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Market Issue

SPECIAL ISSUE 2011

Volatility Can Be a Drag on Your Portfolio

The week of August 8, 2011 was one for the record books. Never before had the Dow Jones Industrial Average gone through four consecutive days when it closed more than 400 points up or down. In fact, in the course of those four days, the market zigzagged a total of more than 2,000 points, or nearly 19% of its value at the close on Friday, August 5.

After all the gyrations, the Dow was down only 175 points — 1.5% — for the full week. Still, the cluster of swings was an eerie reminder of how much the market can fluctuate on a short-term basis. And those swings underscored the real — though not widely appreciated — problem with volatility: even when stock prices recover, volatility is a drag on returns.

Illustrations are in order. First, the table below compares the returns over three years in two hypothetical portfolios, each of which invests $10,000.* The table summarizes the returns in three ways: the arithmetic average of their rates of return, the volatility of their returns (as measured by standard deviation), and their compound growth rate per year.

	Portfolio A		Portfolio B	
	Return	Market Value	Return	Market Value
Year 1	25%	$12,500	20%	$12,000
Year 2	-20%	10,000	-5%	11,400
Year 3	25%	12,500	15%	13,110
Average return		10.0%		10.0%
Volatility		26.0%		13.2%
Compound annual growth rate		7.7%		9.4%

While both portfolios have the same average rate of return when computed arithmetically (i.e., the sum of the percentage returns divided by three), they have quite different final balances. The reason is that portfolio A's returns were much more volatile than portfolio B's. As a result, there is also a significant difference in their compound rates of return.

The explanation is that big losses take away from the power of compounding. Whenever a portfolio loses money in a given year, it takes a bigger percentage gain to break even. That also explains why an aggressive portfolio that gets much better returns than a more conservative portfolio in years when the stock market is strong can *underperform* a slower-but-steadier strategy.

Here's a more real-world comparison.* Again, each of these hypothetical investments starts with $10,000, but this time, actual returns are used for five years based on returns of the Standard & Poor's 500 Index and of long-term government bonds (Source: *Ibbotson Stocks, Bonds, Bills, and Inflation Classic Yearbook*, 2011). Portfolio A invests only in stocks, while portfolio B puts 60% in stocks and 40% in bonds.

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Coping with Market Volatility

Keep repeating to yourself, "I'm investing for the long term. Short-term fluctuations are an expected part of investing." Still having a difficult time remaining calm during this volatile period? Volatile markets are frustrating for all investors. Should you stay the course of an "all-weather" strategy, or should you depart from it to minimize your losses? Or, should you be more aggressive and try to profit from any downswings? These are challenging questions that are difficult to answer. However, here are some strategies that can help you during this difficult period:

❍ **Review the reasons why you have invested.** If you haven't

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Reverberations of the U.S. Debt Downgrade

In early August, Standard & Poor's (S&P) downgraded the debt of the United States from AAA to AA, followed by subsequent downgrades to various securities backed by the U.S. federal government, including housing bonds collateralized by Ginnie Mae, Fannie Mae, and Freddie Mac.

One Out of Three Isn't Bad

Despite the markets' volatile reaction in the week that followed, the news wasn't all bad. First of all, while disappointing, the downgrade wasn't unexpected. Second, the agency's "short-term" rating was affirmed, which basically means that there is no chance of the U.S. defaulting on its debt payments within the next year (the recent downgrade is based on a three- to five-year timeline). Third, the downgrade was a modest move to the next level, which is still considered an investment-grade rating. And fourth, the other ratings agencies (Moody's and Fitch) have not lowered their ratings at all.

Government Response

Many global economists, Wall Street analysts, and the White House Administration lashed out at S&P's decision, calling the downgrade unfounded due to a $2 trillion error in its calculations of the federal budget, while S&P indicated that it was more influenced by the degree of uncertainty surrounding the political policy process. The Federal Reserve met shortly thereafter and responded in two ways. First, it announced it would keep rates low until 2013. Second, it did not increase capital charges for banks holding Treasuries.

Government-Issued Securities

As for Treasury bonds, the yield curve could steepen initially, but this is unlikely to deter the market's focus on the economy's slow growth and investors' continued flight to quality. In the credit markets, spreads are likely to widen in response to the downgrade, particularly for high-yield bonds. The downgrade will likely impact S&P ratings of securities within the municipal bond market in the near term, but the longer-term impact will depend more on the success of federal deficit reduction and any impending tax reform.

Mortgage Rates

Initially, news of the downgrade pushed mortgage interest rates even lower. For what is believed to be a short time before rates begin to creep up again, there is a window of opportunity for homebuyers and refinancers to apply for loans.

