Stay In…Get Out…What's an Investor To Do?
Navigating the Land of Volatility

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If you opened your investment statements on a regular basis over the past decade, you know the exhilaration of the surge forward and the queasy feeling as investments plummet. Welcome to the *Land of Volatility* where the traders try to catch the waves and investors often get caught in the undertow. We know the terrain. Ragged peaks, deep valleys, and rough roads crisscross the landscape. What caused the gentle upward sloping market we experienced from 2003 through 2006 to violently erupt and reshape itself into a sea of uncertainty? More importantly…what can you do about it?

Looking at research papers and technical articles on volatility can make you feel like you've fallen down a rabbit hole of tech-speak where it only takes one sentence to know that you've obviously already lost your head. For example: "*The stock market risk-return relation is found to be positive, as stipulated by the CAPM; however, idiosyncratic volatility is negatively related to future stock market returns*".[1]

Will anyone who knows exactly what that means to their portfolio raise their hand? Most articles on volatility talk about correlation, velocity, and standard deviations. As a math major with a degree, I feel right at home. As a Certified Financial Planner™, I can tell you that's not where my clients live. So let's talk about volatility as it relates to everyday people, their investments, and ways to deal with it.

First, what causes volatility? Simple…fear, greed, and uncertainty which are currently abundant. We have high unemployment, low GDP, foreign conflicts, increasing foreclosure rates, declining real estate prices, rising deficits & debt, tax cuts due to expire, a mid-term election on the horizon, European sovereign debt concerns, austerity measures abroad, domestic bank failures, global warming, cap & trade, immigration…need I say more?

Fear fuels volatility. Couple the fear and uncertainty with the psychological tinderbox left in the wake of the market moves over the past 20 years. Is it any wonder investors are nervous, anxious, fearful, and bewildered? The market decline from 2000-2002 decimated many portfolios and subjected investors to significant volatility. In 2003, the volatility began to subside. The markets started a rather orderly advance. By 2007, the S&P500 returned to the 1500 level and investors regained their confidence in the market and WHAM! The Credit Crisis threw a knock-out punch to their portfolios. Volatility skyrocketed and the recovering portfolios sank, again.

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[1] Idiosyncratic Volatility, Stock Market Volatility, and Expected Stock Returns by Hui Guo and Robert Savickas; Working Paper 2003-028B, September 2003, Revised July 2005, FEDERAL RESERVE BANK OF ST. LOUIS, Research Division

Figure 1 compares the S&P500 index performance with that of the CBOE Volatility Index (VIX) over the last 20 years. The inverse nature of the relationship becomes pretty obvious. Volatility increases (sometimes substantially) whenever the market drops. The real question is “why”.

