It’s in the mix

Know the trade-offs

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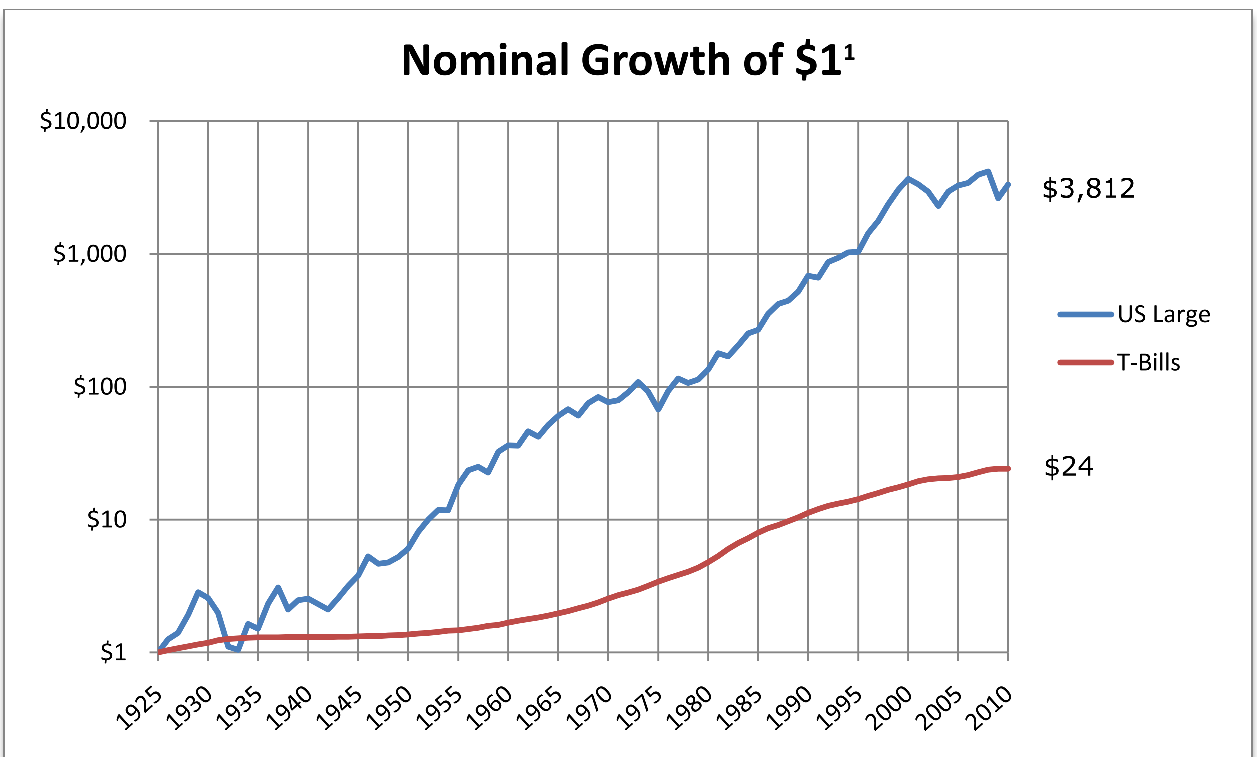
Perhaps the two most potentially damaging risks investors face are *inflation* and *volatility*. Simply put, inflation is potentially the worst enemy of the long term investor, while volatility is potentially the worst for those with shorter time horizons.

The conundrum is that each of us is *both* a short and long term investor! How do we manage these two major risks? What’s worse is realizing the solutions for each threat are competing! That is:

	Bonds	**Stocks**
Strength	Low volatility	Hold up to inflation
Weakness	Crushed by inflation	High volatility

