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

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

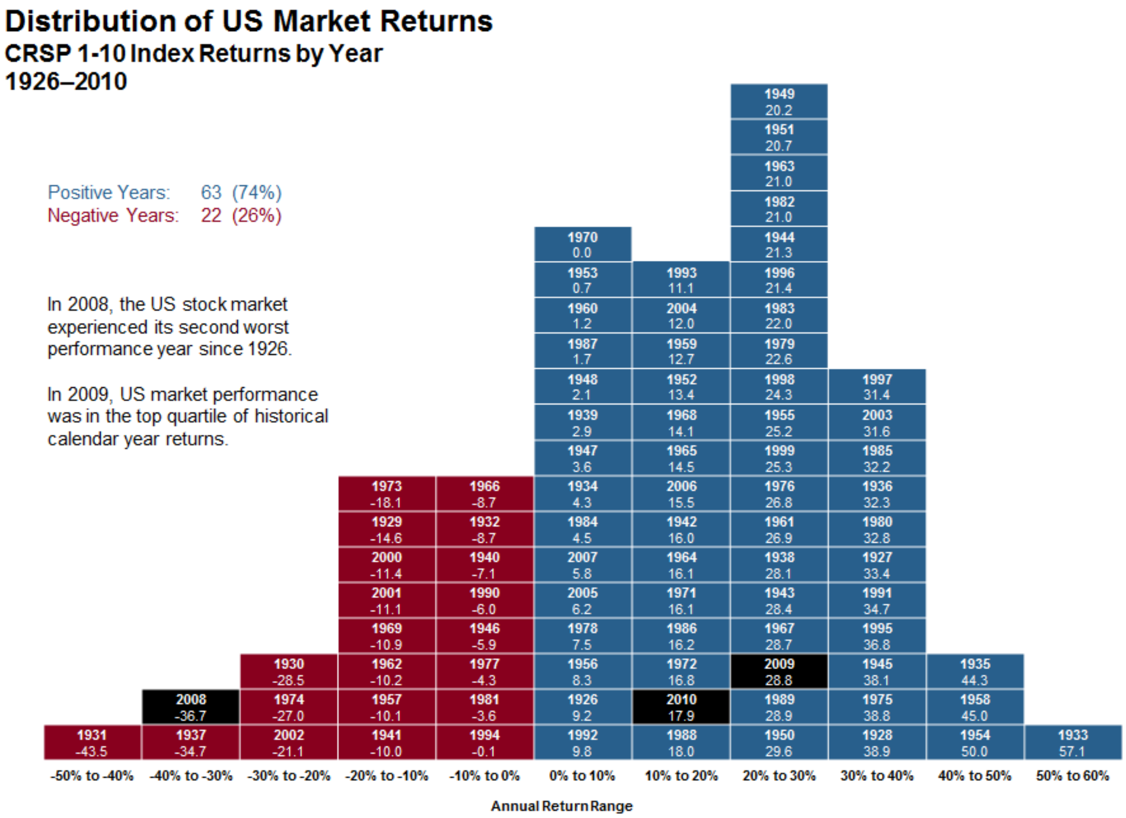
Recent days, weeks, months and even the past several years have left many equity investors feeling more than a little seasick. The credit crisis and vicious bear market of 2008 caused investors to question whether they can trust the financial system. Many seasoned investors have fled to the relative 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 investment 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.



CRSP data provided by the Center for Research in Security Prices, University of Chicago. The CRSP 1-10 Index measures the performance of the total US stock market, which it defines as the aggregate capitalization of all securities listed on the NYSE, AMEX, and NASDAQ exchanges. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Source: DFA

In addition to expecting volatility each year, we should anticipate significant market fluctuations ***within each year*** and within each month. In April 1999, for example, the S&P 500 had **ten days of negative returns** (out of 21 trading days). One day saw a dip of -2.24%. The total return of the S&P for that month was 3.9% **Total return for the year was 21%**, in a year in which **five out of 12 months saw negative returns**.

When asked in the 1970s about the impact of the French Revolution of 1789, Zhou Enlai is rumored to have said “it is far too early to tell.” If your friends and neighbors ask you how your portfolio is doing, you might consider borrowing that line. In the meantime, please remember:

- **Volatility in the equity markets is normal;**
- **Systematic risk and returns are related;**
- **We don’t know which will be the good days, months or years, but our clients will remain in their seats in order to capture the returns that the markets have historically offered;**
- **We cannot control the markets. We can control costs, diversification, asset allocation, tax-efficiency and discipline. Over an investing lifetime, this can make all the difference.**

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Passive Capital Management, LLC
2328 West Joppa Road, Suite 120, Lutherville, MD 21093, 443-275-2703
Two Clinton Square, Suite 215, Syracuse, NY 13202, 315-478-3130
www.passivecapital.com
A registered investment advisor