

Debunking the Myths About Volatility

By Andrew Menachem

When the stock market goes up, most investors feel good. They're happy with their investment decisions and start counting all the money they've made on paper. Of course the opposite occurs when the Dow Jones index goes down. Investors get scared and wonder why they ever bought stocks in the first place.

But it's important for investors to overcome those natural emotional responses – on their own or with the support of their financial advisor – in order to be successful over the long term. Despite their short-term volatility, stocks historically have solidly outperformed "safe" assets like government bonds and T-bills, which have barely kept pace with inflation.

One recent study by Morgan Stanley's Consulting Group using Morningstar data, shows that if you had invested \$1 in small-cap stocks (smaller publicly traded companies) back in 1926, you would have received a \$17,016 return by 2010. If you had invested in large-cap stocks (bigger companies) your return would have been \$2,982. However, long-term government bonds returned only \$92, and T-bills only \$20 over the same period – not much more than the \$12 impact of inflation. Certainly, stocks are more volatile than many other types of assets. But unless you're at a point in your life where you have to sell your shares in the near future – regardless of market price – that volatility shouldn't keep you awake at night. Although most investors remember the wild swings and sudden drops of the 2008 financial crisis, those fears of a sudden loss shouldn't keep most investors out of the stock market. Analysts who study market volatility by measuring standard deviation – how much short-term ups and downs differ from the long-term trend – say there has been very little change in market risk over the last four decades. In fact, the periods of decline have been counterbalanced by solid gains in the 1980s and 1990s and mid 2000s.

With stocks moving up again in the first quarter of 2013, some investors worry that the "law of averages" will mean a decline later this year. While that's certainly possible due to any number of economic, business or investment factors, the law of averages isn't one of them. After all, if you flip a coin and get three heads in a row, there's still a 50-50 chance you'll get heads on the next toss.

That theory is supported by the market's actual performance again noted in the above study by the Consulting Group: The S&P 500 index has risen in 61 of the 85 years between 1926 and 2010. That's a 72 percent positive track record – a lot better than a 50-50 tossup. And if you're afraid about losing your investment, there were only six years when the S&P 500 lost more than 20 percent of its value, compared with 32 years when it gained more than 20 percent.

It's certainly important to understand market volatility and how it can affect your investments. But you should also consider other risks, like inflation, which can erode the value of all those dollars you have saved through the years. That's why many successful investors construct a diversified portfolio of different assets – including stocks, bonds, real estate, managed futures, hedge funds, commodities and money market funds.

Holding a "bundle" of varied assets can reduce the overall volatility of your investments, since you don't have all your money riding on the stock market. A balanced portfolio can also generate potentially higher returns than keeping your money in a savings account or government bonds.

Remember that fear is a natural emotional reaction to a market downturn, just as you may feel exuberant when the Dow Jones average sets a new high. But don't let those emotions sway your investment decisions. Think things through and maintain a balanced portfolio for the best chance of long-term success.

Andrew Menachem, CIMA®, CWS®, is a Wealth Adviser at The Menachem Wealth Management Group at Morgan Stanley in Aventura and teaches at The University of Miami.

Andrew Menachem, CIMA® is a Wealth Advisor at The Menachem Wealth Management Group at Morgan Stanley Smith Barney in Aventura and teaches at the University of Miami. Views expressed are those of the author, not necessarily Morgan Stanley Smith Barney, and are not a solicitation to buy or sell any security. The strategies and/or investments referenced may not be suitable for all investors

.