by Joseph Lipsitz, CFP®, CPA

On Volatility: 6 things to keep in mind.

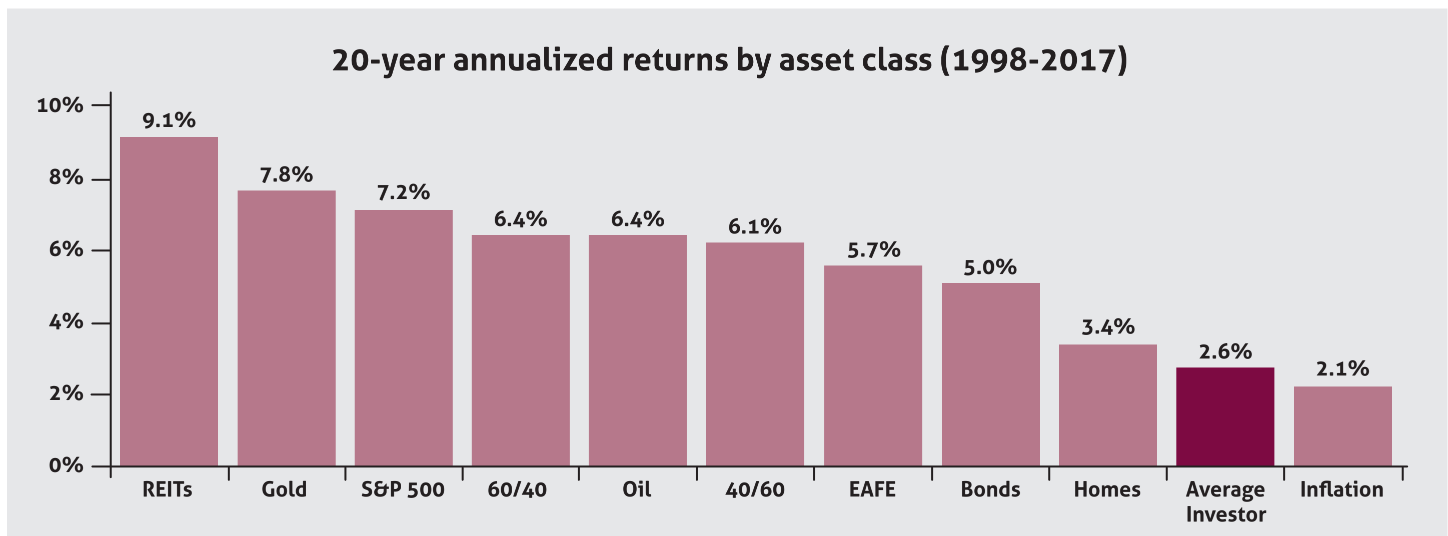
One: In finance, the bottom line is usually at the bottom, after everything else. But we won't waste any time getting to it: **this is what we're here for.**

At the end of 2018, the US stock market quickly fell by 20%. It has been bouncing around wildly since. If you're concerned about the market decline, if you're uncomfortable with the amount of risk in your portfolio, if you're worried that this decline might require a change in your retirement plans…this is what we're here for.

Concern in the face of rapid market declines is not merely the rational human response, it is itself an important cause of the decline. So please, call us. Email us. Come see us.

Two: The average person is a failed investor because investing is difficult. During the last twenty years, the average investor has underperformed nearly every meaningful comparable, and we're here to make sure our clients don't end up as a statistic.

One reason why investors often fail is because it's hard to maintain discipline when facing severe declines. Charles Stein at Bloomberg reported that investors withdrew $56.2 billion from mutual funds in a single week at the end of December 2018[i]. We don't believe volatility is a good reason to make investment changes.



Source: JP Morgan, Guide to the Markets

If you are inclined to sell your investments, selling is not merely an abstract concept. There must be a buyer on the other side of that trade who thinks now is precisely the right time and the right price at which to be buying what you're selling. It's increasingly likely in times of severe decline that the buyers are sophisticated investors, companies buying back their own shares, and large financial institutions. As Warren Buffett said, "the stock market is a device for transferring money from the impatient to the patient."

