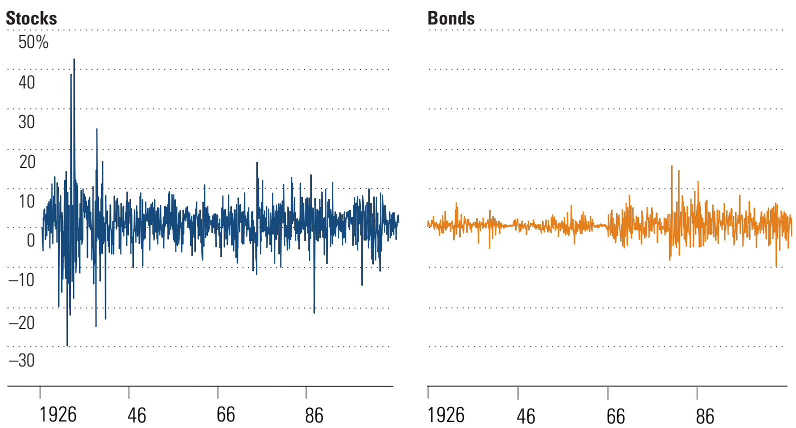
Market Volatility Risk

How volatile are stocks and bonds?

Market volatility risk refers to how much the capital markets, and more specifically, the value of your investment assets, fluctuate up and down. Every investment has some level of risk or volatility. Investments don't increase in value in a straight line over time. They weave and wind from point A to point B. You can think of the jaggedness of returns over time as market volatility risk.

Historically, stocks have been riskier than bonds
Volatility of stock and bond monthly returns 1926–2006



The illustration above contrasts the historical monthly volatility in returns of large stocks and long-term government bonds. Although stocks volatility decreased after WWII, they are still more volatile than bonds on a month-to-month basis. But over long holding periods, stock investors have been rewarded with higher returns for assuming greater risk.

Many retirees traditionally have invested most of their asset in bonds, perceiving them to be safer and more predictable than stocks. That may no longer be prudent as bonds have become more volatile over the past 25 years. You should consider carefully what level of exposure to stocks is appropriate given your risk tolerance, time horizon, and needs.

Another important concept to grasp is the importance of managing downside risk, or years of large negative returns. Consider an investor who invests $1,000 and suffers a 25% loss in the first year, followed by a 25% gain in the next year. Many people would assume the investor ended up where he or she started, but that isn't the case. After two years, the investor would have only $937.50, a loss of 6.25%. This happens because the 25% gains are applied to a smaller asset base at the end of year one. The larger the downside returns, the longer it will take to regain your footing. If the same investor suffered a 50% loss followed by a 50% gain, he or she would have only $750 after two years, for a loss of 25%. This illustrates that it can take years to recover from large losses.

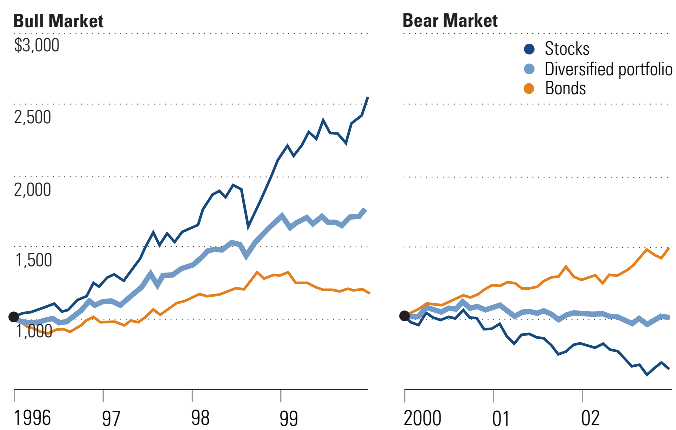
How can I manage downside risk?

Asset classes such as stocks and bonds react differently to economic events. Because of this, it pays to spread out your investments among multiple asset classes. Effective diversification can reduce portfolio volatility and downside risk.

Investments that react in opposite ways are said to be negatively correlated. Such is the case with small stocks and intermediate-term bonds which historically have had slightly negative correlation. Most asset categories, however, have some level of correlation with each another. Given this, diversification commonly includes mixing asset classes with low correlation to each other. An example would be the combination of real estate or commodities with stocks.

The old saying "don't put all your eggs in one basket" is sound advice. By diversifying your portfolio among several types of investments that have low or negative correlation, you can help insulate your portfolio from major downswings in any single asset class. How much to allocate to each asset class depends on factors such as your goals, investment time horizon, and risk tolerance.

Diversified portfolios preserve wealth in bull and bear markets
Stocks, Bonds and Diversification: 1996–2002



The line graphs above illustrate the concept of diversification. The image on the left shows the hypothetical growth of three different $1,000 portfolios invested during a four-year bull market for stocks. The all-stock portfolio performed very well, but with significant volatility, while the all-bond portfolio showed slow and steady growth. The diversified portfolio composed of 50% stocks and 50% bonds charted a middle course, with much less volatility than the all-stock portfolio.

The image on the right illustrates the hypothetical growth of the same three portfolios during a three-year bear market for stocks. The all-stock portfolio lost nearly 40% of its value over this period, while the all-bond portfolio was up more than 40%. The balanced portfolio again charted a middle course, ended about where it started, and experienced much less volatility.

A critical point here is that at any given point in time, you don't know whether you're likely to see a bull or bear market. Given that you don't know, a diversified portfolio will limit your downside risk in a

Questions to ask your advisor:

- What range of returns and volatility can I expect from various asset classes and my portfolio?
- What allocation to stocks is appropriate given my needs, time horizon, and risk tolerance?
- Should I have exposure to asset classes with low or negative correlation to my core stock and bond positions?
- Given the asset allocation of my portfolio, what is a reasonable expectation for returns and volatility?

bear market and provide growth in a bull market. This is the goal of diversification: to reduce volatility or risk during all types of market conditions.

Should allocations change in retirement?

The primary goal for most investors saving for retirement is wealth accumulation, or building the biggest possible nest egg. But the primary goal for most investors in retirement is the preservation of wealth and purchasing power.

Traditionally, investors in retirement allocate more of their portfolio to asset classes with lower volatility, such as bonds. However, a conservative portfolio in retirement does not necessarily mean shifting all of your money to cash or bonds. Conservative portfolios in retirement can still have a large allocation to stocks. Stocks help diversify the interest rate and market risk associated with bonds (bond prices fall when interest rates rise and vice versa), and help maintain purchasing power by outpacing inflation over time.

Keep in mind that an investment cannot be made directly in an index, and past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. The data assumes reinvestment of all income and does not account for taxes or transaction costs. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than the other asset classes.

Source: Stocks—Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general; Bonds—20-year U.S. Government Bond.