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Living with Volatility

The current renewed volatility in financial markets is reviving unwelcome feelings among many investors—feelings of anxiety, fear, and a sense of powerlessness. These are completely natural responses. Acting on those emotions, though, can end up doing us more harm than good.

At base, the increase in market volatility is an expression of uncertainty. The sovereign debt strains in the US and Europe, together with renewed worries over financial institutions and fears of another recession, are leading market participants to apply a higher discount to risky assets.

So, developed and emerging market equities are weakening as risk aversion drives investors to the perceived safe havens of government bonds, gold, and Swiss francs.

It is all reminiscent of the events of 2008, when the collapse of Lehman Brothers and the sub-prime mortgage crisis triggered a global market correction. This time, however, the focus of concern has turned from private-sector to public-sector balance sheets.

As to what happens next, no one knows for sure. That is the nature of risk. But there are a few points individual investors can keep in mind to make living with this volatility more bearable.

- Remember that markets are unpredictable and do not always react the way the experts predict they will. The recent downgrade by Standard & Poor's of the US government's credit rating, following protracted and painful negotiations on extending its debt ceiling, actually led to a strengthening in Treasury bonds.
- Quitting the equity market at a time like this is like running away from a sale. While prices have been discounted to reflect higher risk, that's another way of saying expected returns are higher. And while the media headlines proclaim that "investors are dumping stocks," remember someone is buying them. Those people are often the long-term investors.
- Market recoveries can come just as quickly and just as violently as the prior correction. For instance, in March 2009—when market sentiment was last this bad—the S&P 500 turned and put in seven consecutive months of gains totaling almost

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80 percent. This is not to predict that a similarly vertically shaped recovery is in the cards this time, but it is a reminder of the dangers for long-term investors of turning paper losses into real ones and paying for the risk without waiting around for the recovery.

- Investors remaining disciplined through these downturns have been rewarded over the long term. As the chart below shows, since 1926, about 6% of the monthly returns for the S&P 500 Index showed losses of 7% or more. However, the annualized average return over the next year (starting the following month) was 8.5%. Over the following 5 years, the average annualized average return was almost 10%. The chart shows these patterns are consistent for small company stocks, international stocks, and emerging market stocks as well.

- Never forget the power of diversification. While equity markets have had a rocky time in 2011, fixed income markets have done well—making the overall losses to balanced fund investors a little more bearable. Diversification spreads risk and can lessen the bumps in the road.

- Markets and economies are different things. The world economy is forever changing, and new forces are replacing old ones. As the IMF noted recently, while advanced economies seek to repair public and financial

Market Downturns—A Historical Perspective
Individual Index Monthly Downturns
As of December 31, 2010

	Domestic Large Cap	Domestic Small Cap	International	Emerging
Fund Equivalent Index	**S&P 500 Index**	**CRSP 6-10 Index**	**MSCI EAFE Index**	**MSCI Emerging Markets Index**
Start Date	January 1926	January 1926	January 1970	January 1988
End Date	December 2010	December 2010	December 2010	December 2010
Threshold	-7%	-7%	-7%	-7%
Months at or below Threshold	62	108	30	34
Months in Sample	1,020	1,020	492	276
Percentage of Months below Threshold	6.1%	10.6%	6.1%	12.3%
Annualized Average Compound Return over Subsequent Periods (starting the next month)				
1 Year	8.5%	20.8%	9.9%	7.5%
3 Years	9.1%	16.2%	12.4%	11.9%
5 Years	9.9%	16.2%	12.8%	13.7%
10 Years	8.8%	14.0%	12.3%	11.1%

Sources: The S&P data are provided by Standard & Poor's Index Services Group; CRSP Index returns from the Center for Research in Security Prices, University of Chicago; MSCI data copyright MSCI 2011, all rights reserved. MSCI EAFE Index is net of foreign withholding taxes on dividends. MSCI Emerging Markets Index is gross of foreign withholding taxes on dividends. Annualized average compound return over subsequent periods is calculated as the compound growth rate required to produce the average total return over the same time period. Performance for periods greater than one year are annualized. Indices are not available for direct investment; therefore, their performance does not reflect expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results and there is always the risk that an investor may lose money.

balance sheets, emerging market economies are thriving.[1] A globally diversified portfolio takes account of these shifts.

- Nothing lasts forever. Just as smart investors temper their enthusiasm in bull markets, they keep a reserve of optimism during downturns. And just as loading up on risk when prices are high can leave you exposed to a correction, eliminating risk altogether when prices are low means you can miss the turn when it comes. As always in life, moderation is a good policy.

The market volatility is worrisome, no doubt. The feelings being generated are completely understandable. But through discipline, diversification, and understanding how markets work, the ride can be made bearable. At some point, value will re-emerge, risk appetites will re-awaken, and for those who acknowledged their emotions without acting on them, relief will replace anxiety.

Notes

1. *World Economic Outlook*, IMF, April 2011.

Disclosures

Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Nothing herein constitutes (i) legal, accounting or tax advice, (ii) a recommendation to buy, sell or hold a security or (iii) advice as to whether any investment strategy is suitable for a particular investor.

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Our Value Added Indexing℠ approach utilizes passive and index-related portfolios as part of a comprehensive solution to meet our clients' long term goals. The result is a disciplined investment experience based on sound research and planning, rather than forecasts, emotions or trends.

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