

HEADLINE NEWS



The immensely destructive tsunami in Southeast Asia, hurricanes in Florida, continued fighting in Iraq, economic problems and corporate scandal are only the latest in the parade of global events that shape our modern lives and can affect our investments. But with careful planning the events in the news don't have to derail your investment strategy.



Remember Y2K? Remember also how it failed to live up to the gloom-and-doom predictions of computer disaster? Unfortunately, that calm New Year's Eve has been followed in the past few years by numerous disasters, both natural and man-made. The constant drumbeat of disturbing images on 24-hour cable news has made investors jittery and motivated them to search for ways to protect their assets.

In fact, over the past few years the severity of losses caused by natural disasters has increased. Rapid population growth in areas prone to natural disasters means more homes and businesses now lie in the path of potential destruction. And unfortunately, these events are happening more frequently.

MINIMIZING DISASTERS' EFFECTS

From mudslides in California to hurricanes in Florida, natural disasters have large economic

impact on the communities where they occur. Protecting property and other assets begins with proper insurance and preventive measures to mitigate risks. By following certain building practices that minimize the damage suffered during a natural disaster, insurance policy holders may receive discounts on their premiums. Some insurers in hurricane-prone areas, for example, have begun offering credits to customers who install storm shutters or other protective devices for doors, windows, skylights and vents.





Catastrophe bonds are another tool to mitigate the effects of these natural disasters. “Cat” bonds are typically sold by insurers to counterbalance the potential claims from a specific occurrence, such as an earthquake in San Francisco. In turn, buyers of the bonds, typically hedge funds and institutional investors, receive hefty interest payments of up to 15% per year. If the event — such as an earthquake —

other types of fixed-income securities make them an attractive investment strategy to some investors.

WEATHERING THE STORM

While extreme catastrophic events grab headlines, more common weather shifts such as extreme heat and drought, lack of snow or too much rain all can pose risk to weather-dependent businesses.

Those whose livelihood is dependent on the weather — Florida citrus growers, California vintners, owners of golf courses or ski resorts, even clothing manufacturers and retailers — may want to consider purchasing weather risk management contracts or weather derivatives. Weather derivatives are contracts purchased by companies to hedge against the risk of weather-related losses. Unlike insurance, which covers low-probability events like tornados and hurricanes, weather derivatives cover high-probability events, such as a colder than expected summer.

Weather risk contracts are becoming more common. In fact, the underlying value of weather risk management contracts transacted from April 2003 through March 2004 increased by nearly \$400 million to \$4.6 billion compared to the previous 12 months, reports the Weather Risk Management Association, a Washington, D.C.-based trade group.

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occurs, the insurer’s obligation to pay interest and/or repay the bond holders’ principal is either deferred or completely forgiven and it uses the principal to pay the claims. However, if the disaster does not happen during the life of the bond, the principal is returned to the buyer.

These investments are certainly not for everyone. But their relatively low correlation with equities or

TERRORISM FACTOR

Though natural disasters such as floods, earthquakes and hurricanes can severely damage a region’s economy for a short time, the horrific events of 9/11 have continued to affect the U.S. economy, says John Binder, associate professor of finance at the University of Illinois at Chicago. “Obviously what followed was the war on terror

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and more of the economy funneled toward defense,” Binder says. “There is just a finite amount of resources that can be devoted to producing both military and private goods.”

In this new environment, individuals must decide whether to adjust their portfolios in order to protect their assets from the economic shocks that can be created by a terrorist attack. The more prudent response may be to take a deep breath and avoid hasty, emotional responses that can be counterproductive.

“Typically these exogenous events [short-term shocks to the markets, such as the events of 9/11] bring on a strong emotional reaction, and even an overreaction,” says Northern Trust’s Chief Investment Officer Ori L. Dudley, Jr. “Usually it is detrimental to your financial health if you react to them in a short-term emotional way.”

In fact, research has shown that it does not pay to overreact to major events. For example, while the U.S. stock market plummeted 7.1% on the first trading day after 9/11, the market rose 9% in the following six months, according to Ned Davis Research. The firm analyzed how 37 crises in the 20th century, such as the attack on Pearl Harbor and the assassination of President John F. Kennedy, affected the stock market. On average, the firm found that the Dow Jones industrial average dropped 6.1% on the day of the event, or when the market re-opened if it was shuttered when the catastrophe occurred. But six months after the event, the Dow had risen 2.5% on average. And a year later, it was 8.3% higher on average. (Those returns include the decline during the event.)

TURN OFF THE NEWS

Experts say that it is probably futile to chase profit from the problem or event of the day. Instead,

investors benefit from following a strategic, rather than tactical, investment plan — constructing a diversified portfolio based on their individual financial picture and goals and rebalancing it regularly.

“With strategic asset allocation, your portfolio’s allocation is based on your entire financial picture: risk tolerance, liquidity needs, income tax situation and an estate plan,” explains Mike Simmons, a senior vice president in Northern Trust’s Wealth Advisory Group. “In general, after you’ve developed your strategic allocation, you stay with it.”

In contrast, someone who follows a tactical allocation strategy says, “I think stocks are going to do this in the coming quarter or bonds will do that, and based on that I am going to change the asset allocation,” explains Simmons. Strategic allocation makes more sense for two reasons: First, it is more tax efficient because if you change the allocations every quarter, you will end up paying more taxes and have higher transaction costs. Second, it is nearly impossible for anyone to accurately predict the movements of the market enough or be able to foresee these crises to capitalize on them in advance.

The bottom line is that successful investors must turn off the news and concentrate on constructing a diversified portfolio that can generate positive returns, regardless of the news of the day. As Dudley sums it up: “You don’t construct a portfolio in anticipation of a short-term event.” Instead, he emphasizes that an investor should focus on longer-term investment horizons and risk controls. “One must recognize that if you construct a portfolio properly for the economic and business cycle that you are in, you will meet your objectives. That is our approach.” ■