

Market Observations October 2018



RISK TOLERANCE

Market environments have a way of reinforcing basic investor instincts. Market gains fuel desires to invest even more while market losses stoke fears of investing at all. Accurately anticipating the timing and magnitude of either market environment is challenging. Less challenging is determining an investor's inherent risk tolerance. Such a determination can guide an appropriate strategy for pursuing investment goals through favorable and unfavorable market environments. An assessment of risk tolerance realities can provide perspective.

Perspective

"What level of temporary (one year or less) decline in your total portfolio value would leave you uncomfortable?" An answer to this question is an indication of risk tolerance. The frequency of one-year declines in the Dow Jones Industrial Average ("DJIA") over its 122-year history is shown in Table I. The average of all one-year returns was +8.9% and 68% of the time returns were positive. Declines are displayed in increments corresponding to common ranges of risk tolerance.

Using historical returns, risks and correlations, Table II shows the range of potential one-year declines from diversified portfolios with different equity allocations. There is a 5% statistical probability of these declines occurring. For an investor who would be uncomfortable with a one-year decline greater than -5%, a maximum equity allocation of 25% would be appropriate. To maintain an equity allocation of 75%, an investor must be willing to withstand a one-year decline range of -10% to -15%.

Investor risk tolerance clearly was tested in the last bear market. The DJIA declined -40.6% in the twelve months ended 2/28/2009. With no tolerance for further loss, reducing equity holdings could have followed. If equity allocations before the decline were beyond individual risk tolerances, such an outcome was even more likely. But selling at the bottom would have been costly. Table III presents actual recovery times for different percentages of equity allocation held in the recovery. For an investor who stayed the course, i.e., 100% held through decline and recovery, the investment was made whole in 1.8 years. For a reduction to only a 25% allocation, full recovery has yet to be achieved. Even if returns of the past 9.6 years persist, it will take another 2.5 years to be whole.

Investment Implications

Future market declines and recoveries may bear no resemblance to the most recent experiences. Nevertheless, investor instincts of fear and desire likely will be magnified again by respective market trends. Potential adverse outcomes can be mitigated if portfolio guidelines are aligned properly with individual goals, time horizons and risk tolerances at all times.

TABLE I

DOW JONES INDUSTRIAL AVERAGE ROLLING ONE-YEAR RETURNS*	
RETURN RANGE	% OF YEARS
0% or More	68%
0% to -1%	2%
-1% to -5%	7%
-5% to -10%	7%
-10% to -15%	6%
-15% or Less	12%

*APRIL 1897 - SEPTEMBER 2018

TABLE II

ONE-YEAR DIVERSIFIED PORTFOLIO RISK 5% PROBABILITY OF OCCURENCE*	
EQUITY ALLOCATION	ONE-YEAR DECLINE
0%	-2.2%
25%	-4.0%
50%	-8.7%
75%	-14.2%
100%	-19.9%

* Historical returns, risks & correlations; fixed-income, equity & alternative investments

TABLE III

DOW JONES INDUSTRIAL AVERAGE LOSS RECOVERY FROM 2009 LOW*		
RECOVERY DJIA ALLOCATION	RECOVERY TIME (Years)	ANNUAL RETURN TO 9/30/18
25%	??	4.4%
50%	5.3	8.9%
75%	3.3	13.5%
100%	1.8	18.1%

* Measured from February 2009 month-end. 100% of DJIA return during loss; return from indicated DJIA allocation during recovery plus balance invested in money market.