THE NEW RISK IN STOCKS - OR WHY DIVERSIFICATION IS IMPORTANT

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As most of you know, I am a strong believer in free enterprise, the ingenuity and innovation of American business and consequently I am normally bullish on stocks for the long haul. However, when the author of the 1999 best seller *Dow 36,000* has reason for concern it gives me reason to pause. Here is the author, James Glassman's reasoning from a recent Wall Street Journal editorial titled "I Was Wrong About Dow 36,000", February 24, 2011.

In 1999, James Glassman co-authored a book entitled *Dow 36,000* in which he gave a case for the Dow Jones Industrial Average reaching 36,000. The Dow Jones Average at the time when the book was published in September of 1999 was 10,318. Therefore the authors were extremely bullish on stocks and advised investors to load up. Since the Dow is currently slightly over 12,000 12 years later, his optimism seems to have been exaggerated.

Glassman has reexamined his points from 1999 to see where he was mistaken. The major changes are as follows:

Slower U.S. Growth:

The Congressional Budget office projects 2% growth for the U.S. economy for the next 70 years compared to a 3.5% growth rate for the second half of the 20th century. According to the author this is a "staggering" change. According to Glassman, some of the reasons for this slower growth rate may be the fewer number of workers supporting the increasing number of retirees, the preference for European type security, the inefficient investment in human capital which includes declining K through 12 education, and enormous build up of regulation designed to prevent financial catastrophes of the last few years.

The New Risks in the World Today:

Glassman in 1999 considered only market volatility from security prices and he noticed that even though stocks had volatility (up and down price movement), that if an investor held long enough this risk was modified dramatically or flattened our dramatically. In other words if an investor held stocks for 10 or 20 years that downside volatility was offset by the higher return. Statistics backed up that view.

Today however, with the benefit of hindsight, he now believes there is a new risk of what he calls discontinuous risk or "uncertainties". Some examples of this would be the murder of 3000 Americans in a single day by terrorists, the “flash crash” of last year in which the Dow lost 1000 points in a few minutes due to computer glitches, or the sudden crash in home values. He quotes economist Frank Knight who says that this risk is growing in a world where “technology provides instantaneous connections among markets which allows almost anyone to do anything: anywhere.”

Glassman admits that he could be wrong again. Maybe the US will pursue policies that will promote faster growth, like free trade and more and better training and education for workers. Maybe the world is not riskier than it has been. However, he concludes that this is a time of caution and advises investors to protect themselves by lowering their exposure to stocks to something like 50% stocks and 50% bonds or fixed income. Alternately, he suggests hedge funds that do well in bear markets as a protection from these new risks.

Finally, although he stills tends to believe that stocks are good long term investors, he notes that in extreme bear markets, human nature causes people to sell at the bottom rather than hold on for the recovery. This panic selling resulting from fear or a need for cash is another reason that has forced him to reevaluate his original recommendation. He now says that investors should be more cautious.

The bottom line of this commentary is that it is important to try and diversify among different types of investments to help protect again all types of situations. Cash, insured certificates of deposits, treasury bonds and other guaranteed investments offer safety and liquidity. Treasury Inflation Bonds offer protection against inflation, as does gold and commodities. Stocks are still an important part of an investment portfolio but these should be diversified also. Owning multiple stocks or several funds provides diversification as does owning different styles, growth, value, and different size stocks, small, medium and large capitalization as well as international stocks. This is not a time to be fearful but it is a time to be cautious and prudent.

Remember, every investor’s situation is unique, and it is important to review your specific situation with a financial professional.

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