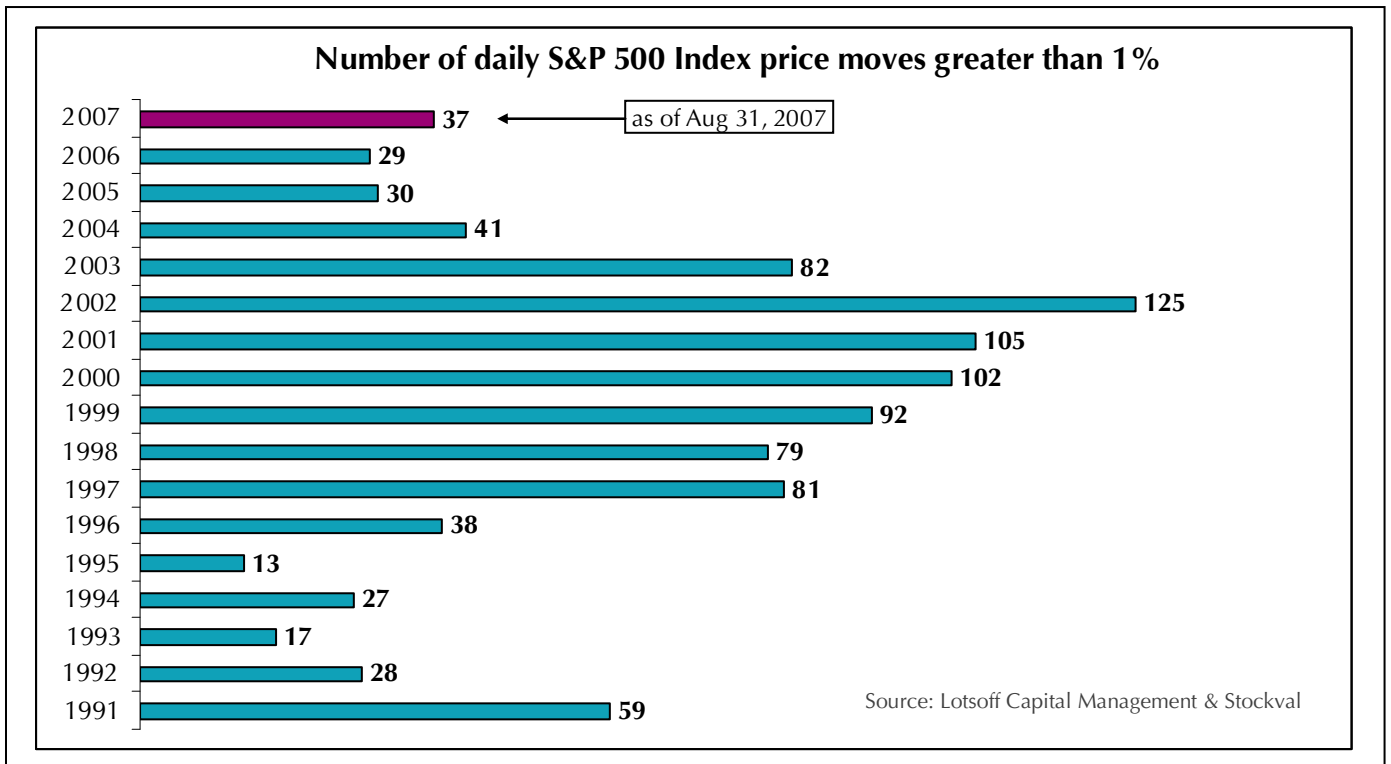


Volatility – Something to be avoided?

