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Annual Fall Sale

From October 16 through December 15, 2007, my annual fall sale offers a 20% discount on all services except IRS (or other government) audit assistance. So, save on year-end tax planning, getting your computerized accounting up and running before the new year, business consulting, and personal financial planning. Call today to set up your appointment. To take advantage of the discount, you need to pay your invoice within 10 days of billing. (Note: This is *not* the same as the prepayment plan for 2007 tax return preparation, which you will receive in December.)

Protecting Financial Assets

Most everyone has insurance of one sort or another. Life insurance protects your family's well being should the insured person die before you've built up enough assets to provide for them. Property insurance, including car insurance, protects physical assets from loss of value due to specified events. Liability insurance protects you in case you do something accidental or stupid that causes damage to another person or their property.

But how do you protect financial assets against loss?

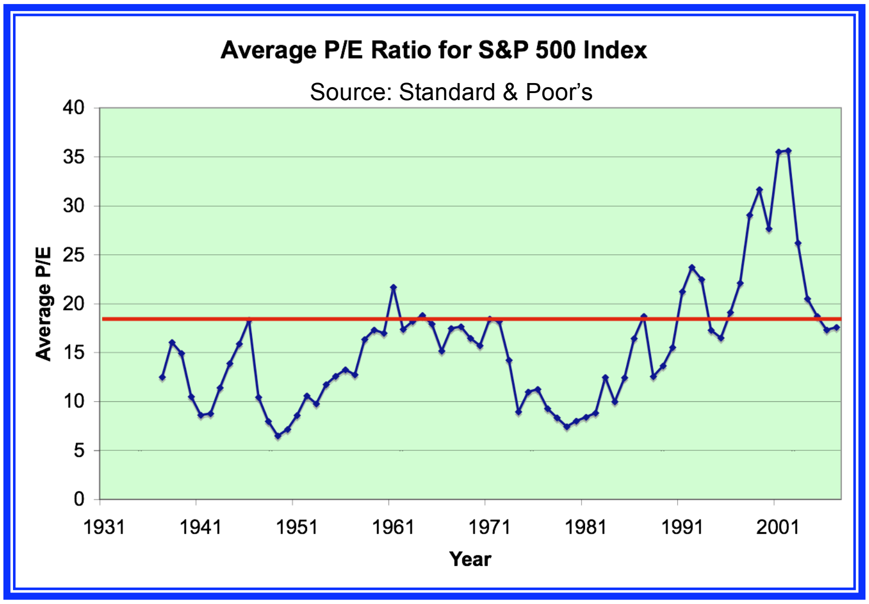
Insurance products

Before the New Deal came along in the 1930s, there was little protection available. If a bank or brokerage went bankrupt, tough luck — jump out the window! That's when federal deposit insurance began; so you look to be certain that a bank in which you put your money has FDIC coverage (most do). It covers money up to $100,000 per account ($250,000 for certain retirement accounts), with some limits based on account ownership. That number has not changed in decades, so as more people have money in excess of that, they have to put funds in several banks to maintain protection. I recently read that in Great Britain, the equivalent protection is only £2,000 (a little over $4,000)!

Later, similar insurance for financial assets came into being. The Securities Investor Protection Corporation (SIPC) protects assets you hold at brokerages up to $500,000 per account. This is NOT protection against declines in the value of the securities, but against loss caused by the brokerage firm going bankrupt.

The Economic Problem

We have had quite a run of increases in securities valuation over the past 20 years, after the October decline of 1987. Interestingly, that was only in the stock market, not in the bond market, so people who had diversified their assets didn't do so badly; also it was nowhere near the calamity of the crash of 1929.



Over time the market price of the top stocks has varied from below 10 times earnings to over 20; this is called the Price/Earnings ratio. Notice the red line I have drawn at about a P/E of 18. Every time the P/E has climbed above that level, the P/E has declined significantly. Also notice that P/Es during the 1990s reached very high levels by any historical measure.

This raises the concern that we may have a long way to go for P/Es to return to "normal" values. Even if the earnings continue to grow at the level of gross domestic product, if the P/E drops from the high teens to around 10, it means either a significant drop in securities valuations or at least a long time of relatively constant values. In that environment protecting against losses appears to be a sensible strategy. Of course, past performance is no guarantee of future results, as financial professionals always say; they also say, "this time it's different." But what if it isn't?

A Conservative Strategy

Assuming that you don't want to put all your assets into CDs at a variety of banks, and that you want to continue to benefit from the anti-inflation growth potential of common stocks, what are you to do? Now, I want you to make sure you have taken your heart medication before you read the next sentence. I'm going to suggest using options as a protection strategy — specifically, put options on an index that measures the value of the largest companies in the country (or the world, for that matter). OK. Now that your heart has settled down, let's continue. The S&P 500 is one such index, though there are many others to choose from, depending on the makeup of your portfolio.

The way it works is you buy a put option at a particular "strike price," normally near the current value of the index. If the value of the index rises, the value of the option decreases, reaching zero at the "exercise date," which can be anywhere from a few days to several years from the day you buy it. If the index rises, it probably means that your investments have also done well. But if the index falls, the option value rises, offsetting some or most of the falling prices. That's the insurance aspect of put options.

When you buy insurance, you don't expect to make money from it, do you? You are willing to fork over the dough just in case the insured event happens. And if it doesn't happen, you're happy to go on with life. If you consider these put options as insurance, it shouldn't bother you if the value drops; your concern is what happens if we get a one-day big drop in the market (not a few hundred points on the DOW, but a few thousand).

Talk to your investment advisor about whether index put options can be part of your portfolio management. You may even sleep better at night, knowing the protection is in place!

Promote the use of the democratic process in all endeavors.