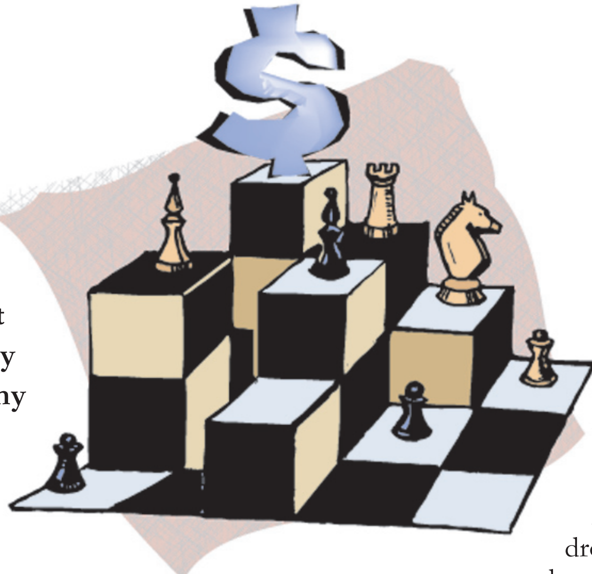
Your Portfolio: Maintaining Perspective

By John Markese and Maria Crawford Scott



At times of financial turmoil, such as those we have experienced for the last year and even more severely over the last month, many investors may feel lost in unfamiliar—and extremely discomforting—territory.

In times like these, when the media headlines are screaming "meltdown" and "unprecedented crisis," fear and uncertainty can prompt an emotional response that causes investors to flee their stock holdings and run for the cover of more certain investments such as Treasury bills.

But this emotional response is based on a short-term perspective, and it could result in the opposite of what you intend—substantially increasing the risk that your long-term investment goals will not be reached.

Instead, you need to take emotions caused by short-term conditions out of the equation by putting things into perspective and sticking to the fundamental rules of investing.

The Bear Market Perspective

First, let's put the current bear market conditions into perspective. Is the unsettled state of the current market "unprecedented"?

Many market and economic crises are "unprecedented"—that is, it is the lack of historical guidelines for the particular conditions that creates much of the uncertainty and fear. But the stock market has always recovered from these "unprecedented crises," and the current market drop has not yet shattered all bear market records.

As of this writing in late October, the market as defined by the Standard & Poor's 500 has fluctuated violently on a day-by-day basis over the last month, including several daily drops of over 9% each (and a one-day gain of 11.6%). Through October 21, the market is roughly down 15% for October, down 33% since the beginning of the year, and down 39% from its peak last October.

While the daily fluctuations have no doubt frayed investors' nerves, the overall decline from last year's high has not yet surpassed other severe downturns. Stock market investors in past bear markets, for instance, have seen drops of nearly 50% on at least two occasions, from January 1973 to October 1974 (–48.2%) and from March 2000 to October 2002 (–49.2%).

Second, what happens if you abandon your plan and drop out of stocks at this point in the market cycle?

Most likely, you will either never re-enter the stock market, or you will re-enter at a point higher than now—in other words, you will have bought high and sold low, not a winning stock market strategy.

If you never re-enter the market, you will of course entirely miss out on the market's long-term return advantages. But even if you do re-enter the market, the likelihood that you will re-enter when the market is still low is very small. If you have abandoned the market due to an emotional response to the negative market conditions, you are not likely to re-enter until conditions have turned far more positive. By that time, the stock market will have already moved much higher. Stock market rallies come quickly and unexpectedly. If you are out of the market, the likelihood of missing one of those rallies is high. For example, after the 1973–1974 bear market, the market gained 37% in 1975 and 24% in 1976; after the 2000–2002 market, the market gained 28.7% in 2003.

The shorter the time period that you are invested in the stock market, the more subject you are to violent short-term swings in the stock market. Investing in the stock market over longer time periods tends to smooth out returns, while allowing you to participate in the overall upward trend in the stock market.

The Long-Term Perspective

If you flee the stock market, you still need to decide where to invest your assets.

What are the alternatives?

If you are currently wary of the stock market, the current state of the real estate market is not likely to lure you in.

Other investment alternatives, such as cash and fixed-income investments, are substantially less volatile than stocks.

But the long-term risk all investors face is a failure of their portfolio to grow in real terms after inflation, and the possibility that they may even face a loss of their portfolio's purchasing power over time due to the ravages of inflation.

Among the major asset classes, stocks have always provided the best long-term protection against this failure to grow in real terms. In contrast, Treasury bills—which have virtually no short-term volatility—have failed to offer real growth over the long term; they are subject to substantial inflation risk.

Table 1 shows the long-term average rates of return for stocks, intermediate-term government bonds, and cash (Treasury bills) since 1945. Stocks have substantially outperformed the other two categories despite going through several very severe bear markets.

Table 1. Average Annual Rates of Return (1945–2007)

S&P 500	11.8%
Intermediate-Term Gov't Bonds	5.8%
Treasury Bills	4.5%
Inflation	4.0%

In addition, the long-term returns indicated by the intermediate-term government bond figures and Treasury bills include time periods when yields were substantially higher than today's current yields. Since the yield from a fixed-income investment is the primary component of that asset category's return, it is important to note that current yields on both intermediate-term government bonds (currently 3% to 4%) and Treasury bills (around 1%) are substantially below the long-term average returns. Inflation in 2007 was 4.1%.

A look at the most recent period puts the market decline into perspective even more. Table 2 shows the returns for various segments of the stock market over time periods that encompass the most recent stock market losses, through October 21, 2008. The rates of return are average annual rates of return (except for the year-to-date figure), but they cover non-calendar-year ending time periods.

