

# Panic Is *Not* a Strategy—Nor Is Greed

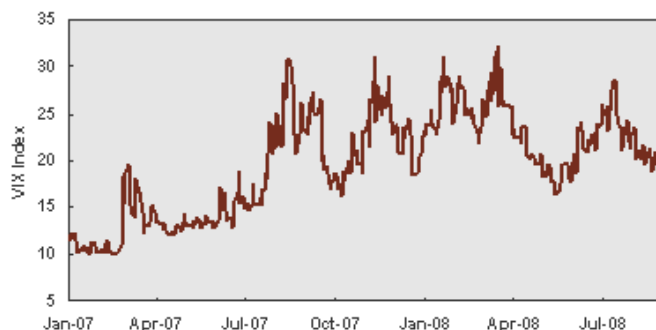
by [Liz Ann Sonders](#), Senior Vice President, Chief Investment Strategist, Charles Schwab & Co., Inc.  
Updated September 2, 2008

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If markets are good at one thing, it's reminding investors that they don't go up uninterrupted forever. Witness an uncharacteristically weak start for the stock market in 2008, following back-to-back corrections in late 2007. As the chart "From Complacency to Fear All in a Day" below illustrates, the surges in the CBOE Volatility Index® are increasingly more frequent. In fact, we have witnessed a few unprecedented single-day spikes in volatility. Based on conventional models and assumptions, such events were ostensibly out of the realm of possibility ... or so the modelers thought!

## From Complacency to Fear All in a Day



As of August 31, 2008.

The VIX Index shows the market's expectation of 30-day volatility.

It is constructed using the implied volatilities of a wide range of S&P 500 index options.

This volatility is meant to be forward-looking and is calculated from both calls and puts.

The VIX is a widely used measure of market risk.

Source: FactSet.

We are always quick to remind investors that neither panic nor greed are investment strategies. Your only real insurance against the unpredictable is having—and sticking with—a long-term strategic asset allocation plan.

## Mind-set matters: strategic trumps tactical

In reality, investors should rarely, if ever, react to a short-term move in the market. As intriguing as it may seem to try to catch every market wiggle in order

to reap big profits (or so you think), the "tactical" (or shorter-term) approach to investing has its limitations ... and its risks.

We believe it's the "strategic" asset allocation decision—and the ability to stick with it—that will ultimately reap the greatest rewards. These decisions are not a function of short-term market gyrations or forecasts (mine, yours or anyone else's), but are tied to your risk tolerance and long-term goals. Developing and maintaining the right long-term asset mix is by far the most important set of decisions a client will ever make.

Never before has information about the global economy and markets been more readily available and disseminated. As a result, global markets have become very interconnected. In turn, our reaction mechanisms have kicked in, and investor time horizons have shortened dramatically—but not necessarily to our advantage. Yes, the long term is really just a series of short-term events, but it's how we react to them that decides our ultimate fate as investors.

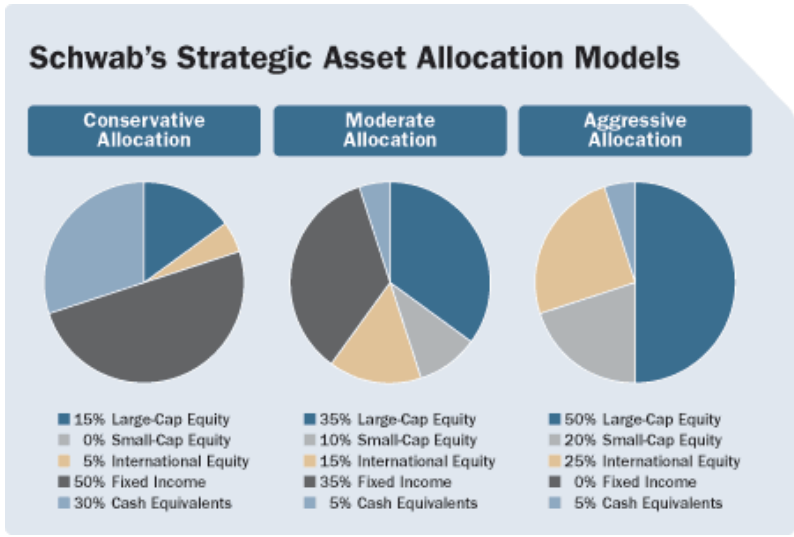
### **Asset allocation and diversification: investors' "free lunch"**

One of the most important areas where Schwab offers advice is the development of a long-term strategic asset allocation plan. Many investors assume that their position along the risk spectrum from conservative to aggressive is largely based on their age and time horizon. But a more important factor is their risk tolerance. Also important is judging the difference between an investor's financial risk tolerance and their emotional risk tolerance—a spread that's often quite wide and only acknowledged during tumultuous market environments.