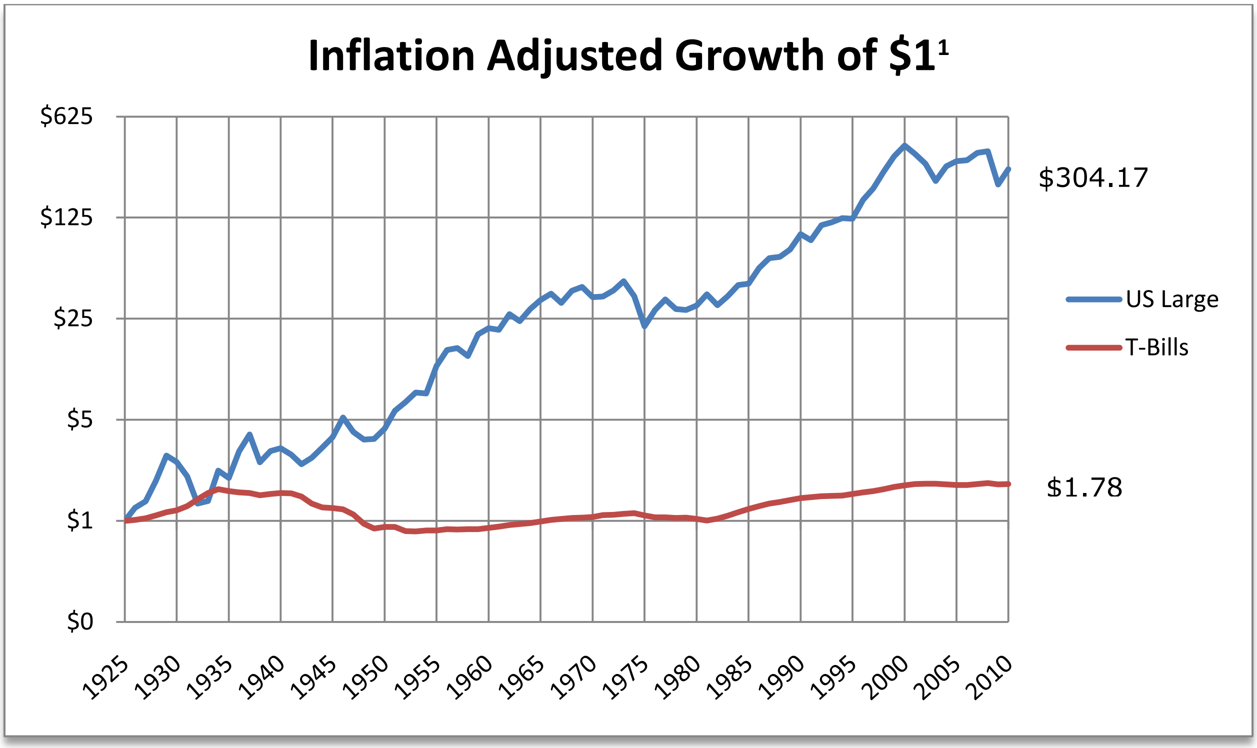
Let’s begin by looking at the nominal growth of stocks and bonds from 1925-2010:



[1] Source: Calculated by Commencement Financial Planning LLC, using data from Shiller, Bloomberg, U.S. Federal Reserve, and U.S. Dept. of Labor Bureau Statistics. US Large Cap data include dividend reinvestments. T-Bill duration ranges from 3-months to 1-year. Taxes and transaction fees are not included in data. Growth assumes no additional contributions or withdrawals are made during the period measured.

Even though stocks dramatically outperformed bonds in the long run, the long term investor that has little tolerance for the bumpy ride stocks provide along the way may find the lower bond result an acceptable trade-off.

However, when we factor in inflation the results are dramatically different:



We now see the total *real* increase of the bond portfolio over the period barely kept up with inflation, while the stock portfolio provided a stunning total *real* increase of 30,417%!! The long term stock investor was rewarded handsomely for taking on the risk of additional volatility.

Then why not just invest in stocks if evidence suggests stocks will provide superior results over the long term? The answer lies in *volatility*.

The risk of volatility necessitates further examination of our time horizon. As we get closer to drawing upon our investment assets to meet our cash needs, we want to position ourselves so we hedge against the risk of near term volatility.

History provides us with an excellent look at how volatility affects investors with differing time horizons. We'll examine this further on the following pages.

