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NORTHERN EXPOSURE

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Complacency and Calm Markets

Recently, investors have experienced positive market returns and low volatility. While neither of those contains reliable information about what future returns may bring, now may be a good time to reinforce appropriate investment expectations with clients.

With the exception of a few recent instances of increased volatility, the equity markets have been quite calm in the past few months, despite global events that include the Syrian war and refugee crisis, Brexit, terrorism in Europe, the US election and its political aftermath, and the North Korean nuclear threat.

Exhibit 1 shows the rolling 20-day[1] volatility of daily returns of the Russell 3000 Index since 1995. We see that it has fallen below its standard deviation for the entire period—an indication that US equity market volatility has been low.

There have been many stories in the press speculating about why volatility has been low, how this is related to the real economy and global events, and what it might mean for future returns. However, the stories are just that—stories. But it might not matter much anyway, as research shows that recent volatility does not indicate whether future returns will be high or low.[2]

Instead of dwelling on the unknowable, we should focus on what we do know. Over time, stock markets have been volatile. They have always had their ups and downs—and we believe they always will. Clients should not be caught off guard by the next market downturn, whenever that might occur. The level of volatility will not tell us when, why, or by how much the market may drop because volatility often spikes *during* a market decline.[2]

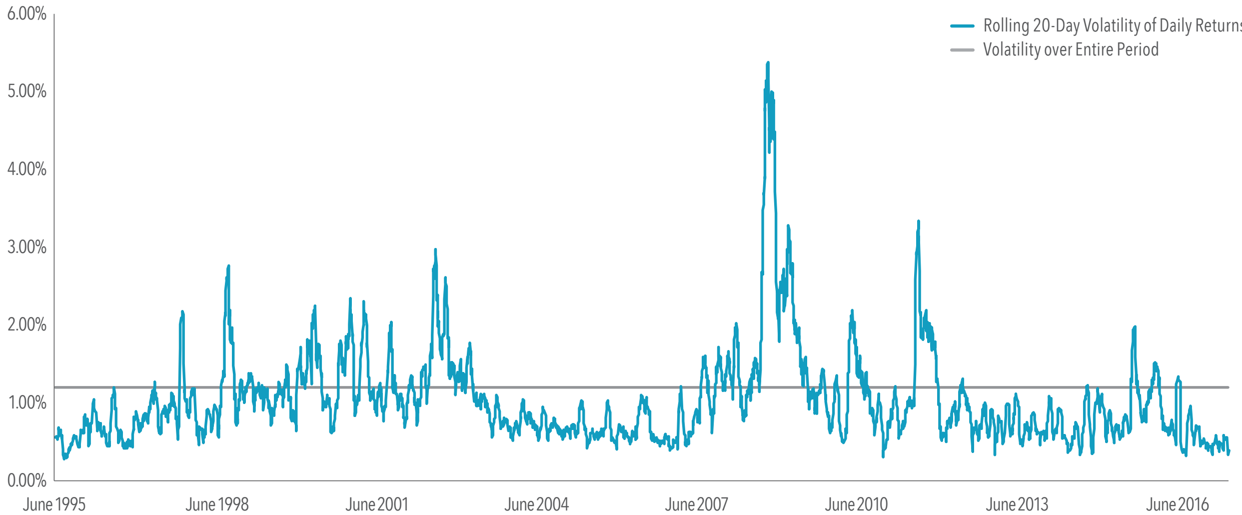
WEATHERING DOWNTURNS

Even if recent market volatility has been low, history has shown that volatility spikes and market downturns can happen unexpectedly. This is why it is important to develop an appropriate asset allocation and to set reasonable expectations that can help investors weather market downturns.

Clients may vary in their ability to bear volatility in returns. Those with little appetite or ability to experience declining portfolio values may want to control volatility with fixed

1. We use 20 days as an approximation for the number of trading days in a month.
2. "Can Volatility Predict Returns?" (Issue Brief, Dimensional Fund Advisors, July 2016).

Exhibit 1: Rolling 20-Day Volatility of Daily Returns—Russell 3000 Index
June 29, 1995–June 23, 2017



In USD. Volatility is measured as standard deviation. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Past performance is not a guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

income. During periods when equity markets fall, a well-designed allocation to fixed income can help mitigate the declines experienced at the overall portfolio level.

Setting expectations should be an ongoing exercise. Advisors can mistakenly assume that clients who weathered turbulent markets in the past can maintain their discipline in the future. Even though past experiences can inform our future actions, falling stock prices typically come with a litany of bad news and the stress of not knowing when the downturn will end, which can cloud memories and tempt investors to assume that "this time it's different." Calm markets give you the opportunity to set appropriate expectations for clients so that they can better weather a significant decline in the event one occurs.

