EMPYRION™

WEALTH MANAGEMENT

Investing with Integrity ®

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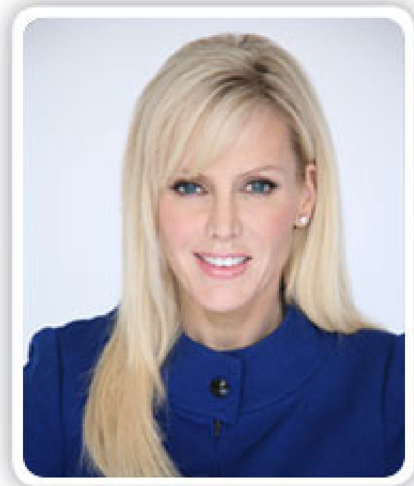
When Volatility Spikes, Stand Firm and Proceed with Caution



Kimberly Foss, CFP®, CPWA®

Behavioral finance teaches us that when facing uncertainty, we are hardwired to react with fear. A recent Caltech study, for example, imaged subjects' brains as they made decisions with increasingly less information. You might figure that sparse data would lead the subjects to hesitate and to carefully evaluate what little information they were provided with. Yet, the reverse was true. The less data the subjects had to evaluate, the more irrational and erratic their decision-making became. Of course, there's a scientific root to this behavior. As the uncertainty of the scenarios increased, the subjects' brains shifted over to the limbic system, the place where emotions, such as anxiety and fear, overpower reason.

Of course, in uncertain markets like we are currently experiencing, it's important to hang onto reason. And that can be difficult when we are confronted with so much uncertainty. Individual investors who don't work with advisors are often hurt when they make investment decisions in response to news headlines. Generally, that means buying high and selling low. I caution our clients not to respond to the fearful urge to "do something" or to disengage with their plan. That's because we build diversified portfolios to withstand market swings. We emphasize the importance of broad diversification, efficient portfolio design and execution, and consistent asset class exposure as the most reliable means of capturing market premiums that can offer investors higher expected returns and minimizing downside risk.

And, quite simply, the markets reward discipline, not knee-jerk reactions. For example, one dollar invested in the MSCI World Index (net dividends) from 1970–2014 is worth $45 today. This is true in spite of all the volatility surrounding events such as the oil embargo and S&P 500 drop of 45% in the 1970s, the Dot Com Bubble, the Subprime Mortgage crisis when the S&P 500 fell 46%, and the government's fiscal cliff crisis.

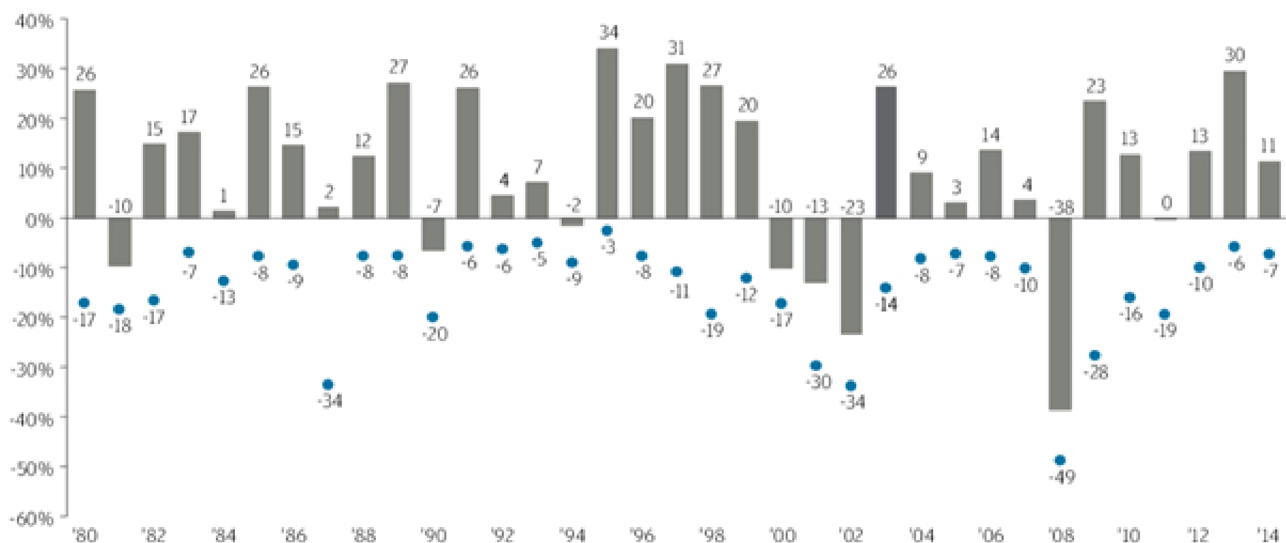
Still, however, fear can freeze investors like a deer in the headlights. As trusted advisors, we need to ensure our clients have the ability to move forward in a positive way in spite of so many uncertainties in the current market. Will the volatility continue? Will the Fed raise rates later this fall or in December? We don't know. However, we still need to stay committed to our plan.

And focusing outward, on the news headlines, can be very harmful to both your short-and long-term goals. Therefore, when listening to news stories about recent volatility, it's important not to let the reporter's mission of communicating what happened that day deter from your long-term investment perspective. Often reports center on

news that simply does not matter for your properly diversified portfolio. Yes, the Dow Jones Industrial Average may have fallen that day, but the market fundamentals have not changed.

Especially in times where volatility spikes, it is even more important to distinguish between market performance that stems from short-term news rather than long-term fundamentals. Think back to October 19, 1987, or “Black Monday,” when the S&P 500 plummeted 20.5%. Notably, the worst day on record for the stock market was a result of trading behavior, not underlying economic fundamentals. Although the fall was steep, the S&P 500 recovered to end the year with a slight gain. And investors who stayed stay invested during these few months were rewarded. More recently, in 2014 we saw a market pullback, when the market fell 7.4% during October over a variety of global concerns. Yet, performance was solidly positive by the end of the year. The S&P 500 posted an 11% return.

This chart from J.P. Morgan shows that despite average intra-year declines of 14.2%, annual returns for the S&P 500 were positive in 27 over the last 35 years.



This certainly provides encouragement to keep your eye on the long-term. J.P. Morgan’s “Investing with Composure in Volatile Markets” also makes the point that diversified, regularly rebalanced portfolios have typically resulted in higher Sharpe ratios than other singular equity asset classes over 10-, 15- and 20-year time horizons. Specifically, over the last 10 years, a diversified “asset allocation portfolio” with the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Barclays Capital Aggregate, 5% in the Barclays 1-3m Treasury, 5% in the CS/Tremont Equity Market Neutral Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index has generated annualized returns of 6.5%, comparing favorably to other major asset classes. More importantly, the returns were achieved with lower volatility than other equity asset classes. Over this 10-year period, the asset allocation portfolio’s volatility was two-thirds that of the overall stock market and almost one-third that of emerging market equities.

That smoother ride in and of itself can keep investors from making poor decisions when the road ahead looks uncertain. And so, today, rather than change with the market winds, we continue to advise staying diversified and focusing on the long-term. We must not view volatility through an intra-day, intra-week, or even a quarterly lens.

Further, as with any relationship, consistency is always a comfort in times of major stress. And our investment approach has not changed as a result of the increased volatility in the markets. We make changes to your portfolios when your goals, time horizons or risk tolerance change, not in direct response to market fluctuations.

Stay Diversified, Stay the Course!

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