

Quality Asset Management

Grow Your Wealth with Peace of Mind

Make Volatility Your Friend

By Gil Hanoch, November 4, 2005

Volatility is known as an undesirable thing that you should strive to minimize. This is very logical – when you invest your money, you want it to grow. You want to be able to take it out whenever you want or need and make a profit.

Unfortunately, investments that grow steadily with no declines provide very low returns. After considering inflation and taxes, you are left with very little gains, if any. Good examples are money market accounts, CDs and short-term government bonds.

Can you get higher returns? Yes, you can get much higher returns! But it comes at a price: volatility. Stocks, on average, provide much higher returns in the long run, but they also may decline in value. You may even lose your whole investment!

How can you avoid losing your whole investment? Luckily stocks as a group tend to grow in the long run. Globally diversified stock portfolios have never declined without recovering. Our desire to get things done as simply and cheaply as possible is what keeps companies growing.

As long as you keep your money diversified over many companies in different industries and countries, you are not likely to see it disappear. In addition, you would have to avoid mutual funds that research companies and try to choose specific stocks or the timing of investments, since the wrong decisions may lead to irrecoverable losses.

Can you avoid losing any money? If history is any indication for the future, yes! If you can hold on to your diversified investments through decline periods and make sure you sell only after full recovery, you are not likely to ever lose money.

The catch! The catch is that you might need money before your investments recover. You cannot control the timing and the length of declines of your portfolio. During long recessions, you may lose faith in stocks before they recover.

Is there a solution? There is a very good solution: diversify and study the history of your portfolio. There is no guarantee that the future will not be worse than the past, but by knowing how your portfolio reacted to catastrophic events, you can get a sense of how long severe declines tend to last. With that information at hand you can achieve two things:

1. You can plan for a catastrophe worse than anything you've seen in decades, and keep some money in stable investments to support you through these periods.
2. Whenever your portfolio declines, look back at history, recall why companies have always existed, and get ready for a recovery. The longer and deeper the decline, the bigger the recovery.

Can volatility be good? Yes! So far, we treated volatility as something that can negatively affect our investments, and found ways to minimize the chances for these negative effects. But I would dare to go one step further and claim that we need volatility. The high returns we get on our stock investments are a compensation for the volatility. If stocks ever stopped being volatile, the returns on investing in them would decline significantly. Much lower returns would compensate for the lower volatility.

The ideal practical world. Considering that high returns are compensation for high volatility, the ideal world is the one in which we can choose investments offering high long-term returns, and prepare for the volatility so well that it does not put us at any significant risk or stress. Fortunately this solution exists and is simple. Let's review it:

1. Choose the most profitable investment: stocks.
2. Diversify them significantly, while including the asset classes that tend to grow the most and ones that are least correlated: small stocks, cheap stocks ("value"), international stocks and emerging markets stocks.
3. Avoid any attempts to choose individual stocks that do better than average – you will have no way of being truly confident that huge declines will be followed by rapid growth.
4. Learn the portfolio's long-term historic behavior. Make sure to choose a long enough period that smoothes out anomalies. This is normally at least 25-30 years. Find the length of the longest decline of the specific portfolio you constructed, and prepare for worse than that.
5. Keep enough money outside the stock market, to provide for you during the period of decline you chose to be prepared for.
6. Put the rest in your diversified stock portfolio.
7. Make sure you never deviate from your plan! The only reason to update your plan is changes in your own circumstances, not moves in the portfolio.

Smile! Now you are ready to get excited and smile whenever your portfolio goes down, including occasional significant declines – this is what keeps your pay so amazingly high.

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