WJM FINANCIAL, LLC

Fee-only financial planning & investment management

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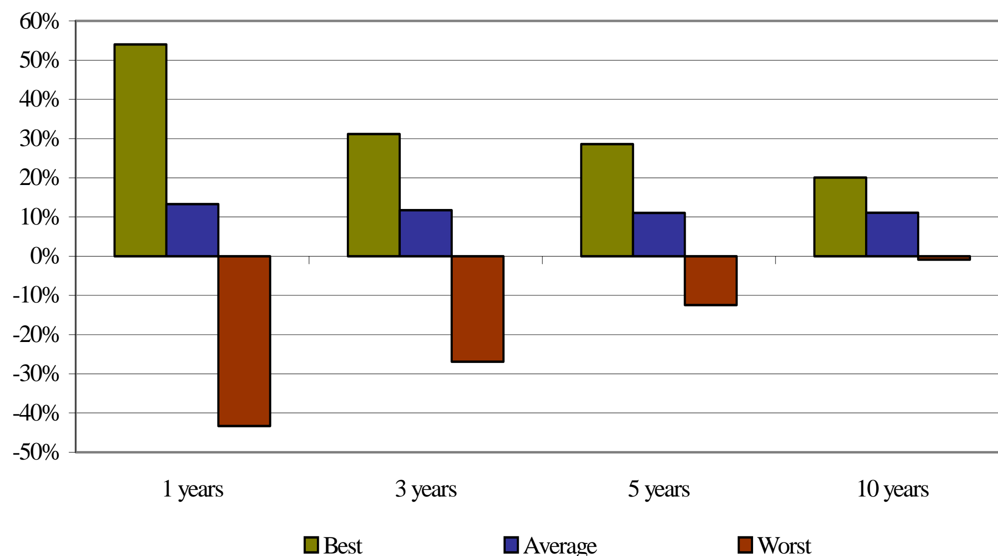
TIME HORIZON AND INVESTMENT RISK (March 2002)

A long enough time horizon may be the elixir that cures many investment-related headaches. Although investors are beginning to appreciate the trade-offs of risk and return, the risks that they often consider are relatively short-term; what are the chances that they'll lose money this year, or over the next three years?

Investing in stocks is undoubtedly a risky proposition if your time horizon is 5 years or less. From 1926 to 2001, single year returns for the S&P 500 have ranged from -43% to 54%. If nothing else, this historic volatility should help to put the last couple of years into perspective.

Historically, investors with time frames that have exceeded 5-10 years have been able to ride out the impact of this short-term volatility. For instance, rolling ten-year annualized returns for the S&P 500 have ranged from –1% to 20%. The accompanying chart illustrates the best, average, and worst annualized returns of the S&P 500 over 1, 3, 5, and 10-year holding periods since 1926.



This chart underscores the importance of (1) understanding your time horizon before investing, (2) losses in recent years are not extraordinary, (3) single digit returns, or even losses, are not uncommon over time periods that are less than 5 years.

Matching your investment strategy to your goals and objectives.

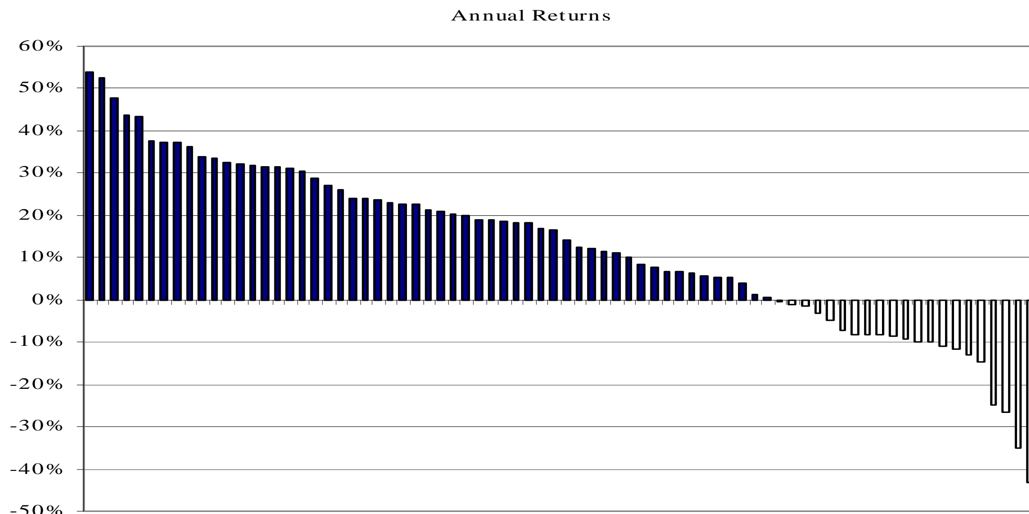
Investing is a means to an end. It is done in order to achieve some other objective --- retirement, major purchase, college, etc… In order to maximize your chances of investing successfully, it's critical that you match your investment strategy to your goals and objectives. Before investing, be sure that you can answer the following questions:

1. What are the goals that you hope to achieve?
2. What is the timeframe over which you will need to access your investments?
3. How comfortable are you with short-term (less than 5 years) volatility?
4. Do you plan to make ongoing contributions to your portfolio (in which case volatility may serve as your ally)?

Obviously, there is no guarantee that future returns will approximate historical returns, but if an investor is unable to stomach short-term swings in the value of his or her portfolio, that investor should not be invested heavily in equities. However, for an investor with a long enough time horizon, investing a significant percentage of assets in a well-diversified equity portfolio may be appropriate (though most portfolios can benefit from at least 10% invested in bonds).

The following charts summarize all 1, 5, and 10-year returns of the S&P 500 since 1926. These returns are sorted from best to worst in order to provide a better feel for the frequency of various outcomes in addition to the historic range of outcomes shown in the preceding chart.

As the charts indicate, investors with a 1-year holding period have lost money almost 30% of the time. The frequency of losses is dramatically reduced over time, however, and investors with 10-year holding periods have suffered a decline in value only twice (both 10-year periods included the depression of 1932 and 1933).



Please do not hesitate to contact me if you have any questions about your portfolio or how it is being managed. It is very important to me that you feel comfortable and confident in terms of investment management.

Thank you.

- Bill Moeckel, CFA, CFP