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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

Thus far in 2008, 103 ETFs have launched in the US. There are now 681 ETFs holding $542 billion in assets

In 2008, the daily cost of a stay in a nursing home actually stabilized. The average price of a private room decreased 0.5% while a semiprivate room's cost increased only 1.1%

Stock Market Volatility

Investors are clearly aware of the decline in world stock market prices since Labor Day. But, apart from the direction of the market, the key development is the surge in stock market volatility. That is, the variability of stock market returns has increased dramatically over long term norms. The increase in stock market volatility may have some implications for portfolio managers. This article will examine this issue.

Measures of Stock Market Volatility

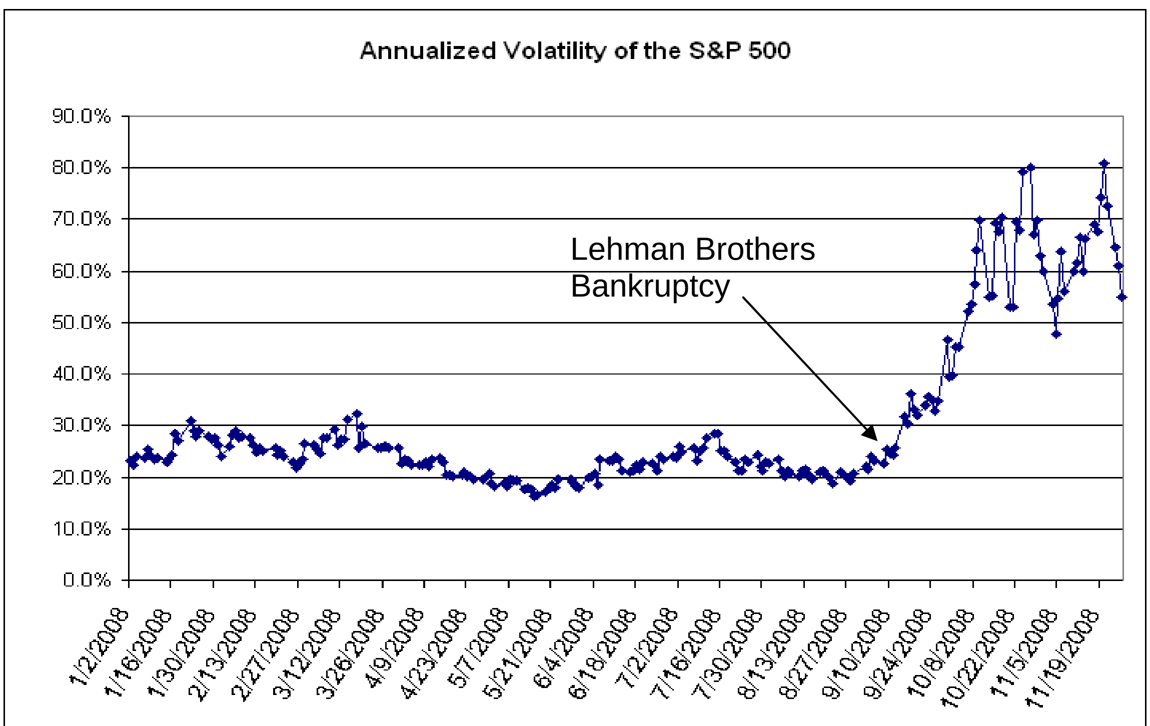
Even casual observers of the stock market have noted the rather dramatic daily movements in stock prices. Since September 15th , the S&P 500 has moved up or down more than 2% in 37 of 53 trading days. For the entire year to September 15th 2008, there were only 32 trading days in which the S&P 500 moved more than 2%!

Recent history has often paired heightened stock market volatility with financial stress. Stock market returns were highly variable just after the 1987 crash and the 1998 Russian debt crisis. One might argue that news developments take on greater significance during periods of duress.

Certainly, the debate and subsequent enacting of the original $700 billion treasury bailout package was a key pivot point for the stock market. Earnings guidance, jobs reports, and even cabinet appointments of the incoming administration are closely followed as investors gauge the severity of the recession.

There are two primary measures of stock market volatility – both have increased dramatically. The first is observed directly by calculating the variability of historical stock market returns. The second measure is forward looking as it is derived from prices of options on major stock market indices – implied volatility. The most generally accepted forward looking measure of volatility is the VIX.

