

Stock Market Volatility

in a long-term investment perspective

The rumor of defaulting government bonds sends foreign markets down. Two months with no rise in the S&P 500 Index creates worry about another drop in big-company stock prices. China's rapid growth hints at a new bubble. Even after a recovery from the financial-market plunge that started in 2008, you still have an uneasy feeling about what's around the corner.

What to do? Dump your holdings? Curse the financial advisor who suggested investing? Fly to Las Vegas?

For starters, step back and consider the situation in the perspective of time.

Prices in any open, public market fluctuate over time as a result of new information, changed conditions, the proportion of buyers to sellers, investor attitudes and emotions, and other factors. Stock prices go up and down every day. That's what they do in the market. When they fluctuate wildly, they are said to be *volatile* (from Latin *volare*, to fly). Price volatility itself is a negative risk factor for any investment, no doubt about it. If two investments return an average of 10% a year over 20 years, but one is more volatile than the other, returning plus 15% in some years and minus 15% in others, its final value will be less than the investment that grew more steadily. (Counter-intuitive, maybe, but try it on your calculator.)

Now consider the long-term record. Since recordkeeping began, the S&P 500 Index, a proxy for all large-company stocks, has returned an average of 9.8% a year; bonds (the Aggregate Bond Index) about 5.4% a year; and money market accounts (a cash equivalent) less than 4% a year, or almost nothing once average inflation of roughly 3% has taken its cut.

As we know from recent experience, the U.S. stock market has experienced fearful volatility at various times, and not just during the Great Depression. The S&P 500 Index plummeted in the

fourth quarter of 2008, closing down 38.5% for the year, then lost another 20% by early the following March. Another example: returns were negative for three years in a row in 2000-2002. In 1973 the Index had a negative return of nearly 15%, followed in 1974 by a negative 25.5%. Since 1950 the S&P 500 Index has had negative returns in 15 years.

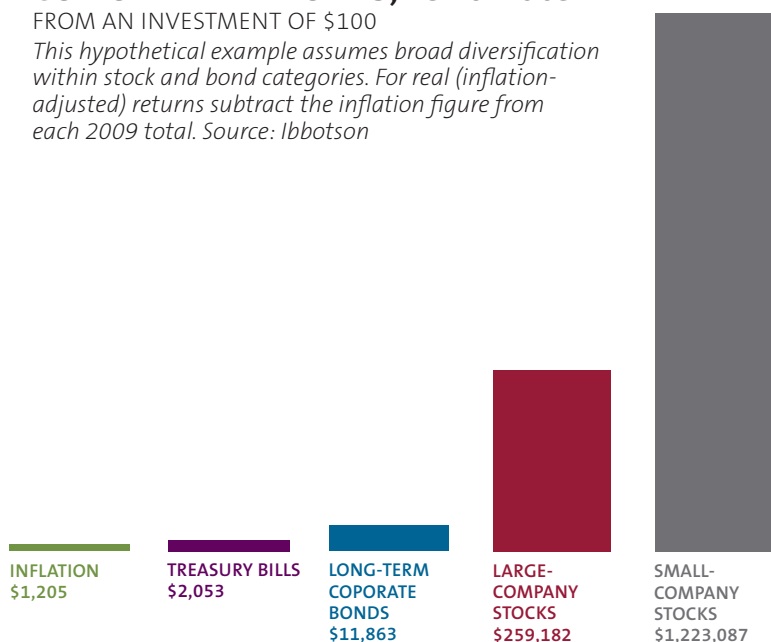
But returns for the S&P 500 Index have been positive in 44 of the years since 1950. And 22 of those years produced returns in excess of 20%, while negative returns exceeded 20% in only three years (1974, 2002, and 2008).

