and an individual investor will thus suffer greatly because of it, could the suffering have been avoided? Was the investor too leveraged by holding too much debt in other parts of their personal balance sheet? Were they maintaining expectations that were too high for their standard of living, or incurring too many unnecessary expenses anyway? It is always interesting at times to hear of people who have come from humble beginnings that have achieved great wealth either through industry or by being a celebrity, etc. Some of these people can no longer survive on several million dollars of income a year! Something went wrong in the way their finances and expectations were being managed—something that really should not be blamed on anything or anybody externally. It was a disaster waiting to happen on its own merits. Financial plan-

ning thus becomes key to many individuals who do not really appreciate the relationship between debt, costs of living, income and investment return.

5) Pessimism will fade as time passes. All other periods have had excuses as to why it is different this time, or reasons as to why the good times or why the bad times will continue. We need to be prepared for the time when the investment cycle will shift in the other direction. This cycle shift is something that has been difficult to learn and accept because it is difficult to predict. Emotion has to be understood as a problem that governs our decisions too much in the short run, and that can cripple someone from making rational decisions until it is too late.

6) The next event, even if it's of similar proportion to a prior event, will have a much lesser effect. The world may have appeared to be coming to an end when a similar event happened before—but instead the world survived, and people's lives continued. When something similar happens again, people know it will eventually work out to a sense of normalcy again. Hence a bad investor reaction will not be as severe as the prior one had been.

7) Concerns may have already been factored into market performance and expectations to some degree. Market prices already reflect this addition to the risk premium; therefore, such worries are to some extent already factored into the market.



8) Sometimes we have an opportunity to further educate our investor base. For example, a client may have not considered life insurance, estate planning or other products, until they have witnessed events that further illustrate life is unpredictable. They have not considered the market upside or downside from various other points of view before, or felt that they were smart enough to "see it coming." Unfortunately, in any market decline of the past, no one really saw it coming for the longest time, even when their portfolio declined for a number of months. There is often overconfidence in investors when markets are going up, which sometimes translates to an unwillingness to listen and a belief that they will also know when markets are headed for a fall. Now we can better emphasize that no investor can be assured that conditions will always remain the same, and that it can be foreseen. Hence they should be more willing to listen to the weaknesses in the construction of their personal portfolio.

9) Can we be creative? In the early 1990s we saw all sorts of papers, discussion groups, committees and forums arise that addressed matters involving derivatives and other financial products and services that were coming to the marketplace. These things were new in many cases. We needed to come up with new attitudes and approaches to use and address these new tools. In some sense, the latter 1990s still had much discussion regarding these same tools, but nothing particular new was invented. Perhaps now we need to once again come up with something completely novel to address the needs of the future. Sometimes we just need to package these tools differently.

10) More credibility to discuss a doomsday scenario. Now we have a better opportunity to discuss the worst-case scenario. Before worst-case scenarios were considered to be largely hypothetical and "pie-in-the-sky" prognoses. Now there is a greater proclivity for investors to listen to such scenarios and for us to bring up the matter since we now know that such bad events can happen with much more likelihood than previously envisioned.

Some people today do not feel confident that we will bounce back as when we were coming out of past recessions, but this era that we are currently living in has not been unprecedented. There has always been something to worry about, or in times of prosperity, something to be exuberant about.

Unfortunately we have been accustomed to a safe society where bad things always happened overseas. However, in the past few years we may have felt uncomfortable, given that we saw dangers that we were not used to seeing. In 2003 for example, we saw disease such as SARS which has no quick medical solution; hence the only solution is quarantine. This was not a scare we have had for a very long time in North America, or for that matter, the world. Doctors and new medicines always solved the problem before. We even had hints of mad cow disease, West Nile virus and some other potentially dangerous epidemics that threatened to dot our northern landscape. This does not mean that we should worry, but rather that we may have to come up with new modes of living that may have to recognize that there are other things to keep in mind when undergoing various actions. This is also true investing. In a sense, terrorism may foster a sense of conservatism that we may now need in the marketplace. Before, the average investor may have been too aggressive in their investment posture. Perhaps an institution sponsoring an insurance product or pension plan did not pay as much attention to the relationship of assets and liabilities as it could have. Now that policy may have to be changed. In the process, risk will become better understood, common sense can replace, to some extent, the irrational behavior or excessive risk taking of the past and we will all appreciate our financial situation much more, and won't expose ourselves to unrealistic expectations as much.

We do not like trouble and uncertainty in our life. On the other hand, there may be times when we should view such situations as an opportunity to develop and foster new solutions to help our lives and the lives of others over the longterm. Those organizations and professionals that are able to offer new solutions successfully to their clients ultimately achieve the best results for themselves and society as a whole. Hopefully the actuarial profession can respond to the challenge, since we are the best qualified to quantify such risks in the marketplace.

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