In volatile times, there are two questions that will determine your success as an investor and ours as advisors:

1) When the market drops 30% or more, how surprised are you going to be? And,
2) What are you going to do about it?

We're writing to ensure your answer to #1 is "not at all" and to offer the context to intelligently address #2.

Three: For people who have been investing during the last 46 years (that's L&M's age), it's been a challenging run at times. Here are the biggest bumps along the way:

Drop	When
- 48%	1973-1974
- 17%	1980 *this drop took only 6 weeks*
- 27%	1980-1982 *after recovering from above*
- 34%	1987 *three months, including a -20% day*
- 20%	1990
- 49%	2000-2002 *dot-com bubble*
- 57%	2007-2009 *global financial crisis*

We can add -20% in 2018 to the list. Still, one dollar invested in the S&P 500 in 1972 would be worth over $90 today. Looking back, it's clear that these steep declines were a small price to pay for incredible growth. But without the declines, the growth doesn't happen. Barry Ritholtz wrote: "The entire point of investing in stocks is that you get greater long-term expected returns in exchange for tolerating bigger ups and downs."

As Greg Ip noted in the Wall Street Journal, if GDP continues to grow at only 2% per year, it will be 350% bigger in 2100 than it is today[ii]. Even if GDP grows quite steadily, the market will often experience periods of rapid decline because of the emotions of short-term thinkers and traders. Technology will change and capital markets will change, but human psychology will not. Over time, short-termers will consistently transfer wealth to long-term investors.

Four: Especially for those of us who don't love air travel, it's jarring to be on a really smooth flight that suddenly hits turbulence. The US market had been a really smooth flight for years. During 2017, the US market never fell more than 3% from its previous high and it was positive during every single month. The July-September quarter of 2018 had 0 days in which the US market rose or fell by more than 1%. And until the end of 2018 we hadn't experienced even an average market decline in any year since 2011.

Disciplined investing is difficult because investment returns are not gifted; they must be earned. Investors earn meaningful returns over time by anticipating volatility and tolerating it when it arrives.

Five: So what can be done?

Two things: the first is to anticipate volatility. If you rolled a die, how surprised would you be if it came up as a 1? That's a 16.7% chance, and rolling a 1 would surprise no one. I'd argue the probability of the market rising by more than 30% or falling by more than 20% in 2019 is higher than the probability of rolling a 1. So I'd suggest we shouldn't be surprised if either case of extreme volatility happens.

Historically, this (>30% or <-20%) has happened about one year in six, and the present seems more volatile than average, doesn't it? You should anticipate this with your financial advisor in determining your asset allocation. You should not invest money that you plan to spend soon in the great companies of America and the world. You should also avoid investing money in these companies if you cannot tolerate a decline of more than -20%. And you should understand that the trade-off of more predictable/lower expected returns over more volatile/ higher expected returns is likely to cost you and future generations of your family serious money.

The second thing is to have a plan. The key function of a plan is to make sure that you don't have to sell in the moment when the market is at its worst. This means that on the very day the market hits its bottom, you'll still be correct to be invested in it. We have no "elevator brake" (as one of our dear clients calls it) in place to get out as the market falls because there's no telling when it will begin its uptrend. Not only is it impossible to consistently get out of the market at the right time, it's impossible to get back in at the right time too. And if you feel inclined to get out on the way down, things are sure to feel much, much worse at the bottom. Further, the very best days tend to be clustered around the very worst ones (like the +1,000 point Dow day at the end of December).

The last meaningful market bottom was on March 9, 2009, and every dollar invested then is worth about $4 today. Morgan Housel says "every past decline looks like an opportunity, every future decline looks like a risk." Indeed.

Six: Volatility is a serious cause for concern, but it doesn't have to be. We invite you to review your long-term plan with us, and to consider both rebalancing your portfolio and deploying any cash you've accumulated on the sidelines.

This is what we're here for.

[i] https://www.bloomberg.com/news/articles/2018-12-26/mutual-fund-outflows-surge-to-56-billion-most-since-2008
[ii] https://www.wsj.com/articles/the-world-is-getting-quietly-relentlessly-better-11546430400

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