Heightened Volatility: The New Normal?

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It's not your imagination: The stock market is bumpier than normal. The U.S. economy can't find its footing -- and every piece of bad news, whether at home or abroad, has the potential to send the markets reeling. All that volatility can make it tough on investors to stay the course.

Historically speaking, the market today is about three times more volatile than it has been in the past. Specifically, the S&P 500 rose or fell by 2% or more an average of 5 times per year from 1950 until 1999. Since 2000, however, that average jumped to 12.5 times per year for advances and more than 14 times for declines.[1] What's more, 10 of the 20 largest daily upswings and 11 of the 20 largest daily drops since the beginning of 1980 have occurred within the last three years.[2]

Who or what deserves the blame for heightened market volatility is difficult to say. On the economic side, uncertainty about when and how fully the economy will recover is a major factor. So are factors such as the heightened reliance on government monetary policy, unsustainable fiscal trends, and the apparent lack of collaboration among legislators in Washington. On the investment side, high-frequency trading, hedge funds, and inverse and leveraged ETFs all contribute to the volatility.

What Can You Do?

Regardless of the drivers, heightened volatility requires individual investors and their advisors to exercise specific investment strategies. While many of these strategies are basic investing concepts that can be applied at any time, they are particularly important in a volatile environment.

- **Don't follow the herd.** Don't sell into a rapidly declining market and don't buy into a rapidly rising market. You'll just be following the herd and locking in losses. Panic selling also runs the risk of missing the market's best-performing days. For example, missing just the 5 top-performing days of the 20 years ended December 31, 2010, would have cost you more than $19,000 based on an original investment of $10,000 in the S&P 500. Missing the top 20 days would have reduced your average annual return from 9.14% to 3.00%.[3]

- **Keep a long-term perspective.** It is all too easy to get caught up in the stock market's daily roller-coaster ride. This type of behavior is natural, but can easily lead to bad decisions. Instead, focus on whether your long-term performance objectives, i.e., your average returns over time, are meeting your goals.
- **Take advantage of asset allocation.** During volatile times, more risky asset classes such as stocks tend to fluctuate more, while lower-risk assets such as bonds or cash tend to be more stable. By allocating your investments among these different asset classes, you can help smooth out the short-term ups and downs.
- **Consider buying opportunities.** Although you may be rightfully gun shy in the wake of the recent market turmoil, one strategy you should seriously consider is selectively adding to your portfolio. This is especially true when prices are low versus historical averages.

Source/Disclaimer

[1]Source: Standard & Poor's Equity Research Services, "Shaken and Stirred," August 29, 2011.
[2]Source: The New York Times, "Market Swings Are Becoming New Standard," September 11, 2011.
[3]Source: Standard & Poor's. For the period indicated. Stocks are represented by the S&P 500, an unmanaged index that is generally considered representative of the U.S. stock market. Past performance is not a guarantee of future results.

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