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Volatility and the Long-Term Investor

KEEPING SHORT TERM MARKET DECLINES IN PERSPECTIVE

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The 1990s were an exceptionally favorable decade for the U.S. stock market, leaving many investors with the perception that stocks continually rise and rarely fall. More recently, however, market performance has been disappointing, and major market benchmarks – such as the S&P 500 Index — have become much more volatile.

At times like this, it is important to put these trends in the proper perspective. Sudden declines are hardly uncommon in the stock market. The risk of short-term loss is one that equity investors simply have to be prepared to accept. While diversification and prudent portfolio management may reduce this risk, it cannot be eliminated entirely.

Market volatility can be scary, particularly when you're not expecting it. Amid such uncertainty, it is all the more important to keep your eyes on the market's true prize: superior long-term performance. Over the past 75 years, investors in U.S. stocks typically have been richly rewarded for the risks they have taken – despite the occasional bear markets.

There's no question doing nothing can be hard when the value of your equity portfolio has fallen 15% or 20%. The may seem too risky compared to supposedly "safe" investments such as bonds and money market funds. But successful investors avoid the temptation to adjust their portfolios in response to every short-term dip in the market.

Investors should also understand that many widely accepted "facts" about market volatility actually are dead

wrong. Here's a look at few of these myths, and the realities behind them.

Myth: When the newspapers and magazines turn bearish about the market, that's a bad sign.

Reality: The media has a terrible record at calling the market. A review of the past 30 years of news coverage demonstrates that when headlines have been filled with doom and gloom, the market has often been close to a bottom. When the media has turned bullish, the market has often been near a short-term top.

Myth: Market volatility is getting worse all the time. Owning stocks today is a lot more risky than it was 20 or 30 years ago.

Reality: It's true the past few years have seen an upswing in volatility, as measured by daily price moves. In 2001, there were 105 days when the S&P 500 Index moved up or down by 1% or more. That's up from just 13 days in 1995. But this isn't part of a long-term pattern. As the chart on the next page shows, daily volatility has risen and fallen repeatedly in cycles over the past 30 years.

In any case, sharp daily moves – while unsettling – don't tell the whole story. Investment analysts typically measure volatility by looking at standard deviation: the degree to which market returns in any given quarter diverge from their longer-run trend. By this measure, market risk has *declined* over the past 20 years. During the ten years ending 2001, the standard deviation of returns for large U.S. stocks was less than 14.8% – the lowest since the 1950s.

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Myth: After the kind of gains investors saw in the late 1990s, the law of averages guarantees the next decade will be a bad time to own stocks.

Reality: It's true market returns in the late 1990s were high by historical standards. But there is no "law" that requires returns to be below average in the future because they've been higher than average in the past. Since 1925, investors have earned an annualized return of about 11% on large stocks. Whether returns are better or worse in coming years will depend on economic factors such as inflation, interest rates and earnings – not the laws of probability.

Myth: When the market starts to rise, smart investors can always jump back in and ride the next leg up. Meanwhile, the safest thing to do is to stay in cash.

Reality: Timing the market is something even many professional investors can't do consistently. And the costs of being out of the market for even a short time can be enormous. For example, from 1980 through mid-May 2002 – a period containing more than 5,600 trading days – an investor who missed the 50 biggest up days would have missed almost 80% of the increase in stock prices during that period – converting a 16% annualized rise into less than 4%.

Myth: While stocks have paid higher returns than bonds or T-bills over the long run, the difference hasn't been all that great.

Reality: Over the past 75 years, returns on stocks have beaten cash and bonds not by a narrow margin, but by huge margins. For example, an investor who put \$1,000 in large U.S. stocks at the beginning of 1926 would have had a portfolio worth almost \$2.2 million by the end of April 2001. By comparison, that same \$1,000 invested in long-term Treasury bonds would have grown to just \$51,000 while \$1,000 invested in T-bills would have been worth only \$17,000.

Myth: Buying near the top of a bull market is an easy way to lose money over the long run.

Reality: Historically, investors who put money in the stock market near a short-term peak have done well over the long run – particularly when compared to Treasury bills and other supposedly "safe" investments. An investor who put \$10,000 in large U.S. stocks at the tops of the eight major bull markets over the past 45 years would have had a portfolio worth more than \$1.8 million by the end of April 2002. By comparison, someone who invested the same



