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Surviving the Plight of the Black Swan

A brief look over time at periods of extreme volatility in the stock market shows us that many of these periods are associated with unpredictable, large-scale disruptions, often termed as "black swan" events. We have experienced these events within our own lifetime – the 2011 tsunami in Japan, the collapse of Lehman Brothers in 2008, and the unforgettable 9/11 terrorist attacks in 2001.

The origin of the term "black swan" dates back historically to a time when swans were only believed to be only white in colour. At that time, a black-coloured swan was seen as an impossibility. More recently, former Wall Street analyst and Chicago options exchange trader Nassim Nicholas Taleb redefined a black swan event to be an outlier which has an extreme impact but, due to human nature and rationalization, becomes explainable.

A look back over time shows that black swan events occur fairly frequently. They may have a significant short-term impact on the financial markets, but oftentimes do not create any long-lasting impact. These abrupt market-changing events often cause discomfort and, due to human nature, often pressure investors to hastily react. However, in hindsight, after these black swan events are over and things have returned to normal, the simple act of staying-the-course may also be a viable defense.

Are there any pre-emptive measures that you can take to prepare for a black swan event? Here are some practical investment tactics that you might consider to help you to black swan-proof your investment portfolio.

- **Diversifying** – Having a diversified portfolio may extend beyond ensuring investments across different industries, geographies or asset classes. Consider a strategy that combines various types of risk. Shorter term bonds may be one way to manage interest-rate risk. Inflation-protected investments may help to manage purchasing-power risk.

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- **Rebalancing** – If one of your shares has gone up so much that its value makes up a greater proportion of your overall portfolio, it may be a good time to consider selling to restore balance. By selling high (and buying low!), the basic idea here is to ensure that proper diversification is maintained through balanced allocations.
- **Hedging** – Annuities offer guaranteed income streams and options, such as calls, may help to provide downside price protection to mitigate risk. However, over time hedging a portfolio may be costly and should be managed carefully.
- **Upgrading** – More speculative holdings may be replaced with shares of larger, more established companies to form the basis for your portfolio as these companies may have greater stability and be able to better withstand a downturn.
- **Dollar Cost Averaging** – By engaging in the practice of buying at regular intervals regardless of market conditions, you purchase greater shares when prices are low and fewer shares when prices are high, lowering the overall cost of shares purchased over time.