As you may have noticed, over the last few months the stock market appears to have become more volatile. It now seems that the Dow Jones Industrial Average (“DJIA”) goes up or down 200 or more points on a frequent basis. Of course, with the DJIA over the 13,000 mark, the impact of a 200 point move is not as significant as when the DJIA was trading in the 2,000 point range. For example, on October 19, 1987, the DJIA fell from 2,238 to 1,730, declining 508 points. The 22.6% drop was the worst one-day beating the index has taken since hostilities were initiated in World War I. An equivalent percentage drop today would require the average to sink by more than 3,000 points! When viewed in these terms, daily point swings of 200 points hardly seem worth noting, yet the financial media seem to enjoy focusing on the magnitude of point declines rather than percentage declines. We can only guess that it sells more papers or causes TV viewers to stay tuned longer. Perhaps the keepers of the DJIA would consider splitting the DJIA 10 for 1, so that a 200 point move would be reduced to only 20 points – a number too modest to rate a headline. Of course, this is unlikely to happen, as the keeper of the DJIA is a newspaper publishing company.

This said, volatility has increased in 2007 when compared to the low volatility of recent years. As shown in the chart below, this year the number of 1% or more daily price moves in the S&P 500 has already matched 2005 and 2006, and is likely to surpass 2004 as well. However, there still is a way to go before we experience the sustained volatility seen in the late 1990's and early 2000's. In fact, in 2002 the S&P 500 on average moved 1% or more every other trading day! Indeed, 2007 may indicate that volatility is beginning to revert to higher historical levels.



“A lot of people approach risk as if it's the enemy when it's really fortune's accomplice.” Sting

While volatility may be unsettling, is volatility something to be avoided? And even if volatility can be avoided, should it be? The answer to these questions depends on one's objectives.

For investors who plan to spend a portion of their portfolios on a big ticket item in the near-term, it is wise to avoid volatility. This can be done by investing a portion of their portfolios in cash. Instruments like U.S. Treasury Bills or Money Market funds generally experience very little to no price fluctuation. But they are not without longer term risks. The returns on cash are greatly reduced by taxes and inflation. Historically, the real (i.e. after inflation) after-tax returns on cash have been negative (see table below). Investors who parked their portfolios in cash for long periods of time may have thought they were getting safety, but they lost purchasing power of their money. Historically, the same has been true of bonds. Cash and bonds may be safe in the short-term, but they are not safe over the long-term.

On the other hand, for investors who need their portfolios to provide a lifetime of retirement income, short-term volatility is necessary to improve the likelihood of meeting those long range goals. Stocks, which are volatile over shorter periods, have historically proven themselves to be less risky than bonds and cash, in terms of protecting an investor's long-term purchasing power. Short-term price fluctuation is the price that an equity investor must bear in order to enjoy the long-term benefits of stock ownership.

Often, investors appear to confuse short-term price declines in the stock market with risk. The problem with stocks is that they are priced every day, sometimes drifting higher and other times sliding lower. The equity value of your home also fluctuates, but you don't see the price changes on a daily basis and probably don't worry about what your home is worth (until you want to sell it). The same approach should be taken with stocks. **Short-term declines don't represent permanent losses of capital if you don't have to sell.** Investors who did not sell on October 19, 1987 did not lose any money; only those who panicked experienced losses. In fact, price volatility provides long-term investors with opportunities to purchase equities at lower prices and improve their future returns.

Historical Returns – After-tax and After inflation

Compound Annual Return Percentage from 1926 to 2006

	Nominal	After-Tax*	Real After-Tax
	(Before Inflation)	(Assumes Historical Income Tax & Capital Gains Rates)	(After Inflation)
Short Term Debt (T-Bills)	3.7%	1.6%	-1.6%
Long-Term Debt (Long-Term Gov't Bonds)	5.4%	2.1%	-1.2%
Equity (Large Company Stocks)	10.4%	5.8%	2.6%

* Assumes highest historical marginal tax rates. Total return is the sum of the income return and the capital appreciation. The income component of the total return is reduced by historical income tax rates.

To allow for some tax deferral only one half of the capital appreciation component is reduced by historical capital gains taxes. Performance information shown is historical and is no guarantee of future returns.

“Don't let other people's actions govern yours.” Jean Smith