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What Happened to Volatility?

This year, stock market volatility has been muted even as the major market indexes have reached new highs. Low volatility has led some investors to forget the latent sting of stock ownership. Stock market volatility is often hidden in annualized return data. For example, from 1926 through 2016, the S&P 500 Index has yielded an average annualized return of 10.0% (with dividends reinvested). So far, so good. But this fact alone can deceive the unwary because calendar year returns during this period varied between +54% and -43%.

Let's take a closer look at the historical volatility of several stock/bond allocations. Volatility is usually measured by standard deviation which is a measure of the annual variations above and below the long-term average annual return. For this discussion, I won't use standard deviation but instead look only at declines in a portfolio's value (no one complains about upside volatility). A decline can start at any time and has no fixed length. Investors experience the emotions of falling portfolio values as they happen, not on an annual basis. A portfolio may yield positive returns in a calendar year but during those twelve months, it may have experienced an unpleasant decline that was hidden by the subsequent rebound.

The chart below shows the historical portfolio performance of various stock and bond allocations from January 1972 through December 2016. The equity portion of the portfolios consists of large company domestic and international stocks and the bond portion consists of investment grade domestic bonds. The database contains 540 monthly returns for each portfolio and the portfolios were rebalanced annually. Although the future won't be a repetition of the past, analyzing past volatility spikes can give us a good idea of what the future might bring.

In the chart, the Highest Rise is the greatest rebound from the low point of a decline to a new high point. The deepest fall is the largest percentage decline in the portfolio. Fall Duration is the number of months in the deepest fall. Time to Recover Initial Value is the time between the start of the decline **and the** return to its initial value. The number of portfolio declines of 10% or greater completes the chart.

Allocation	Highest Rise	Deepest Fall	Fall Duration (Months)	Time to Recover Initial Value	Falls of 10% or Greater
100% Stock	48%	-53%	16	62 months	8
80% Stock/20% Bond	42%	-43%	16	41 months	8
60% Stock/40% Bond	52%	-32%	16	37 months	5
50% Stock/50% Bond	46%	-26%	16	35 months	4
40% Stock/60% Bond	41%	-21%	16	28 months	3
20% Stock/80% Bond	31%	-9%	10	14 months	0
0% Stock/100% Bond	26%	-9%	7	9 months	0

As might be expected, the depth of the deepest fall and the time to recovery are directly related to the portfolio's stock allocation. The 62 months required to recover from the deepest fall of the 100% stock portfolio reinforces my belief that you shouldn't put any money in stocks that you will need within the next five years.

Let's take a closer look at the 50% Stock/50% Bond portfolio. This is a balanced, moderate portfolio that would be appropriate for retirees or people approaching retirement. The annualized historical return of this portfolio over rolling five-year periods (1972 – 1976, 1973 – 1977, etc.) from 1972 through 2016 was 9.5%. An excellent return by anyone's measure. Now let's take a closer look behind that exceptional performance.

The highest rise began in February 1985, gaining 46% over the next 16 months. The deepest fall was 26%, beginning in October 2007. The portfolio declined for 16 consecutive months during the financial crisis until it began rising in February 2009; recovering all its losses by September 2010. It's important to note that the 26% decline was an outlier; the only decline that exceeded 20% in the past 45 years. There were three additional declines greater than 10%; ranging from

13.5% to 17.7% but no other declines that exceeded 8%. Of the 78 declines that lasted more than a month, 75 lasted less than six months and 74 were less than 10%. Had you engaged in monthly portfolio peeking over the past 45 years, you'd have seen your portfolio decline one month out of three. Had you limited your peeking to once a year, you'd have noted just seven declines.

