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Financial lessons from 2011

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The year-end performance of the broader markets last year was anything but memorable and the whipsaw volatility throughout was something most investors would rather forget. But a closer look reveals a wealth of wisdom to be gained from observing how events unfolded in 2011 and taking note of the way people and investments responded.

In volatile times, it may make sense to look beyond traditional investment asset classes like stocks, bonds and commodities.

What You Should Know:

1. **Media headlines can be a short-term leading indicator.**

   Savvy investors have long viewed the media as a lagging indicator, reasoning that – by the time most financial stories break – the marketplace has usually priced in the news. However, the correlation between daily headlines and dramatic swings in market indices throughout the second half of 2011 was difficult to ignore. Here are some important things to keep in mind regarding media-driven volatility:

   - Headlines are designed to be attention-grabbing. They often play on people's fear and/or excitement to compel them to read or pay attention. The psychological impact of such messages can also compel investors to react in extreme ways – such as a dramatic reallocation or exiting the market entirely.
   - The most universally agreed upon cause of volatility in 2011 was uncertainty. And the issues investors were most uncertain about – political deadlock over the U.S. budget and deficit, and sovereign debt issues in the Euro-zone – are not expected to change substantially in the near term.
   - Research reports issued by reputable analysts who study the fundamentals underlying share prices are the best way to determine the prospective *long-term* value of an investment.

2. **Volatility swings *both* ways.**

   Investors tend to remember the big drops, like the three larger-than-500-point declines the Dow experienced in rapid succession during the first and second week of August last year. But the Dow also saw three days with gains above 400 points and actually closed the year up 5.5%. Not a great year, but – depending on when (or if) they got back in – investors who pulled out in August may have done much worse.

   - Attempting to time market swings – particularly in a highly volatile environment – can be extremely risky, requiring you to be right twice, once about when to get in and once about when to get out.
   - Wholesale allocation or strategy shifts are rarely a good idea. It is better in times of volatility to keep a portion of your portfolio flexible and nimble in the short term to capitalize on opportunities that arise.
   - The risks (in terms of lost potential return) of not being invested at all may outweigh the risks of being invested on a down day or through a secular bear market.

3. **Everything is connected but not necessarily *correlated*.**

   The relationship between the U.S. and the rest of the world's markets was never clearer than in 2011, as political tensions here and in Europe drove indices and incited downgrades of multiple nations' credit ratings. Similarly, on the days when markets did swing, the effect was often widespread and impacted most traditional investments the same way.

   - Correlation, or the degree to which different investments behave similarly under certain conditions, has increased in recent years – particularly among stocks.
   - While stocks were effectively flat in 2011, U.S. Treasuries logged their best performance since 2008 and gold finished the year up 10%.
   - In volatile times, it may make sense to look beyond traditional investment asset classes like stocks, bonds and commodities and allocate a minority portion of your portfolio to alternatives that are less or negatively correlated with other investments in your portfolio.

What You Should Do Now:

The U.S. Presidential election may provide a psychological boost – or at least some degree of certainty about the future – for investors in November, but any fundamental changes to U.S. economic policy won't take place until next January. Meanwhile, the majority of economists don't expect the Euro-zone to get its collective economic act together until 2013 at the earliest. So it appears the uncertainty that fueled market volatility in 2011 will likely be with us for the bulk of 2012.

You should talk to your Financial Advisor about what worked and what didn't in terms of your investments so that together you can make an informed plan for this year. ■

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