Money Market Outflows

While money market funds are generally considered to have a stable asset base, many are required to invest in AAA-rated securities. Therefore, the downgrade will require some atypical buy/sell adjustments in this market.

Equity Investing

The S&P downgrade is not expected to change the fundamentals of economic and earnings growth, both of which tend to have a greater impact on the markets. However, reactionary short-term market volatility could raise equity prices somewhat and potentially tighten price/earnings multiples. The good news is that conditions in companies both large and small are much different than they were three years ago. High-quality companies have reduced debt, increased margins, and boast healthy balance sheets. Any initial fallout can be attributed more to panic than true valuations based on technical factors.

The fact is, the recent S&P downgrade of U.S. government debt is probably not our most important concern. The bigger worry is slow economic growth and the constant threat of a double-dip recession. While a credit downgrade added to these concerns, what the U.S. needs now more than ever is more jobs to help improve consumer sentiment and spending, which in time should help the real estate market and battered home values. Enabling citizens to gain a financial footing may ease reliance on public entitlement and stimulus programs and help the government manage its debt reduction mandate. ❍❍❍

Drag on Portfolio

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	Portfolio A		Portfolio B	
	Return	Market Value	Return	Market Value
2006	15.8%	$11,579	10.0%	$10,995
2007	5.5%	12,215	7.2%	11,792
2008	-37.0%	7,695	-11.9%	10,394
2009	26.5%	9,732	9.9%	11,425
2010	15.1%	11,198	13.1%	12,921
Average return	10.8%			5.7%
Volatility	24.7%			10.0%
Compound average growth rate	2.3%			5.3%

Historically, over the long term, total bond returns have been lower than returns for stocks, with the tradeoff that bond returns tend to be more consistent year-to-year than stock returns. The difference shows up quite plainly in the above example: a 3% advantage in compound annual return is worth more than $1,700 over the five-year period examined for the slower-but-steadier strategy.

Helping you build portfolios that minimize the damage volatility can cause — while meeting your long-term need for returns — is an important part of your investment plan for the long term. Please call if you'd like to discuss your portfolio in more detail. ❍❍❍

** These examples are provided for illustrative purposes only and are not intended to project the performance of a specific investment.*

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Market Volatility

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done so yet, put your target asset allocation in writing. Indicate why you have adopted this strategy and what long-term returns and short-term losses you expect from this allocation. You may also want to write down the same information for each individual investment. Then, when market volatility makes you nervous, review your written reasons for investing as you did. That reminder should help keep you focused on the long term.

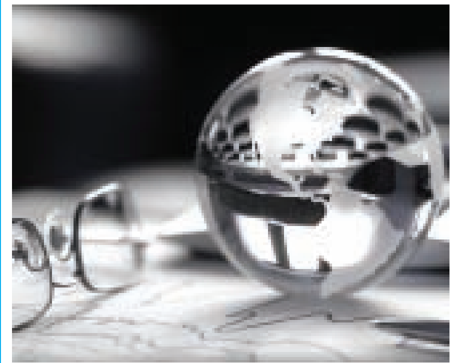
❍ **Reacquaint yourself with the stock market's past history.** While the stock market suffers declines in some periods, over the long term the trend has been upward. Of course, past performance is not a guarantee of future results. Even though short-term setbacks can make even the most knowledgeable investors anxious, take comfort in the fact that staying in the market over the long term, through different market cycles, can help manage the effects of market fluctuations.

❍ **Save more.** When markets are fluctuating, you need other strategies to help increase your portfolio's value. One of those is to simply save more of your income. Even modest increases in the amount invested can dramatically affect the ultimate size of your portfolio.

❍ **Invest in a tax-efficient manner.** Strategies that defer the payment of taxes can also make a substantial difference in your portfolio's ultimate value. There are several strategies to consider. You can utilize tax-advantaged investment vehicles, such as 401(k) plans and individual retirement accounts. Or you can emphasize investments that generate capital gains rather than ordinary income. You can also minimize turnover in your portfolio, so unrealized capital gains grow for many years.

❍ **Diversify.** Spreading your portfolio among a large number of asset and sub-asset classes is a must at all times, but can be particularly beneficial in volatile markets. To the three classic asset classes of stocks, bonds, and cash, you may want to consider adding commodities and real estate. Anyone who added gold to their portfolio 10 years ago has found it to be a good counter to fluctuations in stocks. Also consider investment style, geography, and sectors as ways to further diversify. Consider investing in growth and value stocks, in the U.S. and overseas, and have several sectors represented in your stock portfolio. The key is to find sub-asset classes that are relatively uncorrelated with each other.