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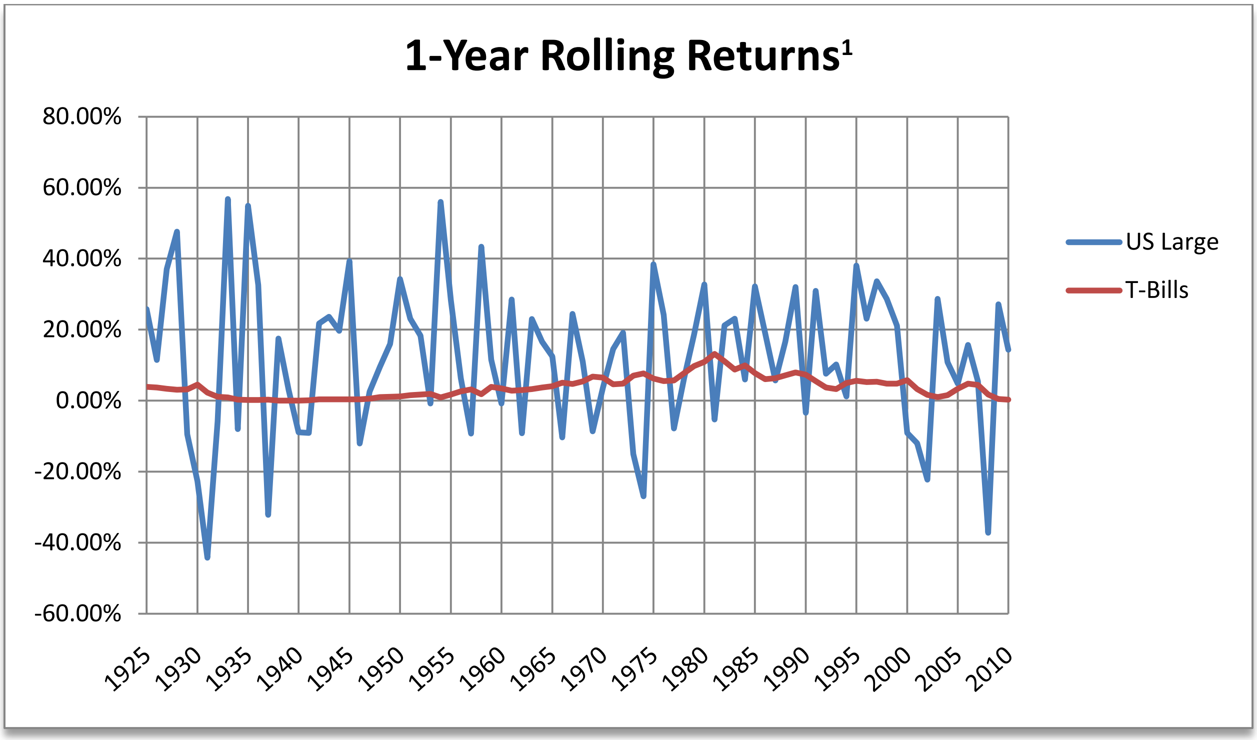
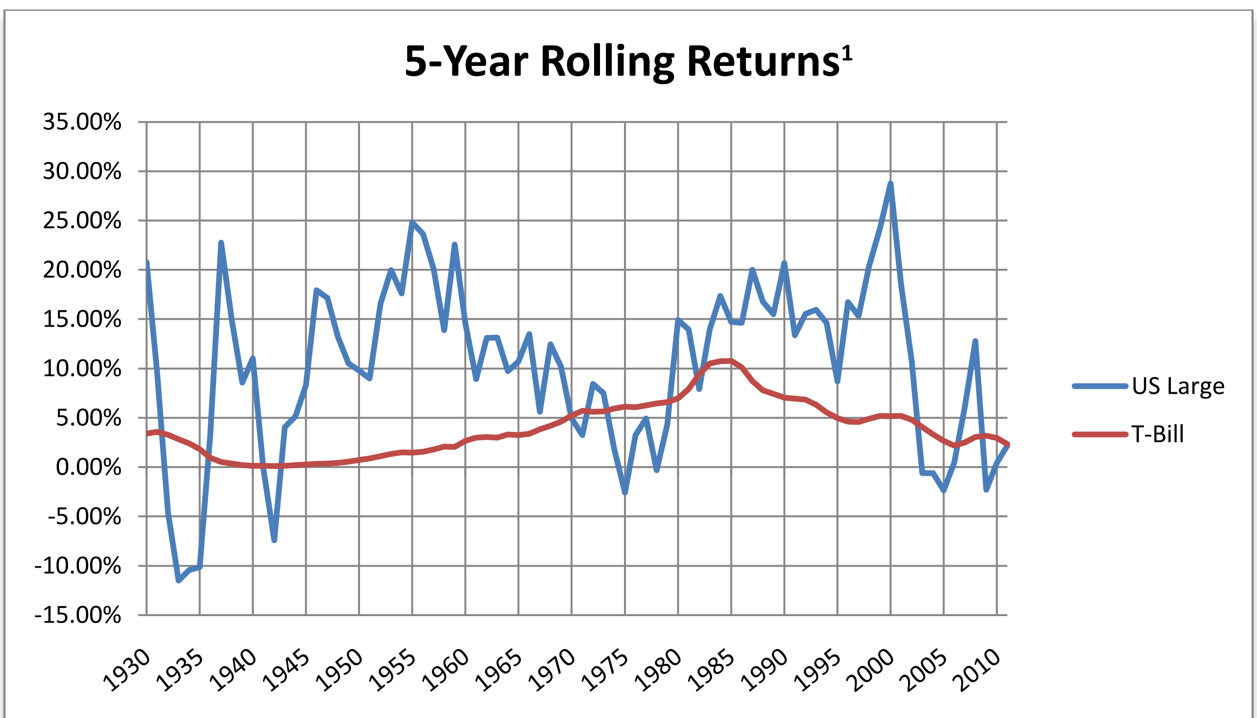
The following graphs depict the volatility of stocks versus bonds over 1, 5, 10, & 20-year rolling periods, respectively:





