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The Five Curse Words of Market Volatility

Overview: When the market experiences significant volatility, investors get bombarded with messages about what they should do with their investments. The following discusses the messages pitched to investors and why investors should simply tune them out.

On January 22, the Dow Jones Industrial Average (DJIA) dropped more than 460 points early in the day. The index swung back before the market closed, but still finished down 128 points, marking the fifth straight day of declines. The DJIA finished down 15.5 percent from its October 2007 high.

Other indexes experienced losses that day as well:

- σ The S&P 500 Index fell 1.1 percent, down 16.3 percent from its peak.
- σ The Russell 2000 Index dropped 0.2 percent, pushing it further into traditional bear market territory. It was down 21.5 percent from its record high.
- σ The Chicago Board Options Exchange's volatility index (VIX) jumped to 37.57, its highest intraday level since October 2002. The VIX finished the day with a reading of 31.01.

While the market was oscillating, the talking heads on TV were having a field day, peppering their audiences with predictions and advice on how to deal with the market fluctuations.

Five "Bad" Words

Many of these commentators were using the curse words of investing, or as the *Wall Street Journal's* (WSJ) Chuck Jaffe put it, "the dirty words that seemingly have been on everyone's tongue over the past few weeks as stock-market turmoil has ordinary folks ready to abandon long-term plans in favor of safe havens."¹

1. Now

With the market spinning out of control, what should investors do now?

Many investors have been trying to avoid the pitfalls of falling stock prices. For example, trading at the New York Stock Exchange on January 22 hit 6.4 billion shares, the second-heaviest trading day in the exchange's history.

Did trading help some investors? Possibly. Did trading hurt some investors? Probably.

As Peter Lynch, legendary manager of Fidelity Magellan, said, "Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves."²

There are some steps investors can do right now: Read their investment plans and see if anything has changed. If so, they should address those changes with their financial advisor. If

not, they need to remember the goal of an investment plan. It is not to make the most money this week. It is to provide a sound plan for the long term.

2. Next

The next thing to do is ...

It's funny how these commentators can tell investors what their next move should be. They do not know their audience's financial situation. They don't know their investment plans. They don't know if these investors are married or divorced, with or without children, or nearing retirement or just starting out in the workplace.

The truth is that the advice being dispensed may be good advice, and may appear to be the next logical step. It just might not be the right advice for everyone. As the *WSJ* noted, "Even if the advice is spot on (and studies of the financial press make it clear that doesn't happen all that often), there is no way to know if the message is appropriate for everyone who receives it."³

Investors listening to such advice should recognize it for what it is: A means of keeping people tuned in to the program. A lot of channels would get changed if the airwaves were filled with people saying "Just stay the course."

3. Must

Here's what investors must do to get through this ...

It certainly sounds like an enticing proposition (one of many that investors may have heard): Move assets around, concentrate in a few key spots and ride out the volatility.

After experiencing the turbulence that occurred on January 22, such advice would have likely sounded even better the following day, as the DJIA dropped more than 320 points by midday.

However, in keeping with the theme of volatility, the DJIA went through a 630-point swing to finish up nearly 300 points for the day. It was the biggest intraday swing since 2002.

As the *WSJ's* Jaffe said, "For most investors, however, success is built on having a plan filled with securities they believe in and not on changing directions every time the wind blows and brings out some new list of what someone must do now with today's top performers and best strategies for whatever market conditions come next."⁴

4. Top

Here are the top funds or asset classes for these conditions ...

The following disclaimer is repeated fairly often: Past performance is not a guarantee of future results. Still, situations like the current market volatility can make investors forget this cardinal rule of investing.

One study by the Financial Research Corporation (FRC) compared the return of mutual funds in the 1990s to the actual returns earned by investors.⁵ The FRC found that while the funds show a 10.92 mean three-year average annualized return, investors received returns of only 8.7 percent. The FRC also found that an average of \$91 billion in net new cash flowed into funds in the quarters following high returns. After funds' worst-performing quarters, they received only \$6.5 billion in new money, suggesting that these investors were chasing good past performance.

“The moral of the study is that investors who make investment decisions ... in pursuit of big stock market gains are more likely to lose out on the long run,” said Jack Sharry, president of Phoenix Investment Partners, which commissioned the study.⁶

Instead of trying to time the market by being in the right fund or asset class at the right time, investors should continue following their investment plans, which were crafted with their particular situations in mind.

5. Best

The best thing for investors is ...

If the answer is anything but “to stick to your personally crafted investment plan,” investors may want to stop listening. It’s alright for individuals to turn off their television sets or change the radio station. It’s also alright for individuals to read the sports section of their newspaper and forgo stories on recent market activity. Market volatility has happened before and it will likely happen again.

That is why proper investment plans are built for the long term. They are designed to give investors the best chance of fulfilling their financial goals. It is important that investors understand how their plan works and continue following it.

Summary

Volatile markets can create a time of uncertainty for investors. Not only are they watching their investment performance start to resemble a roller coaster, but they get bombarded with information from “experts” who tout ways to smooth out the ride.

Investors should remember why they hold diversified portfolios. One of the benefits of diversifying portfolios is that they are better equipped to handle severe market fluctuations. Investors who hold such portfolios are better able to ignore all the noise and to focus on the long term.

¹ Chuck Jaffe, **Beware of ‘Now, Next, Must, Top and Best.’** *Wall Street Journal*, January 24, 2008.

² Peter Lynch, **Fear of Crashing.** *Worth*, September 1995.

³ Chuck Jaffe, **Beware of ‘Now, Next, Must, Top and Best.’** *Wall Street Journal*, January 24, 2008.

⁴ Ibid.

⁵ Lee Barney, **Chasing Hot Funds Translates to Diminished Returns, Study Finds.** *TheStreet.com*, January 17, 2001.

⁶ Ibid.

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