

# BEWARE BLACK SWANS

*The financial system is increasingly intertwined, but you can limit the risk of ruin from a rare 'black swan' event.*

**Susanna Stuart** on how to put your eggs in many baskets



Since starting out as a financial adviser back in 1986, I have witnessed a number of major events — the 1987 stockmarket crash, the dot-com bust, the global financial crisis — which have all had a devastating impact on people's lives and their financial wellbeing. The lesson that stands out for me is not to have all your eggs in one basket, a mantra that remains very relevant.

This has been highlighted by Nassim Nicholas Taleb in his best-selling book on risk called *The Black Swan: The Impact of the Highly Improbable*. He uses the metaphor of the black swan to denote a rare event.

Taleb is a harsh critic of financiers for underestimating risks in an increasingly interconnected world. He argues that not only do black swans come along a lot more often than we expect, but because we're so interconnected

we're all more vulnerable to things going wrong.

The bail-out of AML Insurance was all to do with the Christchurch earthquakes. The ripple effect from this is likely to appear in the way the Government cuts back on spending elsewhere, or the way our country gets deeper into debt. Those quakes have become everybody's problem.

This interconnectedness throws up a challenge to the idea of putting our eggs into separate baskets. I think Taleb is partly correct, but there are still ways to spread risk so we're less exposed to a single big shock:

- Widen your cover. Learning from AML, use more than one insurance company.
- Spread your investments. Always have a mix of cash, fixed interest, shares and property. With shares make sure you have some overseas – New Zealand is a tiny, exposed

country, as we've seen.

- With investments, limit your exposure to any one company. For my client portfolios 10% is the maximum.
- Spread the timing of your fixed-interest deposits so they don't all mature in the same year – just in case it is a rotten year.
- Always have money in the bank that is readily accessible for emergencies.

It is worth noting that even in the very worst financial years –

such as the sharemarket crash of 1987 or during the global financial crisis – there were always at least two types of investment sectors contributing positive returns.

Putting your eggs in several baskets is still a good move. Some may well hatch into an unexpected black swan, but a spread of risk also exposes us to more good possibilities too. **N**

## HAVE YOU HEARD...

People have less confidence in financial service providers and feel less confident about the economy since the Christchurch earthquakes, according to a recent survey. The March-April RaboDirect Financial Confidence Index – which measures public as

opposed to business confidence – has declined markedly since the last measure taken in September 2010. Major worries for respondents included funding the Christchurch rebuild, increased debt and increased unemployment.

## TIPS FOR COPING WITH 'BLACK SWAN' FINANCIAL EVENTS

- 1** Review all your financial arrangements and check for robustness. Are your debts under control? Should your assets be in a trust?
- 2** Check the claims-paying ability of your insurance company. Go to the Ministry of Economic Development website, which shows the ratings of each insurance company.
- 3** Use managed funds for shares to get adequate diversification, especially if

you have small sums to invest.

- 4** For fixed-interest investments stick to 'A-grade' as rated by Standard & Poor's or Moody's. This is not a guarantee, but it will help you stay away from dodgy finance companies.

- 5** If you have a lump sum to put in a bank term deposit, split this into two lodgements. That way, if for any reason you need to cash up, you won't forfeit all your returns.

- 6** Don't lock everything in. Make sure you have some liquid assets rather than have everything, say, in a forestry fund. You want to be able to make adjustments to your investments should your personal circumstances change. Indeed, you may need to respond to an unexpected event.

- 7** Remember too that your financial situation is more robust if you do not have too much debt!