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Today's Economy: Real Risks vs. Fear

You are not alone in your fear of another stock market crash, a memory that many people are still carrying around with them after the dot.com market crash a few years back.

Most investors think there's a 50% chance of a crash, but the actual odds of a 33% loss in any given year is around 2%.

The REAL risk is that we'll get mediocre investment returns for a long period of time and have to learn to live with the more likely 6% return levels. The solution for retirees is to tailor your discretionary expenditures when times are tough to fit the returns you are experiencing. If the market in any year has a x% return, limit your withdrawals from your portfolio to y% (or less) for the following year.

If the market goes down, keep your withdrawal level in the fol-

lowing year the same as it was in the previous one.

A common fear is a collapse in the U.S. economy, perhaps brought on by the Three Horsemen of the Deficit (consumer debt, government debt and the trade balance).



But prognostications of gloom and doom have never been borne out by reality, and there is no reason to think they will be again. The recommendation is to diversify globally so that a malaise in any one economy or sector doesn't affect you too much.

Another common concern is the effect of all those jobs being outsourced to some lower-

wage country. The reality is that around 350,000 jobs are sent overseas each year, but that's out of a work force of 147 million. But there's a more legitimate fear: the technological change and creative destruction inherent in the capitalist system. We recommend reading Thomas Friedman's new book "The World is Flat" for a great discussion of what is happening in the global economy. This is what we refer to as a tectonic shift – a slow, barely felt shifting of the ground beneath our feet – that rumbles underneath the ever-present clamors of the "crisis de jour". We are living in a world where the Digital Revolution, whose eventual impact will be as great or greater than the Industrial Revolution of 200 years ago, is changing everything around us. The ever-present uneasiness magnifies our daily concerns over normal (and sometimes tragic) events that happen around us all the time.



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The press is also filled with prognostications that we are going to have a major pop in the housing bubble. A more plausible scenario going forward is rather for years of low increases in the value of your house, not a collapse into the value of a shed.

How about gas at \$3.00 a gallon? There are some interesting urban myths about our oil and gas economy. For Instance, research shows that when gas prices rise dramatically, the local convenience store or gas station actually loses money on every gallon sold. The profits are typically made when prices are falling, not rising. Why? Because unlike the oil companies, the local independently owned outlets don't have long-term contracts to buy their product. So don't get mad at the local gas station. He's hurting just like you are! Instead, make sure your portfolio holds energy stocks.

The oil crisis has suddenly popped into the national radar-screen.

We fear that hedge funds and shadowy speculators are somehow driving up the price of oil. While it's true that speculation (*and fear!*) adds roughly \$20 to the price of a \$65 barrel of oil, hedge funds account for less than 3% of the volume on the oil futures markets. Right now, there is a generalized fear of dwindling supply, which is shared by many consumers. A study of hedge funds found that they held roughly equivalent long and short positions, meaning that while some were making out like bandits, others were getting



creamed. And the best evidence is that the average hedge fund has gained just 2.1% this year. If they were driving up prices and making so much money, where are the profits?

But isn't it true that the world is running out of oil? A book called

"Twilight in the Desert" by Matt Simmons makes a case that Saudi oil production will decline soon since the Saudi's have never actually told anyone how much oil they actually have there in the desert. This is simply the last in a line of periodic warnings from "Chicken Little" that we are running out of oil. We will address this issue much more fully in a future Northstar white paper, but simply put both the International Energy Agency (IEA) and the US Energy Information Administration (EIA) put the global proven crude reserves – those that could be developed at current prices using existing technology – at 1-1.3 trillion barrels, or enough for 40-50 years.

But the question really is one of supply and demand. As prices go up, demand will go down, and restore some balance to the supply side of the equation. For the foreseeable future I expect technological progress to make up the difference in ways that will surprise all of us.



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The future is built on a wall of worry- and it's never as bad as we fear or as good as we hope.

How about the concern that the U.S. is running out of refining capacity? It is true that the U.S. hasn't built a new refinery in 30 years, but we can just as easily import refined products from the Caribbean, South America and other nearby low-cost countries. The Department of Energy has projected that worldwide refining capacity will increase 61% over the next 20 years. Why build refineries here when you can do it easier and cheaper overseas?

We are also hearing cries that government must intervene to bring down energy prices. But the last time we tried that in the 1970s, we ended up creating gas lines, shortages and little change in price. Price controls, being proposed in Congress and at the state level, have never worked very effectively. Even so, the U.S. now imports 60% of the oil it consumes each year, and that figure is growing. A better approach is to raise fuel-efficiency

standards for cars--even a 10% improvement would save more oil than we currently import from Saudi Arabia or Venezuela. Providing incentives for alternate sources of energy- such as solar and wind power - may prove effective in the future but these can never replace oil during our lifetime. We will be much smarter to stress clean coal and nuclear power as a solution to our problems.

These are tough times to be an optimist, but we hope this helps. The future is built on a wall of worry- and it's never as bad as we fear or as good as we hope.

