Investment Insights

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What Does the Increased Volatility Mean for my Portfolio?

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The investing website Investopedia defines volatility as "a statistical measure of the dispersion of returns for a given security or market index". In more simple terms, volatility refers to the amount of uncertainty or risk about the size of changes in a security's value.

Investors tend to discuss volatility much more frequently when security prices are declining. With the increase in overall volatility during the past several months, we decided it was a prudent time to discuss how we view volatility and how it affects your investment portfolio.

Any asset class without a stable value (i.e. money market fund) will exhibit a degree of volatility. The higher the expected return, the higher the volatility should be. This is the fundamental underlying theory behind the capital asset pricing model. Since stocks have a higher expected long-term return than fixed income, their volatility should be higher. While investors do not dispute this fact, it is during times of higher than normal volatility that investor angst increases.

During the past several months, volatility in the equity markets has been elevated due to a number of uncertainties. The primary concerns are the weak economic data in China (and coincident Chinese stock market weakness) along with tumbling oil prices. A secondary concern is the Federal Reserve and its timing regarding future interest rate increases. While these concerns are valid, we believe they mask a number of fundamental positives in the US economy and financial markets.

We always use historical data when placing a market in context. Looking at the S&P 500 Index for instance, the index has had a positive annual return in 27 of the 36 years dating back to 1980 (75% of the time). Looking within those annual returns, we see that the average intra-year decline for the S&P 500 has been over 14%. This means that despite an average decline of more than 14% in each year since 1980, the index has finished the year with a positive return in 75% of those years, with an average return over the 36 years of approximately 12% annually.

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This long-term focus, rather than the "noise" of daily or weekly events is how successful investment portfolios are designed, constructed and managed. If we understand that periods of increased volatility will happen, we can position ourselves to avoid doing something emotional and rather, look to take advantage of the volatility by purchasing or selling assets that become temporarily mispriced to a great extent.

Another demonstration on the benefits of long-term investing and the avoidance of short-term actions can be seen in this next example. If an investor had the **absolute worst timing possible** and invested equal amounts in the S&P 500 Index on the exact day of the last three market peaks (buying at the absolute peaks of the market in March 2000, October 2007, and May 2015), the investor would still have a positive return averaging about 3% per year over that time period. Many investors who bought near any of those market peaks likely sold shortly thereafter when they had experienced a loss of 10%, 20% or more and stayed on the sidelines during the subsequent rallies.

How many investors sold during the savage 57% decline between late 2007 and early 2009, missing the more the tripling in the index since that nadir? The market tops can be seen circled in the nearby chart of the S&P 500 Index.

(Chart courtesy of Zacks Research)

Investors with a long-term time horizon are more likely to weather short-term volatility and market declines. We have often stated that it is both difficult and risky to attempt to time the market. While human emotion could lead investors to panic and sell when markets decline, staying invested for the long-term has historically been the smart move. The advantage of long-term investing is that it lowers volatility over longer periods of time. Short-term fluctuations can seem random and unpredictable, but they are part of the normal ebb and flow of markets.

In summary, volatility is not only an expected part of investing, but used properly can enhance long-term investment results. The largest factors preventing investors from using volatility to their advantage are fear and emotion. These cause investors to extrapolate recent market results prompting them to do the exact opposite of what they should do to insure long-term investing success.

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