

The Bumpy Ride in Equity Investing – Why the “New Normal” is Really Just “Normal”



S&P 500, August 4-August 23, 2011 (Source: WSJ)

Recent days, weeks, months and even the past several years have left many equity investors feeling more than a little seasick. The credit crisis and vicious bear market of 2008 caused investors to question whether they can trust the financial system. Many seasoned investors have fled to the relative safety of cash and bonds, and younger people are still questioning whether it is worth allocating capital to the global stock markets at all.

During the market swings of the past few weeks, talking heads on television have been searching for ever greater superlatives to characterize this “new normal” state of affairs. Some claim that high-frequency trading and algorithmic strategies have transformed the markets. Others describe the debt ceiling debate and the S&P downgrade of US debt as unprecedented shocks to the system, with the threat of European contagion and a potential double-dip recession adding fuel to the fire. As the story goes, we are in for difficult times ahead.

All of this may be true – only time will tell. What is *certain* is that volatility in the equity markets is, historically speaking, absolutely normal. In fact, volatility is a key component of the risk for which investors should expect to be rewarded over the long term.

To put this in perspective, history tells us that across the whole stock market, **investors should expect negative returns in one out of every four years**. Note that this is not the Dow Jones Industrial Average or the S&P 500, but the entire historical US stock universe – the aggregate capitalization of all securities listed on the NYSE, AMEX and NASDAQ exchanges.

As the chart below shows, annual returns since 1926 form a relatively normal distribution, with a skew toward positive returns. Every once in a while we can expect a stellar year, and about as often we can expect a painful correction. The rest of the time we will see some flat years, and many in the 10-30% range, for good or ill. This is one of many reasons why asset allocation (between equities and fixed income and within those broad asset classes) is such a critical decision. The investment professionals at Passive Capital Management build portfolios that reflect the unique risk tolerance of each client. Investors with a shorter investing time horizon may want very little capital allocated to these traditionally volatile markets. Those investing for the longer term can likely withstand each down year in order to benefit from the corresponding three positive years. Risk tolerance is *psychological* as much as it *chronological*, which is why the client-advisor relationship is so important.

