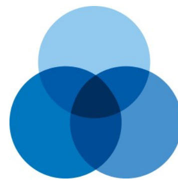
A Compendium on Achieving Financial Independence



EnRich Financial PARTNERS
ALIGNING YOUR MONEY WITH YOUR LIFE

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Volatility-The Fundamental Truth About Investment Success and Failure

Over the past several months, we have been watching our in-boxes fill with e-mail information on webinars and product offerings structured to suppress volatility, as if that were the end goal itself. One fund company advertised, "Adding to Equities? Try Lower Risk." Another company teased with, "short-term volatility mitigation with long-term performance."

To be honest, we understand the attraction. In a perfect world, people prefer less volatility to more. If only that was the complete picture. People might also like to eat all the candy they care to, drink alcohol without regard, and spend money shamelessly without worrying about their balances. You can see where this is headed. All of these actions come with strong consequences, as does volatility suppression. The unspoken truth is that the suppression of volatility must also lead to a corresponding suppression of investment return. When understood fully, one begins to realize that volatility isn't the same as risk. Historically, short-term losses could only be turned into permanent losses by the act of selling when markets were down. This is the behavioral mistake of the ages and the one that the various marketers of lower volatility are pandering to.

> "Do you know what investing for the long run but listening to market news every day is like? It's like a man walking up a big hill with a yo-yo and keeping his eyes fixed on the yo-yo instead of the hill."
> -Alan Abelson

The immutable truths that all long-term equity investors must accept are:

1. Volatility is another word for unpredictability. Volatility is simply the large and erratic nature of market movements to both the upside and downside. Stocks can be up 20% one year and down 20% the following year. Bonds, CDs, and money markets do not behave like that, so people feel they are more predictable.

2. The excess return of stocks over bonds and cash is simply an efficient market's way of pricing and rewarding the equity investor for the unpredictability of the year by year returns. If stock returns didn't vary to the magnitude that they do, their price would be bid up to a point where all the excess return was removed and the long-term return would be the same as a risk-free asset like a bond or cash. This is a wonderful revelation; once you realize this, you discover you cannot have equity type returns without commensurate equity type volatility.

3. This leads to the conclusion that to suppress volatility is to suppress return. There are some that believe markets are so inefficient that volatility

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- Volatility is another word for unpredictability.
- Advances have been permanent; declines have been temporary.

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can be suppressed if only the right investments are selected, which we all know in our hearts is untrue. When the tide goes out all ships go down. There are also those that believe volatility can be suppressed through market timing by side-stepping all or a portion of a market decline—another belief we know is untrue, since there are no acclaimed investors or Forbes 400 members that have achieved their success by timing markets. To side-step a downturn is to also side-step an upturn, since we never know when a market decline will begin/end or when an advance will begin/end.

4. A diversified portfolio of equities has always had a long-term rising trend of earnings and dividends. Therefore, it would be illogical to seek to minimize what have always been temporary declines at the expense of the long-term permanent return. A wise financial journalist, Nick Murray, captured this best when he said, "the advance is permanent; the declines are temporary."

5. The most defeating outcome an accumulator of wealth could possibly seek would be for the suppression of volatility. This is not only borne out in the mathematical history of volatility versus return, but is further supported by the dynamics of dollar-cost-averaging. Higher highs and lower lows actually increase the lifetime return of the diligent dollar-cost-averaging accumulator. Thus, those who accumulated over the past 15+ years of wrenching market return punctuated by two severe bear market declines of 50% were actually enriched by the volatility.

6. In light of the truths above, the only investor that might genuinely be harmed by a temporary decline is the recent retiree. This is the converse to the dollar-cost-accumulator mentioned above. Rather, this is the dollar-cost-distributor problem. If the recent retiree experiences too many poor return years at the wrong time (generally the early years of retirement), the long-term sustainability of the distributions could be in jeopardy. Simply put, buying more shares priced at $0.60 when the market is down and fewer shares at $1.20 when the market is up works great for the accumulator, since you end up with more shares at a below average cost to the market. Selling more shares at $0.60 when the market is down and fewer shares at $1.20 when the market is up actually is a drag on returns (not the enhancer it was for the accumulator). Herein lays the devil of all conundrums, behavioral and real. The investor that fears this outcome in advance seeks out lower volatility investments, which we know lead to lower returns. Conversely, the investor that panics out of equities during the down cycle permanently harms returns from which many never recover. We seek to manage this problem by keeping at least 3-4 years of expected distributions in lower volatility investments (the proper use for this category of investments) and cash, with the rest of the portfolio invested in equities for long-term growth. In severe market downturns of 20% or more, our investors can take all of their distributions from the low volatility side of their portfolio, thereby "protecting" their equities from being liquidated in the down cycle. This strategy would have allowed virtually all investors to weather the historical pattern of bear markets since WWII. Incidentally, since 1924 there have been 13 bear markets with declines of over 20%, and they've come along about every 5-7 years on average. The average of those declines has been about 32%. The average duration of the bear market from peak-to-trough-back-to-even has been about 40 months (3.3 years). Thus, all equity investors should be prepared and expect to weather a decline of about 1/3 in their equity balance about every 5-7 years and wait over three years from the start of the decline to get back to even. This, of course, has always been followed by the permanent advance over the next 2-3 years that Nick Murray referred to. Then the cycle repeats itself.

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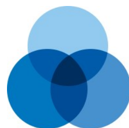
We recognize that understanding the history of volatility and market returns on an intellectual level may not change the emotional response we may be wired to experience during the next down cycle. We can assure you that the 24/7 news cycle will be negative and filled with "this time is different" commentary. It may feel like the global economic system is crumbling and that global growth will never resume. Don't believe it. Feeling uneasy or even scared is normal, but avoiding the flight response to panic out of equities is essential to ensure that you are invested in equities when the market creates what has historically been its "permanent" advance.

We consider it a privilege to speak with our clients when they are feeling uncertain about the long-term investment strategy that has been put in place to serve their long-term goals. Do not hesitate to contact us if we can ever be of reassurance or assistance.



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