www.guidewayfinancial.com

Guideway Financial, LLC
Sharon and Jim Lear
512-487-7762
info@guidewayfinancial.com

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Creating Resilient Portfolios, Part 1: Tolerating Volatility

The stock market drops of 2018 made many people nervous. It's tough to watch your portfolio decline, and it's easy during volatile times to feel like your portfolio risk has increased. However, volatility is not the same as risk, and confusing the two concepts can lead investors to unknowingly increase the chance of losing money. To truly reduce risk, we must accept volatility in our portfolios and be emotionally ready to handle it. This article is the first of a three-part series on creating resilient portfolios. It explains the difference between volatility and risk and lists some tips to cope with volatility.

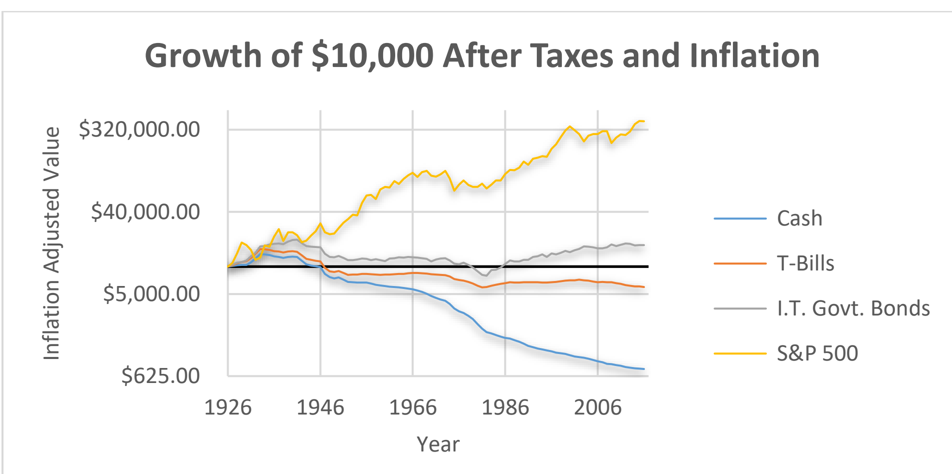
Volatility is not risk

Market volatility scares us, but our emotions can be deceiving. We intuitively know that stocks are not appropriate for short-term investments, but it's harder to understand that capital preservation is riskier over the long term and that more volatile investments can be safer. To see the effects of capital preservation, consider the one-year returns for four assets that vary in volatility from highest to lowest: S&P 500 stock index, intermediate-term government bond index, 1-3 month Treasury Bills (or T-Bills, which are similar to money market funds), and cash in a safe deposit box. The last is the "perfect" capital preservation portfolio. This table shows the percentage of calendar years between 1926 and 2015[i] that each asset lost money. It also includes the percentage of losing years when accounting for inflation and taxes.

Volatility	Asset	% Years Losing Money	% Years Losing Money After Inflation (and After Taxes)[ii]	Risk of Losing Money
Most	S&P 500 Index	27%	31% (33%)	Least
	Intermediate-Term Bond Index	11%	39% (43%)	
	1-3 Month Treasury Bills	1%	40% (53%)	
Least	Cash in Safe Deposit Box	0%	89% (89%)	Most

Even though many investors intuitively feel that higher volatility is riskier, the data says otherwise when taking inflation into account. The lower the volatility, the more likely the investment will lose money to inflation in any one year, especially for taxable accounts. Cash stands to lose value a whopping 89% of the time.

The graph below shows the hypothetical value[i] of $10,000 invested between the beginning of 1926 and the end of 2015, after inflation and taxes[ii]. Cash lost 93% of its value (with or without taxes since returns are always zero), and money-market types of investments (see line for T-Bills) lost 40% of their value.



The takeaway from the above data is that over time, less volatile investments lose more frequently and with more magnitude. To make matters more complicated, human nature causes many investors to move to stable investments when volatility strikes the

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markets. Unfortunately, jumping out of a volatile investment after it has lost money is even worse. No one can predict the inevitable upturn, and therefore, many are left behind when it occurs. A better solution is to invest in the market, but be emotionally prepared for losses before they happen.

Tips to Handle Volatility

To improve long-term safety, it's critical to become comfortable with short-term volatility. Here are some tips that can help you stick with a safer long-term investment strategy, even in the face of short-term volatility:

1. Use "disciplined neglect." Almost everyone feels discomfort over short-term losses – except the people who don't look. Daniel Kahneman, a psychologist and Nobel laureate in Economics said, "If owning stocks is a long-term project for you, following their changes constantly is a very, very bad idea. It's the worst possible thing you can do." Be blissfully ignorant, and you will be happier and more likely to exceed your goals.
2. Turn off the news, especially financial news. News outlets make money by getting your attention, and they do so by scaring you. We've previously[iii] shown that there is no better way to be misinformed than the news.
3. Build cushion into your plan. Some advisors recommend saving 10% of your income after you retire.
4. Ideally, keep critical retirement expenses, such as shelter, property taxes, etc., below your pension and Social Security benefits. These types of income are nearly guaranteed, and perfect to match with critical expenses. If your investments are only for the fun things in life, you can take comfort that the important things are provided for regardless of the market.
5. Be prepared for shortfalls, especially in discretionary spending. You are likely going to suffer at least one year in retirement when income falls short against discretionary spending, and perhaps more. The flexibility to cut back on discretionary expenses in tough times is the key to your financial security. Be ready to reduce dining out or expensive trips.
6. Save excess income. If the market produces higher income for you in retirement than planned, reinvest some of the surplus.
7. Keep in mind that market losses happen regularly – almost half the days and a third of the years. But, losses in a capital preservation portfolio are more frequent. They happen to be hard to see because inflation and taxes are never shown on your statements. Being prepared for loses and knowing they are normal will help.
8. Never be afraid to reach out to your financial advisor. We know volatile times are uncomfortable. We're here to help you stay on course.

In the next article, we'll discuss how to use time to reduce volatility, and how to select a portfolio using time as a guide. We go through an example portfolio and show the resulting retirement income for a hypothetical retiree retiring in in 2008.

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[i] Based on historical returns from Ibbotson's SBBI yearbooks
[ii] Assuming 32% taxes on all returns, including unrealized capital gains, and losses are deductible
[iii] http://guidewayfinancial.com/wp-content/uploads/2016/10/20160701-Brexit-and-the-Media-Frenzy.pdf, https://guidewayfinancial.com/wp-content/uploads/2016/06/20150801-Riding-Out-Turbulent-Seas.pdf, https://guidewayfinancial.com/wp-content/uploads/2016/06/201601-More-Market-Turmoil.pdf

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