❍ **Invest regularly, in all market conditions.** Dollar cost averaging is a proven way to put market downturns to your advantage. Investing the same dollar amount every month means that when prices are down, you buy more shares, so that when the markets recover, you get a better return. While dollar cost averaging is a good strategy for developing the habit of regular investing, it does require the discipline to invest consistently. However, it neither guarantees a profit nor protects against loss in a prolonged declining market. Because dollar cost averaging involves continuous investment regardless of fluctuating price levels, investors should carefully consider their financial ability to continue investment



through periods of low prices.

❍ **Rebalance your portfolio annually.** Rebalancing means selling off a portion of the assets that have gained in price and using the proceeds to buy more of the assets in your portfolio that have fallen in price. This technique forces you to realize some of your gains before a downturn takes them away. It also makes you buy more of the assets that lost value at cheaper prices, similar to dollar cost averaging.

❍ **Consider tactical asset allocation.** The foundation of any sound investment program is strategic asset allocation: a long-term commitment to maintaining fixed percentages of your portfolio in each of the asset and sub-asset classes you define. But if you expect stocks to decline, you could change to tactical asset allocation. This means that you sell off a percentage of your stock holdings and put the proceeds temporarily into cash. It guarantees you escape some of the damage, though you run the risk of mistiming the market.

In the end, it's important to remain calm during volatile markets, since portfolio decisions made in moments of panic tend not to be good moves. In light of the current market and economic conditions, it pays to review your own portfolio and strategies. Your portfolio should reflect your risk tolerance and investment time horizon. Please call if you'd like to review your portfolio in light of current market conditions. ❍❍❍

Global Concerns Impact the Stock Market

For investors, as if low home values, high unemployment, and mounting debt weren't enough, in the last several months both the United States and the world have witnessed significant economic, political, financial, and even weather-related events.

A World Much Maligned

In March, Japan experienced a devastating earthquake and tsunami that resulted in worldwide supply disruptions. At about the same time, oil prices stepped up, and there was increased turmoil in the Middle East.

By early summer, Greece came within hours of defaulting until two bailout packages were bestowed. Due to extended debt problems in the euro zone, these same lending conditions were also extended to Portugal and Ireland. Worries continue that the debt contagion will spread to Italy, Spain, and even France, which is currently co-shouldering most of the costs with private investors and Germany.

Positive Signs

More recently, we've seen signs that things are looking up. Japan is on the mend, and oil prices have declined substantially. While there are no distinct indicators of significant growth, there is nothing visible that is expected to impede modest growth for the rest of 2011.

As for the stock market, there are good reasons to invest in equities. Corporate balance sheets are strong, bolstered by a significant amount of cash, and the recent volatility that accompanied the S&P rating downgrade offered up an entry point into quality investments at affordable prices.

Growth in emerging markets remains strong, accounting for more than one-third of world gross domestic product, and the asset class is expected to grow over 6% in 2011 (Source: Federal Reserve Bank of San Francisco, *FRBSF Economic Letter*, January 2011). This is good news for large-cap companies with exposure to the emerging market consumer.

Banks are well capitalized and oil prices have decreased, giving American consumers greater access to more spending capital. Furthermore, Americans have been vigilant in reducing their own personal debt over the last three years. All of these factors should lead to increased confidence and spending. With increased spending comes increased profits, which in turn, should reward shareholders.

Despite the recent negative events, it's important to remember that it's not where you start the investment process that matters, but where you end it. ❍❍❍

Retirees and Their Investments

While stock market fluctuations are painful for all investors, they are even more so for those nearing or in retirement. If you're looking for ways to help protect your retirement nest egg, consider these tips:

- **Try to withdraw as little as possible from your investments.** If your investments have declined in value, reevaluate your current withdrawal amounts. Withdrawing the same amount from a substantially smaller portfolio means that you will deplete the balance much sooner.
- **Consider postponing retirement or going back to work.** If you haven't retired yet, you may want to postpone retirement until you are sure your investments will provide enough income for retirement. Those who are already retired may want to consider going back to work at least part-time.
- **Build up a reserve of investments not tied to the stock market, totaling three or four years of expenses.** Then, you won't have to sell investments during market declines.
- **Withdraw funds in a tax-efficient manner so they last longer.** In general, you should withdraw taxable investments first so that your tax-deferred investments can continue their tax-deferred growth.
- **Reassess your asset allocation.** The recent stock market fluctuations may have made you realize that your portfolio contains too much risk. While you may not want to make major asset allocation changes immediately, you can take steps to gradually add diversification.
- **Decide whether you want a professional to manage your investments.** In volatile markets, you may feel more comfortable allowing an investment professional to make investment decisions for you. ❍❍❍

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