I've known plenty of older investors who thrive on the risk associated with an aggressive investment stance. I've also known plenty of young investors who can't stomach any losses. Too often, investors use a rearview mirror to make their investing decisions, by looking at past performance as a guide to future results. A mirror is a valuable tool but only when turned on yourself to judge your own circumstances—tolerance for risk, time horizon, income needs, etc. As I've often said, there are very few free lunches in investing. Asset allocation and diversification are as close as you get.

### **Risk tolerance: Know what you can stomach**

In the chart "Schwab's Strategic Asset Allocation Models" below, you'll see our long-term recommendations regarding different asset classes for three types of investors: conservative, moderate and aggressive.<sup>3</sup> Note the vast differences in allocations to riskier asset classes, including international equity, as you move up the risk spectrum.



Clearly, over the long term, given the better performance by the riskier asset classes, a more aggressive allocation has historically reaped higher rewards in terms of returns. But there is a dark side to an aggressive posture's higher returns—the risk taken in getting there.

As you can see in the table below, "Higher Returns Come With Higher Risk," since 1970, an aggressive investor would have earned an 11.4% annualized return vs. an 8.5% annualized return for a conservative investor. Who wouldn't want the higher return? Well, it depends on the risk you're willing to take to get there. What this table further shows is that the 11.4% return came within a much wider range of annual returns and, most importantly, was generated only through "stick-to-it-iveness."

Higher Returns Come With Higher Risk			
Hypothetical portfolios 1970–2007	Conservative	Moderate	Aggressive
Average annual return	8.5%	10.4%	11.3%
Best year	22.8%	30.9%	39.9%
Worst year	0.1%	-12.9%	-23.8%
Negative years	0 of 38	6 of 38	8 of 38
Long-term return estimate	5.2%	7.4%	9.1%

Source: Schwab Center for Financial Research hypothetical portfolios.<sup>4</sup>

The aggressive investor had to suffer eight down years, one of which generated a portfolio loss of nearly 24%. Ask yourself how aggressive you'd feel after losing nearly one quarter of your nest egg in one year. And to maintain that aggressive allocation, you'd have to rebalance in favor of the asset class(es) that generated those steep losses and away from those asset classes that had weathered the storm.

Rebalancing to maintain an aggressive allocation is the best way to generate the higher return. That, of course, is the real test—a test that is administered more often during times of increased volatility. Here's a practical way to think about rebalancing: Your portfolio will tell you when it's time to trim from or add to an

asset class. You don't need to rely on anyone's forecast of what may or may not happen.

Now let's take the conservative investor. Your average annual return after 38 years is just 8.5%, but you never had to suffer a losing year, even though your best year paled in comparison to the aggressive investor's best year. Never losing money in a year? For some, it's worth the lower return for the sleep-at-night benefits.

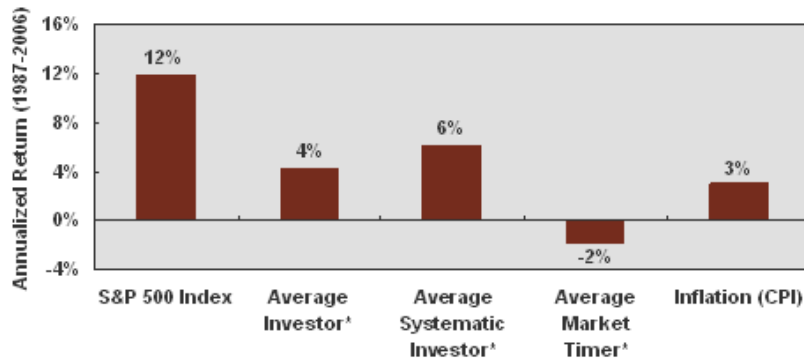
### Market timing: a dangerous game

It's enticing to try to "catch" the next big investment wave (up or down) and allocate assets accordingly. But there are very few time-tested tools for consistently making those decisions well.

Unfortunately, rearview mirror investing (or performance chasing) never seems to go out of style. In one of the more compelling historical studies of investor behavior, the research firm DALBAR discovered that investors have done themselves a great disservice by shortening their time horizons and trying to time asset class performance via their mutual fund allocations.

As you can see in the chart "Market Strong ... Investors Wrong" below, for the 20 years 1987–2006, the S&P 500® index had an annualized return of 12%. Unfortunately, the average equity fund investor had significantly lower returns—only 4% annualized (barely nudging out inflation).

### Market Strong ... Investors Wrong



<sup>†</sup>Measures returns of investors in equity mutual funds. Source: Bureau of Labor Statistics, DALBAR Quantitative Analysis of Investor Behavior 2007 ([www.dalbarinc.com](http://www.dalbarinc.com)).

Most interesting, though, was the difference in returns between "systematic" and "market timer" investors. For those who were consistent in their investments, the annualized return jumped to 6%—still only half that of the S&P 500 but much better than for the average investor. On the other hand, those investors who tried to outsmart the market by timing their inflows and outflows saw their returns plunge well into negative territory—generating an annualized loss of 2% over the period!

