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Forget About Black Swans, the One Floating Ahead is Neon

By JASON ZWEIG

You've heard of black swans—events that are unthinkably rare, immensely important, and as unpredictable in advance as they are inevitable in hindsight. Now, with no one ruling out a default or downgrade of U.S. Treasury debt, investors face a new kind of threat: what we will call the neon swan, an event that is unthinkably rare, immensely important and blindingly obvious.

The politicians in Washington have a couple weeks to forestall a disaster that has begun to seem like a certainty. Investors everywhere are perfectly aware of the consequences if Congress and the Obama administration can't strike a deal: The U.S. is likely to lose its privileged triple-A credit rating, and corporate bonds and stocks alike could plummet in response.

As Nassim Nicholas Taleb's bestseller "The Black Swan" made clear, the human mind is poorly equipped to prepare us for rare, important and unpredictable events. But maybe our minds—and our markets—aren't very well equipped to protect us against neon swans, either.

Christophe Verlot

Many investors seem to be coping with what seems like an obvious risk simply by closing their eyes.

Theodore Aronson, a partner at Aronson Johnson Ortiz in Philadelphia, oversees $21 billion in stock investments for 90 institutional clients. In roughly 75 conference calls with clients over the past few weeks, says Mr. Aronson, no one has asked whether a different investing approach is needed in light of the risk that a U.S. debt crisis might make the markets go haywire.

"I find it amazing," he says, "that we have not gotten a single question or comment about it."

Then again, Mr. Aronson adds, his firm hasn't done anything to protect against the risk of a crisis in the Treasury market. "We've thought about it, but we don't know what to do," he says. "As best we can figure it, there isn't anything we can do."

Some investors are worried enough to ask questions, but not many have taken any action yet, says Paul LaRock, a principal at Treasury Strategies, a Chicago-based firm that helps large corporations manage their cash. "Companies are pulling out their investment policies and rereading them," he says. One major firm on the East Coast, Mr. LaRock says, asked this week whether its investment-policy statement, which places "no limit" on its holdings of U.S. Treasurys in the company's cash balances, needs to be amended to keep the company's coffers secure.

Mr. LaRock says the client is still mulling that question. And, even with disaster seeming inevitable, many investors may be paralyzed by uncertainty. "U.S. government securities have long been the yardstick for measuring the risk of most other investments," he says. "One of the most disturbing things that we all have to get our minds around should the unthinkable happen," he adds, "is that the reference point for pricing securities around the globe could be lost. No one can predict what would happen worldwide."

Not that Treasurys will necessarily get pounded. If the U.S. defaults or its credit rating is downgraded, says William Bernstein of Efficient Frontier Advisors in Eastford, Conn., Treasury prices would probably "go to 97 or 98," losing only a few percentage points in value. "You're not going to wake up one morning over the next couple of weeks and find they're priced at 50 cents on the dollar," says Mr. Bernstein.

"It is absolutely inconceivable that we would flat-out default and not pay anything," he adds. "The worst-case scenario is a very temporary payment problem, and I think the Treasury market knows that."

But the ripple effects could be considerable. Mr. Bernstein expects corporate and municipal bonds to drop much more drastically if the Treasury market is hit by default or downgrade. And stocks, he says, could be massacred. For investors with cash and courage, a crisis in U.S. Treasurys might well pose a historic buying opportunity. If, instead, it turns out to be "like a giant asteroid hitting the earth, Mr. Bernstein says, "then there isn't much of anything that's likely to protect you."

Thus, keeping a sizable balance in short-term Treasurys—the securities that suddenly feel shaky—is probably a good idea in case stocks and bonds go on sale. You can make a sudden move into gold or cash, but they carry risks of their own, especially if the debt crisis somehow gets averted.

It is important not to be complacent. If you are blindsided by bad news that was staring you in the face for weeks before it came to pass, you will feel like a fool. On the other hand, the forces that do the worst damage to markets "are never the ones that you think are going to get you," Mr. Bernstein says. Waiting may well be the wisest course this time. You don't want to ignore a neon swan, but you don't want to overreact to it only to have it swim quietly away.

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