Madison
WEALTH MANAGEMENT

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Volatility and Real Risk

The volatility we've experienced in the financial markets over the last six months has been extreme (and hopefully, it's the most severe we'll see in our lifetimes). **While losing money, even if it's "just on paper," is a painful experience, it is not how risk should be defined**. You may be asking yourself, "if losing money isn't risk, then what is?" Please allow us to explain. First, we'll explore what volatility is, and then we'll discuss the real risk that investors face.

Price. How are prices of various investments determined? For some types of investments, it's easier than others. Government bonds, for instance, are easy to price. Because we don't have to worry about whether we'll receive our money back if we buy a U.S. Treasury, the price is simply a function of the current interest rate and discounting it back over the life of the bond. Corporate bonds work similarly, but occasionally corporations go bankrupt, so if we are buying a corporate bond, we must build in some additional compensation for the risk that we won't get our money back.

Valuing stocks is more difficult. Every weekday, millions of individual and professional investors, and speculators make their best guesses as to the worth of thousands of companies. Their best guesses are reflected in the form of bid and ask prices that on any given day average into a market price that provides a collective estimate of a company's worth. But, this average price ignores another very important piece of information, which is the certainty of those guesses. Enter volatility…

If no one can value a company precisely (and, to be clear, no one can because of all the unknowns that are yet to be encountered in the future), then we should expect to see the price of any company fluctuate and sometimes dramatically. Price fluctuation, or volatility, occurs for many reasons, but for the most part is driven by the level of uncertainty in the eyes of investors. Markets dislike uncertainty and, today uncertainty is running high. As a result, during a recession, a credit crisis, a hotly contested election, and ever-changing government regulations it's understandable that investors have less conviction about what companies' stocks or bonds are worth. Less conviction means that prices must fall to a level where investors find the investments attractive even after factoring in all their worries and uncertainties.

"Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years."
Warren Buffett

Today we find ourselves in an environment where the price of most of our investments, our home, or for that matter, any non-U.S. government issued asset is priced at a much lower level today than one year ago. Are we now less wealthy? Have we really lost wealth if the home we live in is still physically unchanged, or if the number of shares of stock we own hasn't changed, or if the painting that hangs on the wall is still the same masterpiece it was a year ago?

However, the answer to the question is definitely "yes" only if we need to liquidate or borrow against any of those assets today to meet a spending need (e.g. to put food on the table). The value of those assets will certainly buy less food today. But for most of us, we really haven't lost much wealth, as true wealth can only be measured by what our assets can purchase over time, not at a single point in time.

Herein lies the real risk that most investors face: the permanent decline in purchasing power. It's not the value of a portfolio that matters, but rather what you can buy with it. Just ask someone in Zimbabwe how it feels to have a $100 billion bank note in their pocket, when it takes $100 billion to buy just three eggs (as of July 1, 2008 when this note was first issued)! This is an extreme case, but it makes the point that money is simply a medium of exchange and that real risk comes from the loss of purchasing power.

The challenge for investors today, as they face this very uncertain world, is how to preserve their purchasing power after a market decline of the magnitude we experienced last year. We suggest the following:

First, don't take any action that makes a temporary decline in your portfolio value permanent. The natural reaction to investment losses is to withdraw from investing, but converting assets that have depreciated to cash virtually ensures a permanent the decline in the purchasing power that it currently represents. Cash is an asset that cannot appreciate over time except during times of deflation. Although we may be in a deflationary period now, we shouldn't underestimate the Federal Reserve's resolve to bring us out of it quickly. Cash loses its purchasing power quickly during times of inflation.

Second, take advantage of the volatility to "increase your share of the economic pie." By purchasing more shares or at least retaining those you currently own while others are selling, you are effectively increasing or holding steady your personal market share of the economy. Unless you doubt the resiliency of the U.S. people and strength of our economic system, then increasing your personal market share will be a winning strategy when the current elevated level of uncertainty begins to subside and prices return to a more normal (and narrower) range.

Third, find the right balance between the safety of cash and government bonds, and the longer-term protection offered by corporate bonds and stocks. Finding a comfortable balance will help ensure that you survive this recession, the next one, and the one after that without losing too much sleep. More importantly, it will help you to live comfortably in an uncertain world.

"Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it." **Warren Buffett**