In 1993, the Chicago Board Options Exchange® (CBOE®) introduced the CBOE Volatility Index®, VIX®, and it quickly became the benchmark for stock market volatility. It is cited daily in the *Wall Street Journal* and other leading financial publications. VIX measures market expectations of near term volatility conveyed by stock index option prices. The stock index in



question is the S&P 500 – an inclusive basket of the US equities. Think of it as the market's best guess of stock market volatility over the next 30 days.

To provide some context about stock market volatility, it is useful to consider the historical values of the VIX. Since its inception in 1993, the VIX has averaged just under 20%. For most of the last ten weeks, the S&P 500 has been three to four times as volatile as its long term average. In fact, it exceeded 80% on two occasions. See the chart on the preceding page.

Numerous efforts have been made to backfill stock market volatility as far back as 1900. Based on these efforts, there is a consensus that the persistently high volatility of the last ten weeks has not been matched since the 1930s. Moreover, the volatility of other financial markets such as corporate bonds and foreign stocks has similarly spiked in recent weeks. As is often the case in times of stress, correlation among the world's stock markets has increased. All major markets are down substantially.

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What about investment portfolios? Are there constructive responses to this period of heightened volatility? There is no obvious answer. One response is to go to bonds 100%. This extreme method effectively abandons the target asset allocation. Such a measure will leave the investor flatfooted when equity markets recover. Bond instruments have a poor record of outperforming taxes and inflation by themselves and are thus not suited as a long term investment policy.

Another, more reasonable, approach is to stick to the target asset allocation irrespective of asset levels. The implication here is to buy more underperforming stocks in order to restore the asset allocation targets. In my view, this is the best approach under most circumstances

In times of greatly heightened volatility, however, it makes sense to consider the underlying risk tolerance of individual investors. A three to fourfold increase in portfolio volatility argues for an adjustment of asset allocation. One might reasonably infer that investors would prefer more bonds if their risk tolerance remains constant while basic risk measures spike. There is theoretical support for a downward revision in stock allocation in periods of persistently high volatility.

How does one reduce portfolio risk in a period of heightened volatility? Part of the implementation happens automatically. Stocks are down far more than bonds and thus bonds now comprise a greater fraction of the typical investment portfolio.

Consider also that this may be the first year in many that investors will be able to harvest capital losses. Those with taxable accounts may want to consider raising measured amounts of cash by selling depressed equity positions. The taxpayer can offset up to $3000 in ordinary income with capital losses. Efforts to sell stocks and further reduce portfolio risk should be limited.

One must keep in mind that even limited cash raising activities of the sort discussed here carry risks. The stock market will not sound an alarm at the advent of its recovery. Those that raise cash risk being left behind in a market rally. When to get back in? There is no obvious rule but I would submit that investors use the same rationale for raising cash in the first place. If high stock market volatility causes the sale of stocks, then a sustained decrease in portfolio volatility might be an appropriate trigger to rebalance one's portfolio to its original target allocation.

Update on Annuities

"The good news is that all 50 states sponsor guarantee funds that insures minimal payouts from individual annuity contracts."

As investors approach retirement, it is useful to consider investments that address the issue of longevity risk. That is, how can a retiree insure an income stream no matter how long he lives. Many retirees have vested pension benefits that already satisfy this concern. Certainly, Social Security benefits have no expiration date. An immediate annuity is one way to supplement those income streams.

Annuities have significant drawbacks, however. As accumulation vehicles, they often saddle owners with high expenses that erode long term investment performance. Tax treatment is adverse in that the annuity owner enjoys no deduction for contributions (unlike 401ks) while gains on those investments are taxed as ordinary income.

For investors seeking lifetime income, annuities can play a constructive role. There are a number of hurdles to address. Even now, the ***expected return*** of an annuity contract is typically less than a corporate bond of comparable credit quality and duration.

The good news is that all 50 states sponsor guarantee funds that insure minimal payouts from individual annuity contracts. Many guarantee funds function in a manner similar to the FDIC in that they are supported by assessments on all incumbent insurers in the state. The insurance market as a whole guarantees the performance of some or all of each annuity contract. It is important to note that the individual states cannot print their own money like the federal government. State guarantees therefore carry less weight.

The state of Texas, for example, guarantees up to $100,000 in an annuity contract in the event of the insolvency of its issuer. That is clearly an argument for diversity. Why expose oneself to credit risk that is not backstopped by a guarantee fund. It's better to buy three smaller contracts than one large one.

While insurers rightfully tout their financial strength, the presence of guarantee funds argues against buying annuities from top rated issuers. It makes sense to take a little bit of credit risk and get a higher payout as long as there is a third party guarantee. Indeed, insurers with a single A credit rating offer up to 40% more in monthly payout than a top rated company like TIAA-CREF.