When it comes to investing, we are our own worst enemy. We fail to achieve our financial goals primarily because of a lack of planning, a lack of discipline and an overabundance of emotions. Our natural response to each new bout of market volatility is "This time it's different!" instead of "This too shall pass." This is why every investor needs a written financial plan – one that contains a portfolio allocation that is appropriate for their goals, time horizon and risk tolerance. The asset allocation will not change from year to year, unless significant changes occur in the investor's goals or financial situation. Investors with written financial plans are more likely to stay on course during bouts of market volatility. In the absence of a plan, investors will be driven by the fads or fears contained in today's headlines.

During times of market volatility, the financial media adds to investor angst by obsessing over events that are out of our control and we waste our time and energy worrying about them. It's important to develop an ability to recognize irrelevance when you hear it. You cannot separate volatility from uncertainty. The next time you read or hear the word "volatility" in the financial media replace it with "uncertainty". There's plenty of uncertainty in the world today but this is nothing new – it's the default setting of life. Yes, we are beset by problems. But we have always been beset by problems. There has never been a golden age in the past free from political, geopolitical and economic uncertainty. Historian David McCullough said the following in his valedictory address to the class of 2004 at Ohio State University –

> "*When bad news is riding high and despair is in fashion. When loudmouths and corruption seem to own centerstage. When some keep crying that the country is going to the dogs. Remember – it's always been going to the dogs in the eyes of some. And that 90% or more of the people are good people, generous hearted, law abiding, good citizens who get to work on time, do a good job, love their country, pay their taxes, care about their neighbors, care about their children's education and believe in the ideals upon which our way of life is founded."*

All investors must learn to deal with uncertainty and volatility. While the actual events that have occurred in the past will not be repeated, the event types (political, geopolitical, economic) can be expected to recur. If you make investment decisions based on a worst-case scenario, you'll own a portfolio that is too conservative to yield the long-term return necessary to meet your financial goals. It's more prudent to have a portfolio allocation based on what is most likely to happen rather than what your fear might happen.

The Next Correction

As of the first week in August, the Dow Jones Industrial Average has set 34 new all-time highs this year. So, it's no surprise that anyone tuning in to the financial media these days is likely to hear some commentator insist that the stock market is ripe for a "correction" – usually defined as a decline of at least 10%. If we use the S&P 500 Index as our stock market proxy there had been 57 corrections since 1946. The last correction occurred at the beginning of 2016 – an event that most investors have already forgotten. Yet all these corrections have been mere temporary declines. The S&P 500 Index has yielded a 10.7% average annualized return since 1946 and provided a positive return in 50 of those 71 years - rising from 15 to 2,470 at the beginning of this month.

The media's negative pundits spout a litany of reasons why the market is ripe for a fall. There's so much data available that it can be selectively edited to support anyone's forecast; whether good or bad. But the stock market's valuation has never been a good market timing tool and most of these negative pundits are just trying to get noticed. Wise investors ignore them. Rather than asking “Are we about to have a market correction?" a better question is, “Does anybody know what the market is going to do next?”

Neither you, I, anyone you know, have read about, heard about, thought about, dreamed about, met or will ever meet knows what the market will do next. No one knows how to get out of the market just before it peaks and get back in just before it rebounds. Even professional money managers can't do it, one reason why most actively managed mutual funds underperform their benchmark index.

Too many financial advisors either don’t know, or have forgotten, that their first calling is to do no harm. They've forgotten, or never read, this piece of advice from legendary fund manager Peter Lynch –

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, that has been lost in corrections themselves."

For many financial advisors, the most difficult words to say when asked to give an opinion about the stock market are: “I don’t know.” If you've never heard these words from your financial advisor, be on your guard. You're dealing with someone who's pretending to know more than he does. The global economic system is far too complex and dynamic for anyone to grasp and understand it all. It takes a lot of self-confidence and intellectual honesty to say: "I don't know" to clients who are depending on your perspective and advice. Advisors who can't say: "I don't know" usually just repeat a smart sounding answer they've read or heard. It's dangerous to act upon anyone's short-term market prediction. None are more reliable than coin flipping -- an investment strategy that is sure to disappoint in the long run.

