Market Volatility and Your Risk-Comfort Level

How do we define risk?

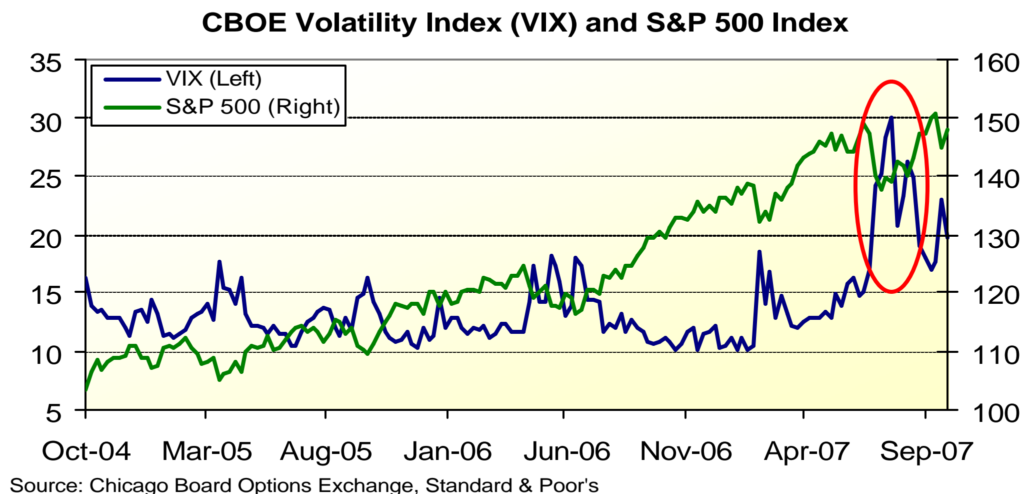
We assess risk constantly in our daily lives as we make decisions ranging from whether to brave the freeway during that rainstorm to whether it's a good idea to chance the week-old Chinese take out in the fridge. When we make these day-to-day risk assessments we think about the *downside*: Is the probability of an accident too great to take the freeway? Do I want to risk food poisoning to avoid cooking dinner tonight? Chances are we will shy away from actions that could cause some small amount of discomfort or delay, so why when it comes to investing do so many people tend to focus on their upside return potential and ignore their downside risk?

It's not a "reward/reward" tradeoff

It's common knowledge that investing involves some amount of risk, and we expect to be rewarded with a higher potential return as the amount of risk we take increases. Investments in emerging markets yield potentially-higher returns as compensation for the risk of taking on currency fluctuations, geopolitical instability, and accounting irregularities, while the relatively-safe haven of U.S. Treasurys do not demand the same type of tradeoff. Taking on this type of higher risk/return profile means that while in one year your investment may be up 35%, in the next it could be down the same amount, if not more. No one wants to lose half of the value of their portfolio on the downside of that risk/reward tradeoff, however most people do not want to sit on the sidelines earning the risk-free rate while their neighbors are talking about the spectacular gains they've posted in the markets. Determining your risk-comfort level, and maintaining it through a well-diversified portfolio, is the best way to balance downside risk and upside potential.

The impact of market volatility

After a period of exceptionally low volatility, we saw the return of instability to the financial markets this summer as the unwinding of the subprime mortgage market took its toll. The green line in the chart below, which plots a 3-year history of the Chicago Board Options Exchange (CBOE) Volatility Index (VIX)[1], shows the market's expectation of 30-day volatility based on S&P 500 index options. The blue line shows the total return index of the S&P 500 (rebased to 100 in Oct. 2004) over the same time period.



[1] The VIX is commonly interpreted as a gauge of investor complacency/fear, with elevated readings indicating a high amount of volatility and investor uncertainty, and lower readings indicating more complacency in the markets.

