

Financial Focus

Concerned About Market Volatility? Study Your History

It happens every time the stock market drops: Investors question their strategy, their luck, and their timing---all in an attempt to determine what went wrong and what they should have done differently. But if you, as an individual investor, really want to know how to respond to today's market decline, you need to look back at yesteryear.

To begin with, market declines are part of the investment process. Over the past century, the stock market has averaged one "correction" (defined as a decline of ten percent or more), per year. Furthermore, on average the stock market has declined 20 percent or more once every three or four years. So, instead of thinking that a severe market decline is a once-in-a-lifetime disaster that "just had to happen" while you were investing, keep in mind that market declines are normal, frequent, and for the most part, short-term. And if you're a long-term investor, these declines usually offer an opportunity to buy quality investments at a lower price.

What other lessons related to a declining market can you learn from looking back in time? Here's one: Over the long term, quality stocks have historically outperformed quality bonds. This fact should be of particular interest to you, if, like many investors affected by a market decline, you begin to wonder if you should scale back on your stock investments in favor of "safer", more conservative vehicles. But look at the numbers: from 1926 to 2008, large stocks returned 10.4 percent per year, long-term government bonds returned 5.5 percent, and corporate bonds returned 5.9 percent. While it's true that past performance is not an indication of future results, it's also apparent that if you want to give your money the potential to grow—and grow at a pace that can keep you ahead of inflation—you'll need at least some exposure to stocks. While you certainly may want to own some bonds, which offer current income and the ability to help stabilize your portfolio in the short run, you don't want to let a down market discourage you from buying stocks of strong companies and holding them for the long term.

Here's one last history lesson to consider: The U.S. economy has proved to be amazingly resilient. Since the end of World War II, each recession has averaged 10 months, and each economic expansion has averaged almost five years. Recessions often begin and end without warning, so if you take a "time-out" from investing in response to a recession-induced market slump, you could end up missing the beginning of the next market rally. And when the market does turn around, your quality investments are the ones that will likely show the quickest recovery.

George Santayana, a well-known philosopher, wrote: "Those who cannot remember the past are condemned to repeat it." As an investor, you can benefit from heeding those words, learning from history, and not getting too rattled by short-term market downturns. By owning a mix of quality investments that are suited to your risk tolerance, time

horizon, and long-term goals, you can develop a strategy designed to weather any storm that hits the financial markets.