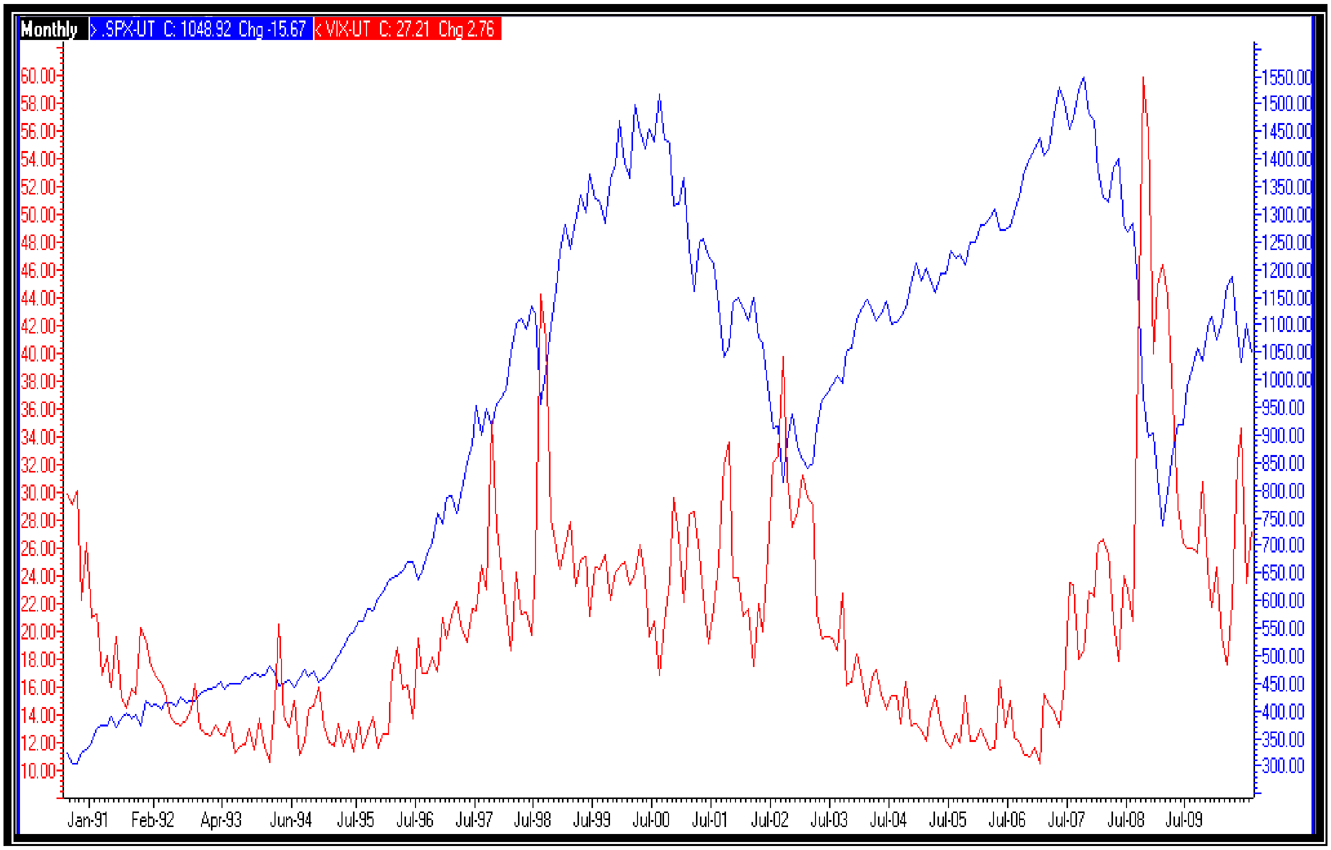

Figure 1 - S&P500 Index versus Chicago Board Options Exchange Volatility Index (VIX®)[2]

This is where our nature may play a significant role. We tend to move into positions slowly. We see others doing well and we want to participate. It’s part of our herd mentality. We also hate to admit we are wrong and often take additional risk hoping to improve our position. Yale psychologist, Laurie Santos, attempted to answer the following question: *Why do smart people make irrational decisions?* To answer the question, she developed a study to determine how monkeys make financial decisions and discovered that monkeys make irrational decisions similar to their human counterparts when it comes to money.[3]

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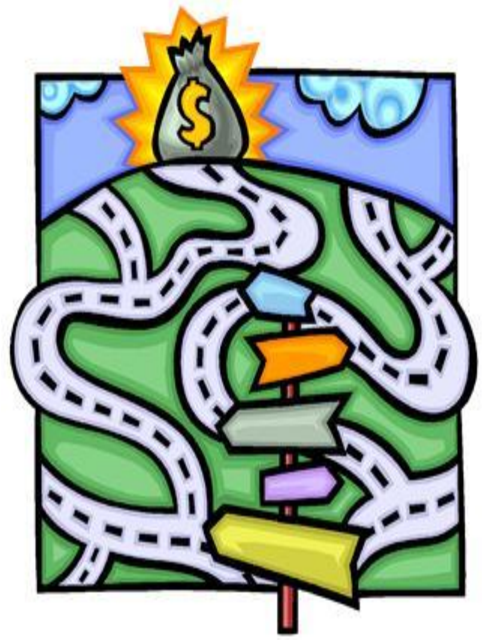
[2] According to the Chicago Board Options Exchange, the CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, VIX has been considered by many to be the world's premier barometer of investor sentiment and market volatility.

[3] http://spoken-gems.com/2010/08/09/laura-santos-a-monkey-economy-as-irrational-as-ours/

Reactions to Volatility – 3 Roads



Stay In! Hang on for the ride! This road may be bumpy. Encouraging voices can be found along the road saying “Just wait, it’ll come back!”, “This is just a correction!”, “We’re in it for the long haul!” The investor grudgingly accepts the volatility, stays in the market, may spend a great deal of time moving assets around within the market, and continues to lie awake at night worrying. Or, worse yet, investors simply freeze, refusing to make any decisions about their investments. Rather than be wrong, they choose to do nothing, not recognizing that no action may indeed be the wrong action. If you rode this roller coaster before and didn’t like the ride, why would you buy another ticket?

Many investors, who choose not to stay the course, take the next option thinking it’s the only choice available.

Get out! This road leads to the coffee can in your backyard which appears to be far more attractive than any investment in the financial markets. Investors decide to pull their assets out of the market and hide in cash, money market funds, CDs, savings bonds, etc. They just want to sleep at night. They want investments that don’t fluctuate. They no longer care about the return “on” their principal. They want return “of” their principal. Thus, the investor accepts low returns in exchange for eradicating the volatility.

