MarketWatch

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How to Black-Swan-proof your portfolio

After Japan, five must-haves for a 'Black Swan survival kit'

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) — Look at any timeline of U.S. stock market history, and every steep spike or free fall carries a brief but descriptive explanation:

"November 1963: Kennedy assassinated"

"September 2001: Terrorists attack U.S."

"September 2008: Lehman Brothers collapses"

Over the past century, financial markets have been pockmarked with dozens of unpredictable, large-scale disruptions. "March 2011: Japan Earthquake/Tsunami" is likely yet another.

What each of these have in common is they can all be considered a "Black Swan" event.

In layman's terms, a Black Swan is an unforeseen circumstance that prompts average investors to contemplate making wholesale portfolio changes — before it's too late.

The Black Swan theory was chronicled by Nassim Nicholas Taleb in his popular 2007 book "The Black Swan" (revised last year). Taleb writes about extremely rare or highly improbable events that have a major market impact, positive or negative, but which surprised even the experts.

One key element is that the Black Swan, in hindsight, can be rationalized. In the case of the current situation in Japan, a possible rationalization is that investors in an island nation in the Pacific earthquake zone can and should expect their positions to be vulnerable to the damaging effects of violent earthquakes and tidal waves.

"Look, we all hate this volatility; it is too much," said investment adviser Judy Shine of Shine Investment Advisory Services in Denver. "The answer is not a 'fear portfolio.' The answer is to only have as much in stocks as you can afford to ignore these very regular traumas."

Indeed, market timelines show that Black Swans happen fairly often, but don't necessarily have long-lasting impact on the stock market. With that in mind, the standard advice of financial advisers has been to stay the course, and, in Shine's words "to ignore these very regular traumas."

Easier said than done. But given that abrupt market-changing events will always be a reality, here are five tools

Quake cluster feared

Most experts believe giant earthquakes strike randomly. But others see linkage among them.

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that advisers say belong in every investor's "Black Swan survival kit:"

1. A diversification plan

Some investment advisers would say the survival kit starts and ends here.

Diversification is not so much about buying different asset classes as it is combining different types of risk, from principal risk (stocks) to interest-rate risk (bonds) to purchasing-power risk (certificates of deposit) and more. Diversify across industries, borders, types of investments -- so you have a fighting chance to avoid problems when trouble flares.

"You build strong, diversified portfolios for your clients, you don't put too much into any one type of investment, and you ride out the inevitable black swans," said Steve Goldberg, principal, Tweddell Goldberg Investment Management in Silver Spring, Md. From the archives: 10 ways to weather stormy markets.

2. Cash

Cash is king, so be a loyal subject and keep it where you can easily get it.

That doesn't mean to stuff the mattress, but do keep a stash at home. If you were building an earthquake survival kit, you would have cash on hand because bank machines could be out of order for many days following a disaster.

Preparing for Black Swan events also requires more liquidity than you might realize. A Black Swan could disrupt your job or source of income; three-to-six months' worth of expenses may not be enough.

Plus, having ready cash gives you flexibility to take advantage of lower stock valuations. Read more: 10 stocks for panicky times.

Japan disaster raises supply concerns

The disaster in Japan could impact supplies of crucial business components. Here's what some companies are doing to deal with the situation.

"You have to keep powder dry," said David Brady of Brady Investment Counsel in Chicago. "A source of funds is needed to take advantage of corrections. We like to put money to work in undervalued markets." Read more: Buy what Japan needs to rebuild.

3. Gold

For peace of mind, gold may be the ultimate tonic. Few other portfolio holdings can match the power of gold to protect against a world in turmoil. Read more: Gold's odd reaction to Japan quake.

"The most important component of a portfolio in the face and wake of a Black Swan event would be cash, followed by gold," said Karl Mills of JMK Advisors in Oakland, Calif.

As part of a predetermined strategy, and as a way to expect the unexpected, Mills typically commits between 5% to 10% of a client's portfolio to gold.

“There are not a lot of hiding places,” he added. “Cash, short-term Treasurys and gold all have utility. Gold is the most volatile, but it is also a good asset to have and hold when things go dark.” Read more: Gold as an insurance policy.

4. Hedging products

To stay in the market but mitigate risk, consider variable annuities, structured notes, and hedging strategies — or even traditional mutual funds that hedge the market.

Many financial advisers hate these products — for good reason. An annuity or options strategy is a form of investment insurance, and over time this portfolio preserver can be costly.

But if market volatility threatens to shake you out of the tree, then an alternative strategy or investment that secures income stream or allows you to stay invested even when the market seems crazy is probably a good idea.

“Clients really understood and appreciated the variable annuities with guaranteed income or withdrawal benefits during the depths of the financial crisis,” said Daniel Dorval of Dorval & Chorne Financial Advisors in Otsego, Minn. “The guarantees created the confidence to remain invested knowing the income stream from that portion of their portfolio was secure. The income guarantees also allowed us … to take advantage of pricing anomalies created by the extreme Black Swan volatility.

“Clients may not have bought into the recommendation of buying low without the underlying income or withdrawal guarantees,” he added. “This means the guarantees not only provided a tangible sense of security for clients, but also allowed us to provide value as advisors doing what we believed was right for long term investing — taking advantage of low prices to buy rather than sell low as so many investors tend to do.”

5. A rebalancing plan

Sell winners and buy losers. Sounds like a direct route to the poorhouse, but in fact this portfolio strategy, known as “rebalancing,” can keep your riches from becoming rags.

Rebalancing on a disciplined schedule forces an investor to sell high and buy low, which after all is the goal. The tactic restores asset-allocation targets that market movements have knocked askew. Put simply, rebalancing reaffirms your diversification decision and puts your plan back on track. Read more: Analysts bullish on Japanese stocks.

Yet rather than rebalance every six months or year, it’s more advantageous to act when allocations move 3% to 5% from target levels.

“Rebalancing your portfolio would have had you selling stocks in 2007 and buying them in 2009,” said Charles Rotblut, editor of the AAII Journal, published by the American Association of Individual Investors.

“It would not have avoided all of the market pain, but it would have given you comfort while the market was facing a traumatic event,” he added. “That’s what you want, because the alternative is to try and predict a Black Swan event, and that’s just not going to happen.”