Is a stock market correction just around the corner? Yes - we just don't know how far it is to the end of the block. Selling a perfectly adequate stock portfolio today with the idea of repurchasing it at a lower price sometime in the future is a nonsensical, risky strategy.

Fortunately, you don't need to know the near-term direction of the stock market to be a successful investor. The time to buy stocks is when you have money to invest. The time to sell stocks is when you need the money for something more important. The 58^{th} correction since World War II will arrive someday and it will be accompanied by large font headlines and frantic commentaries in the financial media. Like all those that have preceded it, it will be quickly forgotten once the market recovers. The best way to deal with it will be to maintain your portfolio allocation, continue funding your portfolio and rebalancing it periodically. Ignore the noise and let time and compound growth work their magic on your behalf.

Starbucks Is Hazardous to Your Wealth?

According to a recent Vanguard blog post, your daily trip to Starbucks may be hazardous to your wealth. The blogger estimated that if instead of spending $3.50 per day at your favorite coffee shop, you invested the money in an account that earned 6%, you'd have $106,000 after 30 years. The blogger concluded – "I don't think anyone would pay $106,000 for coffee!" This may be an interesting example of the benefits of compounding but as a piece of financial advice, it is worthless. Let's take a closer look.

You'll still need your morning cup of joe so the alternative is to brew it at home. I spend $.35 for one K cup of Costco's Kirkland brand dark roast coffee. We must subtract this amount from $3.50; producing a daily net cost savings of $3.15. Invested at 6% over 30 years, it would yield a final balance of $95,000 instead of $106,000.

But you need a Keurig K-cup machine. You can buy one for $100 at Amazon. The compound growth of that $100 over the next 30 years must be subtracted from the final account value. Keurig machines don't last forever so let's assume that you'll have to buy a new one every five years. That lowers your ending portfolio value by about $2,000 - net now $93,000.

But you can't spend that $93,000 until you pay a 15% tax on the long-term capital gain - another $9,000. Net now equals $84,000. If we assume that you retire in 30 years and live another 30 years, that $84,000 will allow you to spend an extra $7.67 per day. That's a good thing because with 2.5% inflation, today's $3.50 cup of joe will cost $7.35 thirty years from now. So, my question for the blogger is: "Who in their right mind would save up for 30 years to buy a cup of coffee?"

The blogger didn't mention that you could double your savings by insisting that your spouse avoids Starbucks for the next three decades. Additionally, you can tell your kids that at $4 a pop, their Big Mac eating days are over. "Daddy, it's 90° out today – can we stop off on the way home and get an ice cream cone at Baskin-Robbins?" "Sorry kids, I'm saving for retirement. There's a can of V-8 juice in the trunk." If you find enough novel ways to save three bucks a day, you just might wind up 30 years from now divorced, living alone and wondering why your kids and grandkids never visit.

Recommendations to forgo small present consumptions to enhance retirement finances appear regularly in the personal finance media. They all suffer from two logical flaws. First, saving a dollar here and a dollar there may enhance your pocket change but rarely, if ever, will pocket change find its way into your portfolio. Secondly, these "save a buck" recommendations start with a faulty premise. They assume that it's what you spend your money on that matters. But that's not true – it's whether you can afford to spend the money that matters.

From a financial planning perspective, your monthly income can be divided into three distinct buckets. One bucket contains the money for paying taxes. The second bucket contains the money you're allocating to savings and investments. The third bucket contains what's left over – it's what you can spend each month. If you adequately fund the second bucket and don't overspend from the third bucket, you can splurge a little – it won't kill you. If spending $3.50 at Starbucks each day is going to ruin your retirement, you've got serious financial issues that need to be addressed that have nothing to do with coffee. Although practicing deferred gratification is an important component of good financial planning, deferring inexpensive, affordable, current gratification is foolish, shortsighted, demoralizing and unlikely to have a significant impact on your retirement lifestyle.