From 1926, when its recordkeeping began, through 2009 the S&P 500 Index has had positive returns in 60 years, negative returns in 24 years. And in all but 12 of the positive years the Index had returns of more than 10%—and more than 40% in five of those years. Only four times since 1926 has the S&P 500 Index declined for two or more consecutive years. Further, the Index

CUMULATIVE RETURNS, 1926-2009

FROM AN INVESTMENT OF \$100

This hypothetical example assumes broad diversification within stock and bond categories. For real (inflation-adjusted) returns subtract the inflation figure from each 2009 total. Source: Ibbotson



Stock Market Volatility

continued

has recorded *no* negative returns for any 20-year period since 1926. So even a hypothetical investment in the S&P 500 in September 1929, just before the great stock market crash, would have had a positive return if held for 20 years.

The S&P 500 Index has had negative returns in only four 10-year periods since 1926. Closer to home, two of those 10-year periods were the ones ended in 2008 and 2009. Unsurprisingly, that is what troubles many investors now. Investors often expect that present experience will continue, that bull markets will continue rising and bear markets will continue sinking. History suggests otherwise.

Consider what has happened after protracted stock-market slumps in the past—again taking the S&P 500 Index as representative of big-company stocks in general. Before the 10-year period ended December 31, 2008, with its negative 1.38% return for the period, the four 10-year periods with the worst results were those ended December 31 in 1937, 1939, and 1974. Returns for those 10-year periods ranged from a minus 0.89% to a positive 1.22%, an average of about zero. Each of the 10-year periods that followed, however, produced more-typical, healthy positive returns, between better than 7% a year to nearly 15%. This broad historical tendency of *reversion to the mean* (loosely, a return to historical averages) is a positive indicator for the stock market in the decade ahead.

RETURNS AFTER PROTRACTED MARKET SLUMPS

S&P 500 Index, annual average returns, 10-year periods ended Dec. 31

1937-1947	9.62%
1938-1948	7.26%
1939-1949	9.17%
1974-1984	14.81%

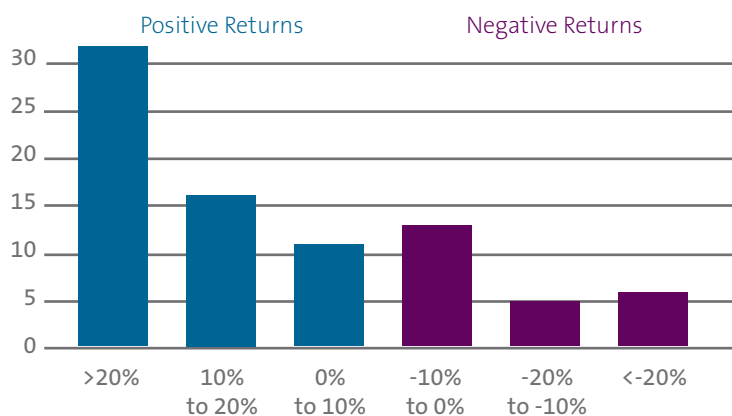
source: Morningstar

There are other positive signs. Among them are global economic developments such as numbers of market economies, increasing communications and trade, economic growth, growing middle classes, and increasing wealth. Positives include, too, the likely economic effects of new technologies and the increasing *pace* of innovation. If one believes that well-run companies will benefit from these developments, then it is reasonable to expect that stocks will not only protect against the ravages of inflation, but provide positive real returns.

POSITIVE VS. NEGATIVE RESULTS

SINCE 1926

Number of years the S&P 500 Stock Index had positive and negative returns, grouped by percentage gains and losses.



The lesson? Time is on your side. But *only* if you are broadly diversified (the S&P Index includes 500 stocks, remember, and stocks are but one type of asset). And *only* if you're invested for the long term. Need that money next month, or next year? It doesn't belong in stocks. Time is *against* you if you hold only a few stocks or your objectives are short-term.

But if you have a long-term perspective, strategies such as asset allocation, other kinds of diversification and dollar cost averaging can mitigate the effects of volatility and make stocks a valuable investment vehicle.

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