In particular, note the returns over the 10-year period—this encompasses one of the worst possible long-term time periods, entering the market at the top of the Internet bubble, including the 9/11 bear market, and ending with the extreme market losses this past month. Even during that worst possible time period, being a long-term investor would have produced positive rates of return—a mere 0.5% in the S&P 500, but substantially higher if you were diversified among the various stock market segments.

Table 2. Stock Segment Returns During Recent Periods

	YTD	Avg Annual Returns Through 10/21/08		
	Return (%)	1 Year (%)	5 Years (%)	10 Years (%)
S&P 500 (Large Caps)	–33.8	–35.0	0.1	0.5
MidCap 400 (Mid Caps)	–33.6	–35.0	2.1	7.2
Russell 2000 (Small Caps)	–30.0	–32.6	1.4	5.3

The Portfolio Perspective

When you are reviewing your current position, don't look at just the stock market portion of your portfolio. Instead, put it into the context of your total portfolio.

If you have allocated among the major market segments, your total portfolio does not consist solely of stocks. Although it may be disheartening to see a drop in the value of your total portfolio, the percentage drop will not be nearly as large as the stock market's decline. That means that the other segments of your portfolio are doing their job, helping to temper the downside risk to your portfolio due to short-term stock market slides.

Table 3 illustrates the risk-reducing nature of this approach. Returns were determined for one-, five- and 10-year rolling time periods from 1945 through the end of 2007 for each of the three major asset classes (for example, the rolling 10-year time periods 1945–1954, 1946–1955, 1947–1956, etc.). The table indicates the worst returns and the best returns an investor would have received over the time period indicated.

The table also shows the results for two portfolios, one composed of 80%

Table 3. Best and Worst Average Annual Returns (1945–2007)

	Worst Average Annual Returns Since 1945 (%)		
	Over 1 Year Periods	Over 5-Year Periods	Over 10-Year Periods
S&P 500	−26.5 (1974)	−2.4 (1970–1974)	1.2 (1965–1974)
Intermediate-Term Gov't Bonds	−5.1 (1994)	1.0 (1955–1959)	1.2 (1947–1956)
Treasury Bills	1.0 (2003)	0.6 (1945–1949)	1.0 (1945–1954)
Portfolio 1 (80/10/10*)	−19.8 (1974)	−0.82 (2000–2004)	2.0 (1965–1974)
Portfolio 2 (60/20/20*)	−13.2 (1974)	0.66 (2000–2004)	2.7 (1965–1974)
	Best Average Annual Returns Since 1945 (%)		
	Over 1-Year Periods	Over 5-Year Periods	Over 10-Year Periods
S&P 500	52.6 (1954)	28.5 (1995–1999)	20.1 (1949–1958)
Intermediate-Term Gov't Bonds	20.3 (1985)	17.0 (1982–1986)	13.1 (1982–1991)
Treasury Bills	14.7 (1981)	11.1 (1979–1983)	9.2 (1978–1987)
Portfolio 1 (80/10/10*)	42.5 (1954)	24.1 (1995–1999)	16.7 (1989–1998)
Portfolio 2 (60/20/20*)	32.1 (1954)	19.6 (1995–1999)	14.7 (1982–1991)

**Percent allocated to stocks/intermediate-term bonds/Treasury bills.*

stocks, 10% intermediate-term bonds and 10% cash, and the other composed of 60% stocks, 20% intermediate-term bonds and 20% cash, where Treasury bills are used as cash investments.

The most striking result is the change in the biggest declines: Compared to the all-stock portfolio, the biggest decline substantially decreases over the short term for the two portfolios that contain all major asset categories. The table also illustrates the advantage of a long-term horizon: The risk of suffering a loss in the all-stock portfolio substantially decreases as the investment horizon is lengthened.

The table illustrates an important implication of your asset allocation strategy: For shorter-term horizons, volatility risk is the greatest concern; for longer-term time horizons, inflation risk becomes a greater concern. For this reason, money invested for the short term should be invested differently than money invested over the long term. Assets that you will need within a five-year timeframe should not be invested in the stock market.

Put another way, your allocation to cash provides a cushion that allows you to ride out any stock market downturns. This is particularly important for retirees who are living off of their retirement savings.

The Fundamental Rules

Maintaining a proper perspective keeps you focused on your long-term investment goals. You can more easily maintain a proper perspective during moments of fear and uncertainty if you follow the fundamental rules of investing.

Remember, while markets are variable, these fundamental rules of investing are constant:

- **Diversification:** Keep your portfolio diversified among the major asset categories (stocks, bonds and cash), and make sure you are diversified within each of those categories, with commitments to all market segments.
- **Liquidity:** Maintain enough of a cash reserve so that you do not have to withdraw from your stock portfolio during extreme market lows. In other words—don't put money into stocks that you will need in less than five years.
- **Market Timing:** Don't try to time the market by making major allocation changes, particularly during extreme market conditions when your decisions are most likely to be driven more by emotions rather than reason.
- **Planning:** Keep your long-term goals in sharp focus, and stick to your long-term asset allocation plan. Change your asset allocation only when your goals or circumstances change, not when markets gyrate.
- **Knowledge:** Understand what you are investing in and how those investments are likely to behave in extreme market environments.
- **Risk:** A portfolio composed solely of short-term assets, while safe from short-term market fluctuations, increases the risk that you will not achieve your long-term investment goals after inflation.

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