AFTER THE CRASH – WHAT NOW?

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After the recent stunning price decline on Wall Street, two questions arise for investors. One is how to handle one's investments and plan financially for the future. The other is how serious and lengthy the economic downturn will be. The two are interrelated, with the answer to the economic question driving investment and planning strategy.

SITUATION ASSESSMENT

An economic downturn is 99% certain. This is not because of the wealth effect or even the confidence effect of the stock market's decline, but rather because the financial system itself is fragile and seriously injured. If banks cannot or will not lend, and if Wall Street is unable to raise capital for corporations or for municipal governments, businesses will suffer and they in turn will lay off employees. Severity of the downturn is an open question, in terms of both duration and severity. Will it be a painful recession, or – the word no commentators are using – a depression?

Arguments for expecting a recession are that:
..1.. the consumer always manages to pull the train and get things moving again. But this
..…time the consumer collectively is less able to spend freely than in other cycles.
..2.. the Fed and other central banks will provide massive liquidity to end the gridlock
..3.. economic growth in China/India and other developing nations is strong enough to shield the world economy from more than a recession
..4.. U.S. domestic political realities under either party require that a fix be found
..5.. authorities are unlikely to foolishly repeat the policy errors of the early 1930s
…...(raising taxes, protectionism, credit contraction)

Arguments for a severe recession or a depression are that:
..1.. massive de-leveraging worldwide has begun and will not end quickly or painlessly
..2.. a (negative) wealth effect will drive down consumption; this is the second major setback for investors in the past decade
..3.. driven by fear, consumers will raise their savings rate to repair their future financial prospects and in so doing will impose a lasting drag on consumption growth
..4.. two stock market busts in seven years will cut willingness to take risk for some time
..5.. lack of bank credit cripples small and large businesses, raising unemployment and generating a negative snowball effect
..6.. many businesses are heavily leveraged, so prospects for failures are higher than usual

IMPLICATIONS FOR ACTION

At a minimum, households should sharply increase their savings rate and reduce their debt, to lower their risk and improve their future financial asset pools. Both actions will depress consumption, lengthening the recovery process for the collective economy.

Investors should consult any of the many credible financial calculators to figure out what amount they need to save and invest to repair their future wealth back to target levels.

Households and individuals need to pay much more attention than previously to understanding risk and reward generally and the process of smart investing specifically. That is why the Retirement Investing Institute was created: to help people.

By learning to make their own decisions intelligently (this is NOT rocket science!), people can cut the majrl drag on returns that commissions and advice fees impose

…Learning investing will help people to ask smart questions and avoid pitfalls/scams

…Investors must learn to avoid the dangerous allure of high-yield investment products (see essay on this point elsewhere on this website).

…Using fee-only financial planners, discount brokers, and no-load mutual funds will rid investors of avoidable costs and free them from being sold inappropriate "products."

SPECIFIC AGE-RELATED ISSUES

Time remaining to retirement is a crucial issue. Longer horizons allow more taking of risk to repair damage. Extending the career beyond earlier plans may be advisable. A person's natural risk-taking profile will also drive decisions. One should not invest outside a personal comfort zone, since adverse market moves will then drive panic selling at bottoms. It may be necessary to adjust one's prior plans regarding legacies and charitable gifts, since assuring financially comfortable retirement is the first necessity.

The recent losses of investors' wealth certainly hurt emotionally. However, if a depression is not forthcoming one's income stream should not be greatly affected. The problem comes if a person or household had structured their plans to live partly off income and partly off capital draw-downs. The latter source is now compromised and selling assets to live will reduce the pool on which future income can be earned.

INVESTMENT STRATEGIES

The Retirement Investing Institute does not provide individualized investment advice. However, given the current economic outlook some approaches seem prudent for anyone in their fifties or older who does not have huge wealth.

The first question raised above was whether we will have a recession or worse. Each investor must make his/her own judgment and structure holdings accordingly. With at least a recession now starting, the following investment tactics are in order:

..1.. do not own any junk bonds (or such funds), as defaults are only now starting

..2.. because of a weaker economy, even the massive inflationary stimulus already voted will not likely cause inflation near term, so it is too early to own TIPS bonds/funds.

..3.. Deflation is more likely than inflation, so currency and commodity positions are high risk until the world economy bottoms out.

..4.. Gold is already up on fear rather than on inflation prospects, so is not an ideal holding now.

..5.. Strictly adhere to the new higher $250,000 FDIC insured-amount limits on bank deposits. Do not risk capital loss by having any deposits whatsoever at non-FDIC banks for higher yield.
..6.. Unless you are a risk-seeking, adventurous investor with a proven record of contrarian success, avoid all exotic and illiquid holdings. Things just change too fast to take such risks when prices move viciously. People have more trouble selling than buying!
..7.. While the U.S. dollar may be in trouble over the longer term due to inflation, in the near term a world recession will make the dollar seem a safe currency, so anti-dollar plays are not now well timed although they were in recent years. Therefore international investing is for only the very brave.

ASSET ALLOCATION

A useful yardstick is the "Rule of 110;" It says the amount of your capital invested for growth should be your age subtracted from 110, in percent. Example: for a person aged forty, 70%. Check your position every six month or so, including now. Low stock markets will create a situation where you should add to what you fear (stocks) while it is low, just as a high market in 2000 would have signaled time to sell and avoid more of what you loved (stocks). This guideline helps its followers to buy (some) low and sell (some) high.

If you believe western capitalist economies will survive, taking a courageous long view is the proper policy, although doing the right thing always feels scary at the time. Only if you expect a depression should you abandon all hope in equities and hold long-term U.S. government bonds only. They will be principal-safe and should rise in price as inflation is reversed and interest rates fall due to low economic activity.