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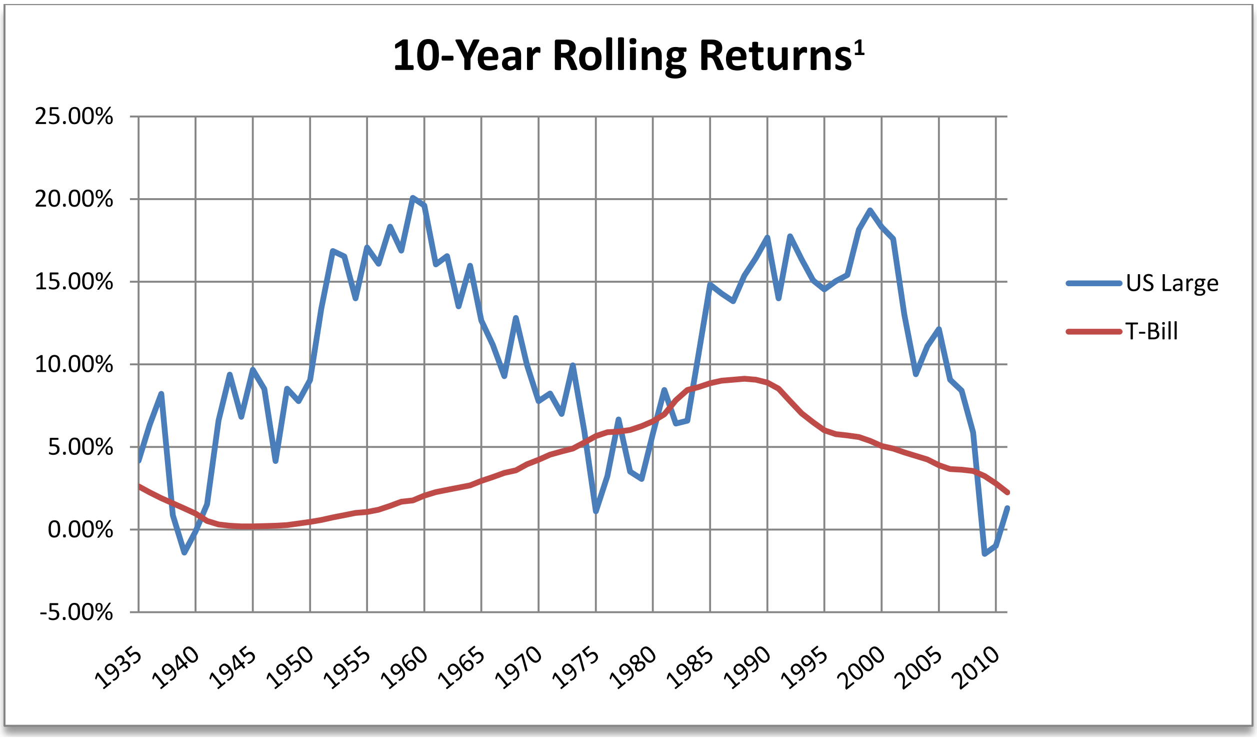