But…there is another road.

Fix it! This is often the road less traveled. It requires work. It may mean searching for a new advisor. It may include taking losses, selling the stock you inherited from grandma, setting the old pie-chart allocation aside, and reassessing your entire portfolio. You have to make decisions. And some of your decisions could be wrong. This choice does not come with an “easy” button. Trust me! I believe it will be worth the effort given what’s at stake.

Step 1: Identify your goals. What does your money need to do for you? How do you plan to use it? Is this going to fund your retirement or be your legacy? When will you need to withdraw funds? As with any journey, the first step may be the hardest and the most critical because it sets your direction.

Step 2: Draw your pyramid (see Figure 2). Subtract your age from 100. The result will give you a guideline for the percentage of your assets you should consider placing at risk. The “at risk” money goes on top of the secure investments which form the base of your pyramid. How does your pyramid look today?

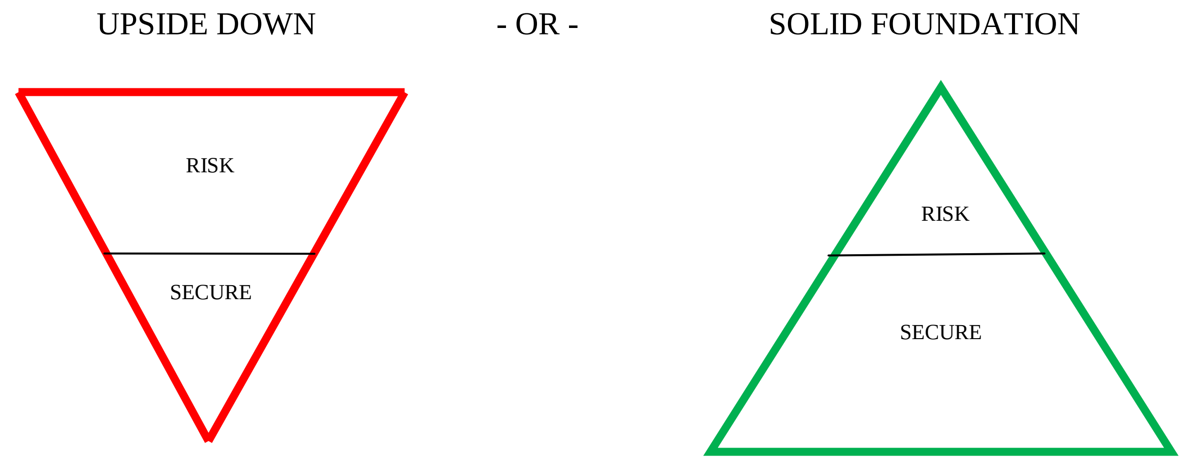


Figure 2 - Asset Pyramid

The Egyptians figured this out thousands of years ago. All it takes is a little volatility to topple the pyramid on the left. Which structure better fits your objectives?

Higher Risk = Higher Volatility, i.e., Mutual Funds, Stocks, Variable Annuities, Bonds, Exchange-Traded Funds (ETFs), Bond Funds, Real Estate & REITs, Currencies, Commodities.

More Secure = Lower Volatility, i.e., CDs, Savings Bonds, Fixed Annuities, Indexed Annuities, Money Market Funds, Treasury Bills.[4]

Step 3: Create a list of the different available investments that could be used as the building blocks of your pyramid. The goal is to put the lowest volatility on the bottom followed by investments with moderate risk and let the high volatility investments ride along the top of the secure foundation. Determine which of these best fits your objectives and timeframes. The perfect portfolio is the one that fits you, meets or exceeds your objectives, and is there for you when you need it.

Step 4: Begin building or reconstructing your pyramid from the bottom up. Establish your secure investments. These will be your S.W.A.N. (e.g., Sleep Well At Night) investments. Once the foundation is in place, look for tactical approaches for the upper tier. Remember, even the investments at the top of the pyramid do not need to stay in the market 100% of the time. Allowing the top money to temporarily slide down into the base when volatility gets too high should always be an option.

Step 5: Revisit your investments and check on the shape of your portfolio on a regular basis. Recalibrate your position whenever a financial change occurs in your life. Make sure your financial advisor understands that you want to stay informed. Schedule regular review sessions. It is your money. Make sure you know what it is doing!

[4] Safety of annuities is based on the claims paying ability of the issuer.

Conclusion:

There appears to be an uncanny relationship between stock market performance and the volatility of the market. The relationship may mean that many measures of risk actually compound in declining markets. Thus, it may make sense to shy away from high volatility investments when market volatility is rising and revisit those investments after volatility subsides. It's easier to move back into the higher volatility investments when your "at risk" dollars have not been cut in half by staying the course.

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