WJM FINANCIAL, LLC
Fee-only financial planning & investment management

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MANAGING PORTFOLIO VOLATILITY (May 2002)

The last two years have been very difficult for most investors. Most major stock market indexes have lost ground, and many losses have been significant. The Standard & Poor's 500 Index has lost over 26% from its peak, and the NASDAQ has lost over 65%.

Unless the S&P 500 performs a surprisingly strong turnaround in the next six months, it will experience a third consecutive calendar-year loss <u>for the first time in 61 years</u>. If the S&P 500 remains unchanged through the end of this year, it will experienced its first 5-year loss (1998 through 2002) since 1941, and only its fourth five-year loss ever.

The following suggestions are intended to help you manage the volatility that is inherent in investing. I hope that you find this information helpful, and I encourage your to contact me if you have any questions about your portfolio or how it is being managed.

Maintain a proper perspective. While stock market downturns may be unsettling, they should not scare investors away. In fact, a universally accepted tenet of Modern Portfolio Theory is that the higher long-term returns of stocks are directly related to their short-term volatility. Stocks have historically returned more than most other investments because of the "risk premium" required to justify their volatility.

Including last year, the S&P 500 has lost ground 22 times since 1926, or once every 3.5 years. Despite these losses, stocks have managed to provide annualized returns of 10.7% over that 76-year period. In fact, the S&P 500 has a return of 12% per year for the last 10 years. Put another way, $10,000 invested in the S&P 500 on May 1, 1992 would have grown to $31,000 by April 31, 2002.

Establish reasonable expectations. As uncomfortable as the losses over the last two years have been, the gains over the prior 5 years were far more extraordinary. In fact, they were unprecedented. The 5-year period beginning in 1995 saw the highest 5-year return ever for the S&P 500, and investors should not base their expectations on those extraordinary returns.

What is reasonable? As late as 1987, the historic average return for the S&P 500 was below 10%. Most professional investment managers, academics, and stock market historians suspect that returns will be in the 7% to 10% range for the foreseeable future. Given the unprecedented appreciation experienced over the past two decades, as well as valuation levels that remain relatively high by historical standards, it is not unreasonable to anticipate single digit returns for an extended period of time.

Understand the importance of time horizon. Historically, a long time horizon has dampened the effects of investment volatility. Although the S&P 500 has lost ground 22 times in the past 76 years, it has not lost ground over a ten-year period since 1939, and it has never lost ground over a twenty-year time horizon.

Understand your goals and objectives. While it may be nice to know that the stock market has never lost ground over a twenty-year period, it probably won't do you much good if your objectives are only three years away. This is why understanding your goals and objectives is critical.

Every investor is unique. Your goals, objectives, and risk tolerance are yours alone, and your investment strategy should be customized to those needs.

Perform an honest reassessment of your personal risk tolerance. This is a great time to reassess your risk tolerance and confirm your comfort level with your portfolio's allocation. Stock market volatility has always been here, and it is here to stay.

Understanding the benefits of an extended time horizon and the historic reduction in volatility as time horizon increases will only matter if you are comfortable riding out those downturns. If not, consideration should be given to altering your portfolio's construction in an effort to reduce anticipated volatility. This might be done by adding bonds and cash, reducing exposure to certain asset classes, or seeking alternative forms of investments.

The following table summarizes realistic return and volatility expectations for different portfolio allocations. This information assumes a well diversified portfolio, and is intended for illustrative purposes only.

Stock/Bond Allocation					
Stocks	**Bonds**	**Expected return**	**Range of returns**	**Likelihood of a 1-year loss**	**Likelihood of a 5-year loss**
90%	0%	8.8%	-17% to 40%	25%	10%
70%	30%	8.1%	-15% to 37%	25%	6%
50%	50%	7.2%	-12% to 29%	20%	4%

Remain well diversified. Diversification across asset classes is an effective method of managing volatility. Although the asset classes that were hot in the 1990's have suffered significant losses, other asset classes have actually done relatively well. In fact, three asset classes that few investors considered in the 1990s – real estate, bonds, and small value stocks – have performed very well in the past 2 years. Real estate has gained 45%, bonds have gained 20%, and small value stocks have gained 52%.

