EQUIUS ASSETCLASS℠
Modern asset class investing principles, research, and perspectives for long-term investors
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Setting Expectations

The equity markets have been quite calm in the past few months despite global events that many investors find unsettling. There have been only a few recent instances of increased volatility.

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

There have been many stories in the press speculating as to why volatility has been low, how it relates to the real economy and global events, and what it means for future returns. However, the stories are just that—stories. Research shows that recent volatility does not indicate whether future returns will be high or low.[2]

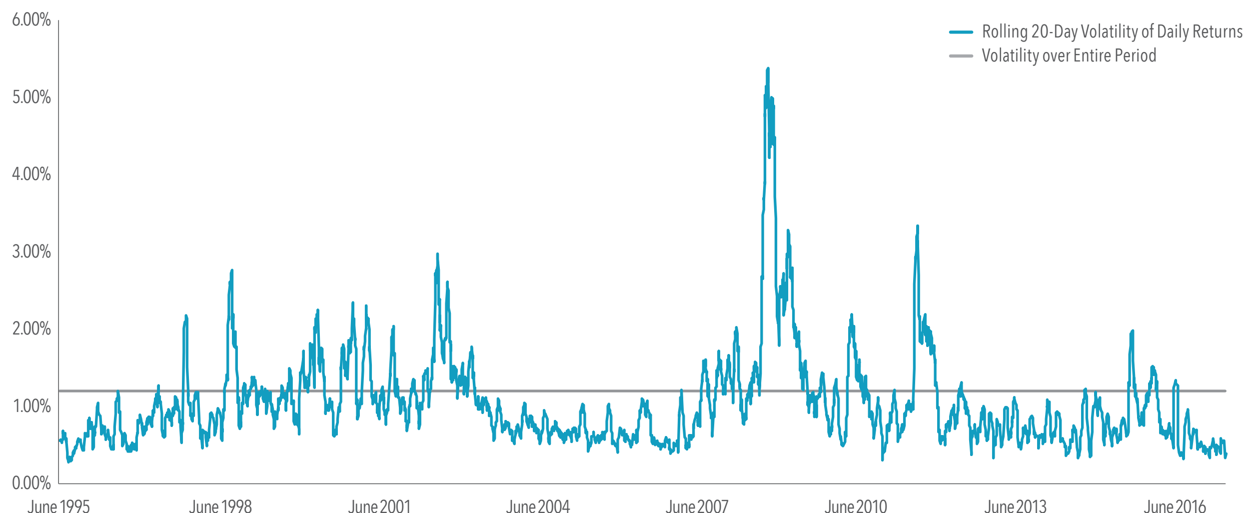
Instead of dwelling on the unknowable, we should focus on what we do know. Over time, stock markets have had their ups and downs—they always will. Investors should not be caught off guard by the next downturn, whenever it might occur. But they should also not expect that level of volatility will tell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

Even if recent volatility has been low, history has shown that volatility spikes and market downturns can happen unexpectedly. This is why it is important for investors to develop an asset allocation appropriate for their risk preferences and establish a disciplined rebalancing strategy.

Investors 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 by increasing the fixed income component of their portfolio. During periods when equity markets are declining, a well-designed allocation to fixed income can help mitigate the decline of the overall portfolio.

As advisors, setting expectations with clients is an ongoing exercise. Just because an investor weathered turbulent markets in the past that doesn't mean they will be able to maintain their discipline in the future. Past experiences can inform our future actions, but falling stock prices typically come with a litany of bad news and the stress of not knowing when the downturn will end can cloud memories and tempt investors to assume that "this time it's different." Calm markets give us the opportunity to set appropriate expectations with clients so that they can better weather a significant decline in the event one occurs.

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.

Dimensional's 2017 Investor Feedback 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 varies among clients. If experiencing a loss equates to falling stock prices, investors will surely face this prospect at some point in the future. Our 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 temporary decline in prices and a *realized* loss by demonstrating the frequency and magnitude of market declines and 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 fixed income 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 years.

Framed in this way, uncertainty and market declines are part of the nature of investing. Uncertainty is not a pleasant experience for most investors; market downturns can bring discomfort. But learning to embrace their inevitability can be liberating. If investment outcomes were certain and prices never declined, we could 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.

At Equius, we are proactive in discussing with our clients the possibility of future market downturns. Although we don't want to induce unnecessary anxiety or leave the impression that we are predicting that another market decline is imminent, we believe that now is a good time to help our clients revisit expectations for their investments.

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 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. e 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.

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