Dimensional's 2017 Investor Feedback Survey highlights the need to set the right expectations for clients. The survey aggregated the views of 18,967 clients across 436 advisory practices globally. Approximately one-third (31%) of the respondents indicated that their greatest financial fear was "experiencing a significant investment loss in a market downturn," a response second only to "not having enough money to live comfortably in retirement" (37%).

But what does it mean to experience a *significant loss*? The answer might vary among clients. If experiencing a loss equates to falling stock prices, most investors will surely face this prospect at some point in the future. The advisor's task then becomes one of defining what the client considers to be a significant loss and ensuring that the client's expectations and portfolio are aligned with that definition. It's also important to highlight the difference between a realized loss and a drop in prices by demonstrating the frequency and magnitude of market declines while reinforcing the point that global markets have historically recovered.

Stock prices can and do fall, but global markets are resilient. **Exhibit 2** shows how a hypothetical 100% equity strategy and a hypothetical 60% equity/40% fixed income strategy would have fared in the past six global stock market downturns of at least 20%. On average, a decline of this magnitude has occurred about once every seven or eight years since 1973. The last occurrence was in 2011. The addition of bonds would have helped to mitigate the decline in the 60/40 strategy relative to 100% equity strategy. Additionally, investors might take comfort in knowing that for most of the historical downturns, $1 invested in either strategy at the market high point (before the decline) would have resulted in positive growth within five or 10 years.

Exhibit 2: Hypothetical Growth of $1 Invested at the Market High
Past Six Market Declines of at Least 20% (1973–Present)

			100% Equity			60% Equity/40% Fixed Income		
High	Low	Market Total Return	At Low	5 Years After High	10 Years After High	At Low	5 Years After High	10 Years After High
Jan. 1973	Sep. 1974	−37.26%	$0.64	$1.45	$3.51	$0.79	$1.45	$3.07
Aug. 1987	Nov. 1987	−23.41%	$0.77	$1.52	$3.76	$0.87	$1.54	$2.99
Apr. 1998	Aug. 1998	−21.13%	$0.79	$1.10	$2.63	$0.88	$1.21	$2.20
May 2002	Sep. 2002	−20.86%	$0.79	$2.41	$2.36	$0.88	$1.82	$2.00
Oct. 2007	Feb. 2009	−58.37%	$0.42	$1.00	—	$0.62	$1.10	—
Apr. 2011	Sep. 2011	−22.10%	$0.78	$1.37	—	$0.87	$1.25	—

In USD. Source: Dimensional Fund Advisors. Market Total Return reflects the return of the 100% equity strategy for the indicated period from high to low. Returns are based on Dimensional balanced strategies. The strategies are hypothetical, for illustrative purposes only, and are not to be construed as investment advice. They do not represent actual portfolios or investments. Assumes $1 invested at the high point. The 100% equity strategy is 70% US stocks and 30% non-US stocks. The equities are composed of 20% S&P 500 Index, 20% Dimensional US Large Cap Value Index, 10% Dimensional US Small Cap Index, 10% Dimensional US Small Cap Value Index, 10% Dow Jones US Select REIT Index, 10% Dimensional International Marketwide Value Index, 5% Dimensional International Small Cap Index, 5% Dimensional International Small Cap Value Index, 3% Dimensional Emerging Markets Index, 3% Dimensional Emerging Markets Value Index, and 4% Dimensional Emerging Markets Small Cap Index. Returns for the 60% equity/40% fixed income strategy are based on a 60% allocation to the 100% equity strategy and 40% allocation to fixed income, which is represented by an equally weighted blend of the BofA Merrill Lynch One-Year US Treasury Note Index, Citi World Government Bond Index 1–3 Years (Hedged), Bloomberg Barclays US Treasury Bond Index 1–5 Years, and Citi World Government Bond Index 1–5 Years (Hedged). The S&P data provided by Standard & Poor's Index Services Group. Dow Jones data provided by Dow Jones Indices. The BofA Merrill Lynch Indices are used with permission; © 2017 Merrill Lynch, Pierce, Fenner & Smith Inc.; all rights reserved. Citi fixed income indices © 2017 by Citigroup. Bloomberg Barclays data provided by Bloomberg. The balanced strategies are not recommendations for an actual allocation. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results. Diversification neither ensures a profit nor guarantees against loss in a declining market.

Framed in this way, uncertainty and market declines are part of the nature of investing. Uncertainty is not a pleasant experience for most investors—and market downturns can bring discomfort. But learning to embrace their inevitability can be liberating. If investment outcomes were certain and prices never declined, we would not expect more than the risk-free rate of return. For many investors, the expected return of short-term Treasuries is not sufficient to meet their long-term financial goals. In a world of stable portfolio values, investors would end up trading one risk (volatility) for another risk—loss of purchasing power after taxes and inflation from investing only in short-term Treasuries.

Advisors should not shy away from having a discussion with their clients about the possibility of future downturns. Although you don't want to induce unnecessary anxiety or leave the impression you are predicting that another market decline is imminent, perhaps now is the time to help clients revisit expectations for their investments.

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