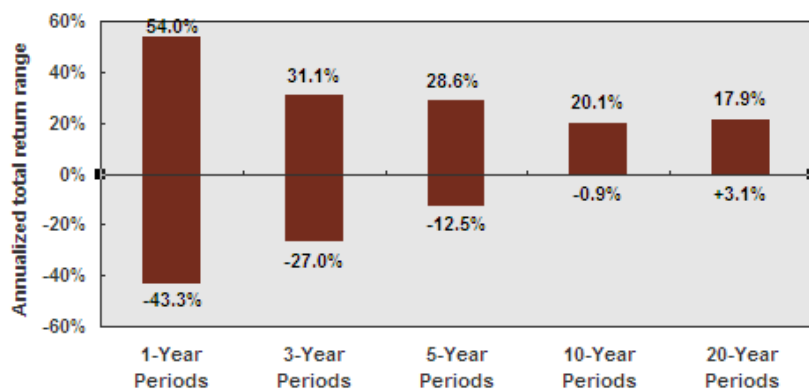
### Time horizons: the longer, the better

According to a recent study by Bain & Company, the length of time that

individual investors hold mutual funds has shrunk precipitously over the last 50 years. In 1960, investors held their funds, on average, for eight years. Today, that holding period has dropped to less than a year—10 months, to be exact! And the trigger for selling and/or buying is often short-term performance chasing: buying last year's hot performer and running from last year's loser.

In the chart below, "Longer Time Horizon = Lower Downside Risk," you can see the power of long holding periods when it comes to minimizing downside risk. The longer you extend your time horizon, the less likely you'll experience a loss over that holding period.

### Longer Time Horizon = Lower Downside Risk



Source: Schwab Center for Financial Research with data provided by Standard and Poor's. Every 1-, 3-, 5-, 10-, and 20-year rolling calendar period for the S&P 500 Index was analyzed from 1926 through 2007. The highest and lowest annual total returns for the specified rolling time periods were chosen to depict the volatility of the market. Returns include reinvestment of dividends. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. Past performance is no indication of future results.<sup>5</sup>

### Patience and stick-to-it-iveness

Admittedly, the development of a long-term strategic asset allocation plan isn't the hard part—it's sticking to it that often becomes the real challenge. The best way for an aggressive investor to have generated the 11.4% annualized return since 1970 was for that investor to have remained aggressive throughout the period, including during eight down years. That meant rebalancing, typically in favor of underperforming asset classes and away from outperforming asset classes. The same goes for the rebalancing associated with maintaining a conservative allocation.

Adding to underperforming asset classes and trimming outperforming asset classes goes against the emotions of fear and greed that often drive investment decision making. But if we learn from our mistakes, use our brains over our hearts and look to our portfolios as rebalancing guides, we can expect a more successful investing future and maybe even get a free lunch along the way.

#### Is your strategic asset allocation up-to-date? Take action online.

- Log in to Schwab.com and click on the Planning & Advice tab.
- Clients can click on Portfolio Checkup for four easy steps to check your allocations

and manage your portfolio.

- Click on the Investor Profile Questionnaire in step 1 to make sure your risk tolerance is aligned with your portfolio

### **Important Disclosures**

1. Market drop is represented by S&P 500 index.
2. The Chicago Board Options Exchange SPX Volatility Index (VIX) reflects a market estimate of future volatility. VIX is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward-looking and is calculated from both calls and puts.
3. See Schwab.com/portfoliocheckup for five strategic asset allocation models, including Moderately Conservative and Moderately Aggressive.
4. Data from Ibbotson Associates, Inc. The return figures for 1970 through 2007 are average, maximum and minimum annual returns of three hypothetical portfolios, which are rebalanced annually with dividends and interest reinvested. Conservative is 15% large-cap stocks, 5% international stocks, 50% bonds and 30% cash. Moderate is 35% large-cap stocks, 10% small-cap stocks, 15% international stocks, 35% bonds and 5% cash. Aggressive is 50% large-cap stocks, 20% small-cap stocks, 25% international stocks and 5% cash. Indexes are S&P 500 index (large-cap stocks), Russell 2000 Index (small-cap stocks), MSCI EAFE® net of taxes (international stocks), Lehman Brothers U.S. Aggregate Index (bonds) and Citigroup 3-Month Treasury Bill Index (cash). CRSP 6-8 was used for small-cap stocks prior to 1979; Ibbotson Intermediate-Term U.S. Government Bond Index was used for bonds prior to 1976; and Ibbotson U.S. 30-Day Treasury Bill Index was used prior to 1978. Long-term return estimates are weighted averages of Schwab's long-term return estimates for each asset class: large-cap stocks, 9.0%; small-cap stocks, 10.7%; international stocks, 9.1%; bonds, 4.8%; and cash, 3.2%.
5. The highest and lowest annual total returns for the specified rolling time periods were chosen to depict the volatility of the market. Returns include reinvestment of dividends.

The S&P 500 index is an index of widely traded stocks. Indexes are unmanaged, do not incur fees or expenses and cannot be invested in directly.

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Past results are not a guarantee of future performance.

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