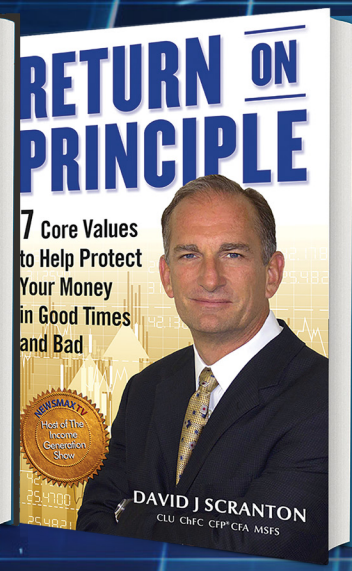
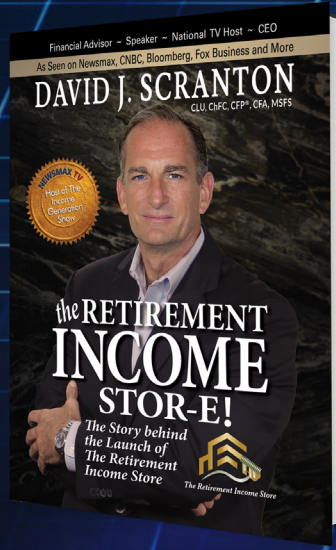


# The Importance of **FINANCIAL** *Defense*

- Is Another Major Drop Possible?
- If it Happens, How Huge an Impact Might it Have on You?



David J Scranton's financial game strategies  
Visit at [amazon.com](http://amazon.com)



# The Importance of Financial Defense

The great Alabama coach “Bear” Bryant once said, “Defense wins championships,” and you can bet that almost every great coach in nearly 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” Auerbach, 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 will need to regain 100 percent of it in order to break even. That takes time and depends on whether or not the market drops again.

The fact of the matter is, this very thing has happened to domestic investors in the US twice in the last 20 years. From the beginning of 2000 through 2002, 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 two years for the market to drop by nearly 50 percent and then five 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. This time, it took roughly seven years to recover to its previous high. So, there have been two drops of approximately 50 percent or more and subsequent rebounds in the last 20 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 (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 the fact that these investors have twice had to re-double their lost gains with virtually no portfolio growth over this entire period. We 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, they 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, they would have to average about a 10 percent average growth rate. In that sense, those investors from March 2002 to October 2007 were lucky because they made that 100 percent break-even gain in only four-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 20 years, investors lost approximately 42 percent of their buying power due to inflation. That means what was worth a dollar 20 years ago is now worth only 58 cents.

But, let's go further and factor in something called "lost opportunity cost." Whether we're talking 4 years, 7 years, or 13 years, 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 3 to 5 percent they could have earned while their market losses were recovering to previous levels is the lost opportunity cost.

The point is that when you add inflation to lost opportunity cost, it's pretty easy to see that those investors who were so relieved when their portfolios finally regained their original value over the course of several years, didn't 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 the past 20 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?
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 possible within the next 7 years. 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 another major drop could have 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. 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, he would have had \$650,000 left seven years later in the year 2007. Unfortunately, however, the impact would have been far worse.

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 would have had to liquidate more shares in those years to give him that same amount of income. As a result, this poor retiree would have cannibalized the fund. By the time the market would have come back in 2007, he might only have had \$500,000 or less left invested — half of his original portfolio or less!

## 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 hardwired to be optimists, which is an admirable quality, but it can have its drawbacks where investing is concerned. The main reason that even people who have been badly impacted by financial losses continue to ignore financial defense is that much of the financial services industry does likewise.

A lot of people in the industry are salesmen first and advisors and educators second, and their first priority is to move product. It’s easier to move well-known products that are “sexier,” 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 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. They know you’re more likely to stay invested if you’re optimistic and believe the market will forever be 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 I believe there is some historical evidence out there to suggest that we could in a secular bear market cycle that still has a long way to go and that another major drop is possible.

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 investments designed to generate income through interest and dividends. This is income you can spend if you’re retired or 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.