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Historically, the VIX and the return of the S&P 500 tend to move in opposite directions, meaning that increased volatility and uncertainty coincide with market downturns. This is exactly what we saw in late July when the VIX index spiked and the S&P 500 declined. In fact, the S&P 500 fell nearly 10% from mid-July to mid-August as investors fled to more stable and liquid investments. Most educated investors know that the way to safely navigate episodes like this is with a diversified portfolio of non-correlated assets. What many do not realize, however, is that the level of diversification in their portfolio may differ significantly depending on the market environment.

Correlations vary with the market environment

If we evaluate the riskiness of a portfolio over broad historical periods, we are only assessing the behavior that will occur on average. History shows that when volatility increases and the U.S. equity market falls, correlations between "risky" assets tend to increase, thereby increasing the standard deviation of the overall portfolio.

The following table shows the correlations between the S&P 500 and several other asset classes in "Up Markets" (defined as a positive monthly return for the S&P 500) and "Down Markets" (defined as a negative monthly return for the S&P 500) over the past 15 years. A correlation closer to 1 implies more interrelated movement, while a correlation closer to 0 implies almost no linear relationship. A negative correlation implies that the returns move in opposite directions.

Correlations	S&P 500	U.S. Fixed Income	Hedge Fund of Funds	International Equity	Emg. Mkt. Equity	Gold	Avg. VIX reading
"Up Market" S&P 500	1.00	0.09	0.14	0.39	0.23	-0.19	17.74
"Down Market" S&P 500	1.00	-0.22	0.47	0.66	0.62	-0.05	22.47
Source Index:	S&P 500	Lehman U.S. Aggregate	HFRI Fund of Funds Comp.	MSCI EAFE	MSCI Emerging Markets	DJAIG Gold SubIndex	CBOE VIX

It's not unexpected that international and emerging equity markets become more correlated with U.S. equities during a downturn – investors tend to flee investments demanding a risk premium for the safe haven of fixed income. However, many people would be surprised to realize that some investments favored for their diversifying characteristics, such as hedge funds, may not exhibit the correlation profile they had assumed when market volatility increases and equity markets retreat.

The data above highlight the importance of scenario testing a portfolio to accurately assess your risk-comfort level. On average you may expect a return of 10% per year, but are you comfortable with achieving that annualized return through a down year of -20% sandwiched between two years of +30%? What is the maximum loss you could sustain if an unexpected shock hit the markets?

A focus on downside risk and loss potential is at the core of our customized risk analysis. We employ sensitivity analysis using historical economic and market scenarios to help you better understand your complete and total risk and return profile. This customized risk analysis, coupled with careful selection of the appropriate investment vehicles, allows us to personally design a diversified investment portfolio that reflects your risk-comfort level.

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Market Monitor – October 2007

The market downturn of the summer has given way to strongly positive returns in the last several months. Equities outperformed fixed income and cash in October, while the price of gold posted a very strong month with the spot price shooting above $800. Within the U.S. equity market, growth stocks continued to dominate across the style spectrum, and small capitalization companies outperformed their large and mid-sized counterparts. Geographically, emerging markets posted double-digit returns in October, with the BRIC countries (Brazil, Russia, India, China) leading the pack. Developed international markets outperformed the domestic equity market for the second month in a row.

Capitalization				
Small	>	Large	>	Mid
Style				
Growth	>	Core	>	Value
Geographic				
Emerging	>	Int'l Dev.	>	U.S.

Asset Class						
Gold	>	Equity	>	Bonds	>	Cash

Legend
> +2%
+0.5% to +2%
-0.5% to +0.5%
-0.5% to -2%
< -2%

Capitalization: Small = Russell 2000®, Mid = Russell Mid Cap®, Large = Russell 1000®

Style: Growth = Russell 1000® Growth, Core = Russell 1000®, Value = Russell 1000® Value

Geographic: Emerging = MSCI Emg. Mkts., Int'l Dev. = MSCI EAFE, U.S. = S&P 500

Asset Class: Equity = S&P 500, Bonds = Lehman U.S. Aggregate, Cash = Lehman 1-3 Mo T-bill
Gold = DJAIG Gold subindex

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