One other interesting point in regards to diversification…of the 6,322 individual stocks included in the Morningstar Principia database, 24.7% (1,565) have lost at least 50% over the past 3 years. Only 4.5% of the 2,520 domestic mutual funds have lost as much. Diversification and spreading one's risks really does work.

Remember that valuations matter. When you purchase a stock you are actually purchasing a portion of the underlying company. Like any other purchase, the price that you pay will play a critical role in the value that you receive. Determining the price that you pay is tricky, though.

When considering how much you are paying for your portion of the company, share price is not necessarily the best indicator – since each company issues different amounts of shares, each company's share is worth a different percentage of the business. Pay attention to a company's Price-to-Earnings (P/E) and Price-to-Book Value (P/B). These figures tell you how much you are paying for your share of the company's profits (P/E), or its underlying assets (P/B). Historically, stocks that have higher prices relatively to earnings, which are often referred to as growth stocks, have provided investors with lower return.

HOW WJM FINANCIAL MANAGES PORTFOLIO VOLATILITY

We are advocates of Modern Portfolio Theory (MPT), and we believe that your overall asset allocation is the primary determinant of long-term portfolio performance. In order to manage portfolio volatility in our clients' portfolios, and more importantly, to increase the likelihood that our clients achieve their financial objectives, we will continue to take the following steps:

1. **Minimize investment costs**. We have always believed that investment costs have an erosive impact on portfolio performance, and that they need to be managed aggressively. We focus on expenses in the following areas: (1) mutual funds expense ratios, (2) mutual fund trading costs, (3) custodian expenses, and (4) transaction costs.

2. **Maximize tax-efficiency**. Like expenses, taxes can dramatically affect overall performance. We optimize tax efficiency by (1) proactively harvesting tax losses in order to reduce current year taxes, (2) analyzing each investment's tax efficiency and potential tax exposure before recommending it, and

   (3) by utilizing tax-advantaged accounts for less tax-efficient investments and taxable accounts for more tax-efficient investments.

3. **Consider less traditional asset classes.** Despite recent stock market losses, stock values are still high by historic standards. Consequently, we believe that it remains important to consider exposure to less traditional asset classes.

   We are currently considering Real Estate Investment Trusts (REIT) for certain accounts in order to enhance diversification, increase yield, hedge against inflation, and improve overall return/risk attributes. We are also considering Treasury Inflation Protected Securities (TIPS) for certain accounts to protect fixed income investments from the risks associated with inflation and future interest rate increases.

4. **Rebalance prudently**. Although we believe strongly in the benefits of asset allocation and the importance of rebalancing a portfolio to its target allocation, we do not rebalance portfolios blindly. Before any changes are made to a client's portfolio, we weigh the benefits of increased diversification against the drawbacks of potential trading and tax expenses.

5. **Monitor mutual fund changes**. During turbulent times it is natural to seek shelter. Mutual funds sometimes do this by changing their strategy or investing in different types of asset classes. Since we select mutual funds to fit a certain portion of our clients' portfolios, it is important to us that the mutual fund manager remains consistent to his or her objective. To maintain this consistency, we monitor our clients' investments to ensure that they are doing what they have been selected to do.

6. **Provide timely information.** Education and open communication are critical to helping our clients meet their financial goals. We strive to communicate proactively, educate our clients, and remain available to discuss our clients' questions.

CONCLUSION

Short-term volatility is inherent in investing. Although the past does not predict the future, investors may find reassurance in the fact that the losses of the past three years are not unprecedented, and that the stock market has always recovered.

Expectations should be realistic, however. Stock market valuations remain high despite recent losses, and investors have become understandably cautious in regards to corporate governance, financial reporting, the fallibility of our economy, and global uncertainty.

Although it is unlikely that we will return to the euphoric stock market returns of the past 2 decades for quite some time, it is not unreasonable to expect the stock market to reward patient, well-diversified investors. Remain patient, disciplined, consistent, and focused on your goals.