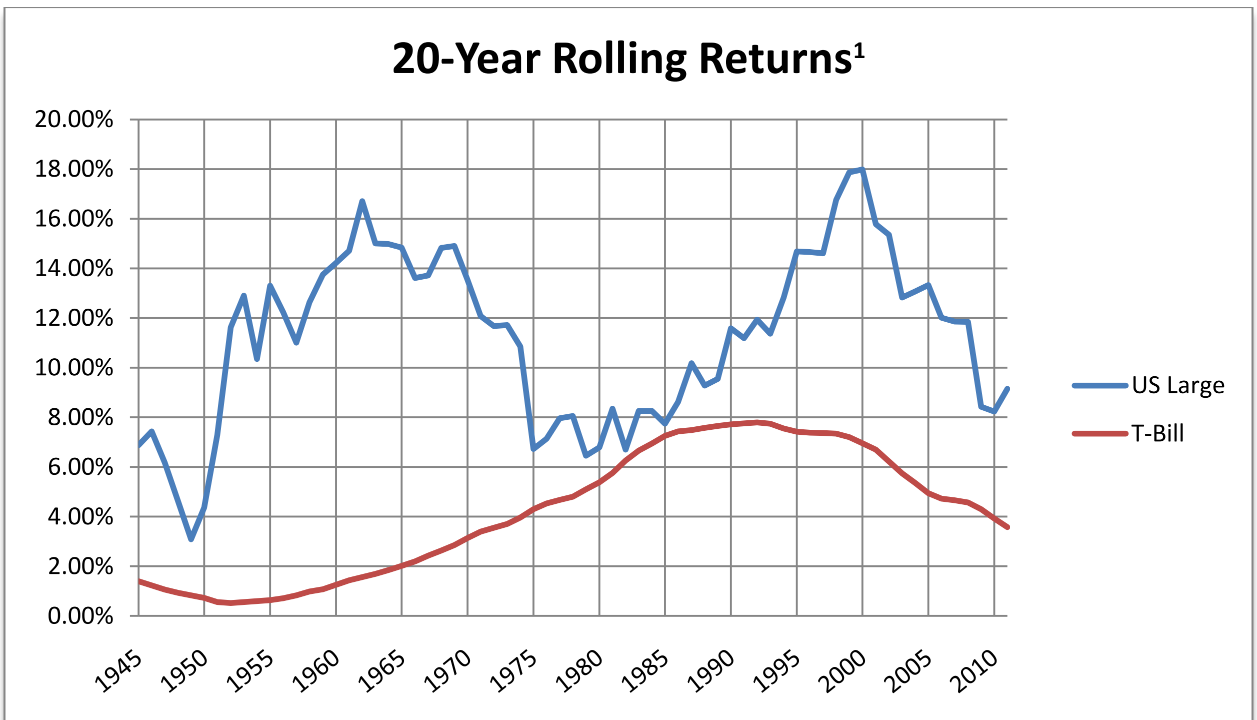

By examining history, we can quickly see that time horizon does matter! From 1925-2010, an investor with a 1-year time horizon would have taken on significant risk investing in stocks, but as investor time horizon increases the risk of investing in stocks *decreased* while the risk of investing in bonds *increased*.

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In fact, an investor with a 20-year time horizon entering the stock market during *any* year between 1925 and 1990 would have outperformed bonds (note: a stock investor requiring funds during the late 1970's through the early 1980's did face significant headwinds due to stagflation and rising interest rates, but managed to stay ahead of cumulative bond returns nonetheless).

This examination of history highlights the importance of adopting the proper mix of stocks and bonds according to your time horizon and tolerance for volatility. The investor soon realizes neither stocks nor bonds are a safe bet on their own. Armed with this knowledge the investor can make more a informed decision about what allocation of stocks and bonds will work best for them.

Ultimately, the investor must understand and be comfortable with his strategy. If an investor doesn't have complete confidence in his investment strategy he will likely abandon it when it's need most: In times of false overconfidence or panic due to short-term market fluctuations.

A strategy that an investor does not stick with through good times and bad is almost as bad as having no strategy at all! A critical mission of the financial advisor is to help his clients to understand their goals and risk tolerance; then help them develop and implement an investment strategy they fully understand and are comfortable with. A client with a deeper understanding of his strategy is one most likely to succeed.