RETIRE IN STYLE

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BEING PREPARED FOR AIR POCKETS

Just like an airplane pilot, one of the biggest jobs for a financial advisor is knowing how to be prepared for the worst.

Imagine a pilot, flying along at 45,000 feet on a crystal clear day, and he suddenly hits an unexpected pocket of turbulence, known as an "air pocket." It has happened before, and is in fact expected, but no amount of preparation can stop his heart from nearly popping out of his chest when he flies through one. Air pockets are essentially turbulence on steroids – unforeseen events that leave you gasping for air.

Actually, flying and investing have much in common. Sudden drops in the stock market are bone chilling, yet just as the plane is built to handle sudden changes in altitude, so should portfolios be built to weather any unexpected turbulence in the markets. We can't eliminate the natural instinct of fear and panic, but we can certainly prepare for it and recognize it for what it is: fleeting.

In the market, people are so focused on the upside and how to get an extra return, they forget to look out on the horizon and answer, "What if? What if an air pocket sends me for a ride? Is my portfolio prepared, and, more importantly, am I psychologically ready?"

As air pockets in the market expand and volatility increases, the probability of a significant drop in the market rises substantially. The 1000-point intraday drop of the Dow on May 6, 2010, the "flash crash," was a game changer. It proved that large sell-offs can and will occur. What is worse is that headlines such as "Trading Glitch Caused Market Drop" and "Congress Seeking Answers to Drop," were meant to pacify rattled investors without a disciplined risk management process.

While in less volatile times, air pockets in the market are very random; the ones we are experiencing lately have been planted akin to landmines – driven by sovereign stimulus and the false assumption that piling debt upon debt upon debt is the answer. There seems to be a governmental air pocket between reality and hope. Europe has given us a warning shot across the bow. But has it registered?

The United States, the veteran pilot of the world's reserve currency, must realize that someone needs to take control of this plane lest we transition from air pockets into a flat-out nose dive from which we cannot recover. With the U.S. deficit as a percentage of Gross Domestic Product (GDP) in the same area as Greece, we can't keep flying through storms and expect to emerge completely unscathed. The world is currently the victim of a grand Ponzi scheme, with central banks playing the role of Madoff, borrowing from one to pay off another. Currently, the U.S. represents the best of the worst. As the Dutch scholar Erasmus said: "In the land of the blind, the one-eyed man is king."

Over my long career, I have been, at times, a bear and, at other times, a bull, but the fact is: I am a realist. Just like a pilot, I remain alert and cognizant of risks on the horizon. I prepare rigorously for the worst, and hope for the best. In my opinion, it's the only way. Managing risk with a disciplined investment process is just as critical as systematically preparing for every flight with a checklist. On a daily basis, I choose whether or not to seek to advance or protect, with a fundamental focus on protecting clients' wealth. Sun-Tzu, the legendary military strategist from the ancient Far East puts it simply: "One who knows when he can fight, and when he cannot fight, will be victorious." Advance and protect. Prepare for the unexpected. This sounds very basic, but most investors are naturally reactive, not proactive. It's just how we're wired.

The ongoing risk management questions that you as an investor should be asking are: "What is my risk budget?" and "How do my assets react to air pockets?" If you wonder what the answer to the first question is, you are not ready for turbulence. Once you realize it is getting choppy, it's too late. You will grasp for safety constraints to find none.

If your response to the second question is, "I hope well," then you need to develop a protection plan. Make sure that the advisor you are working with has your correct risk tolerance in mind. If you are working with an advisor who doesn't manage the air pockets – the risk of your account to fit your age, goals and desires – it may be time to consider an advisor switch so that you can work with someone who is more fitting for the preservation and distribution phase of the financial life that you are now in.✦

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