LORING WARD

April 2015

PORTFOLIO PERSPECTIVES

Volatility — One of The Biggest Threats to Your Savings

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Last month, I looked at volatility and what happens when you take money out of a portfolio periodically to fund your retirement. This month, we'll see how volatility affects your portfolio when you're saving for retirement.

Imagine you are saving for retirement and you have two investment options. Both options will earn an average return of 7.5% over the next 30 years. Investment A will lose 15% the first year then gain 30% the second, repeated for the next 30 years. Investment B will lose 1% the first year then gain 16% the second, repeated for the next 30 years.

Though they both have a 7.5% average return, Investment A's returns fluctuate more from year to year than Investment B's returns. In other words, Investment A has higher volatility. How does the difference in return volatility affect your savings over time? Let's look.

Assume you save $10,000 each year for 30 years, growing it by 2.5% as an adjustment for inflation to maintain purchasing power. If you kept your money under your mattress you'd have $460,003 after 30 years. If you invested in Investment A, you would have $1,064,089. And if you invested in Investment B, you would have over $1,403,593.

Both Investment A and Investment B earned the same average return of 7.5% so why such a difference in ending values? Volatility, that's why!

Volatility is the statistical term we use to describe the difference in return fluctuation between the two portfolios. An investment with higher volatility will cause more drag on the portfolio because of more severe down years.

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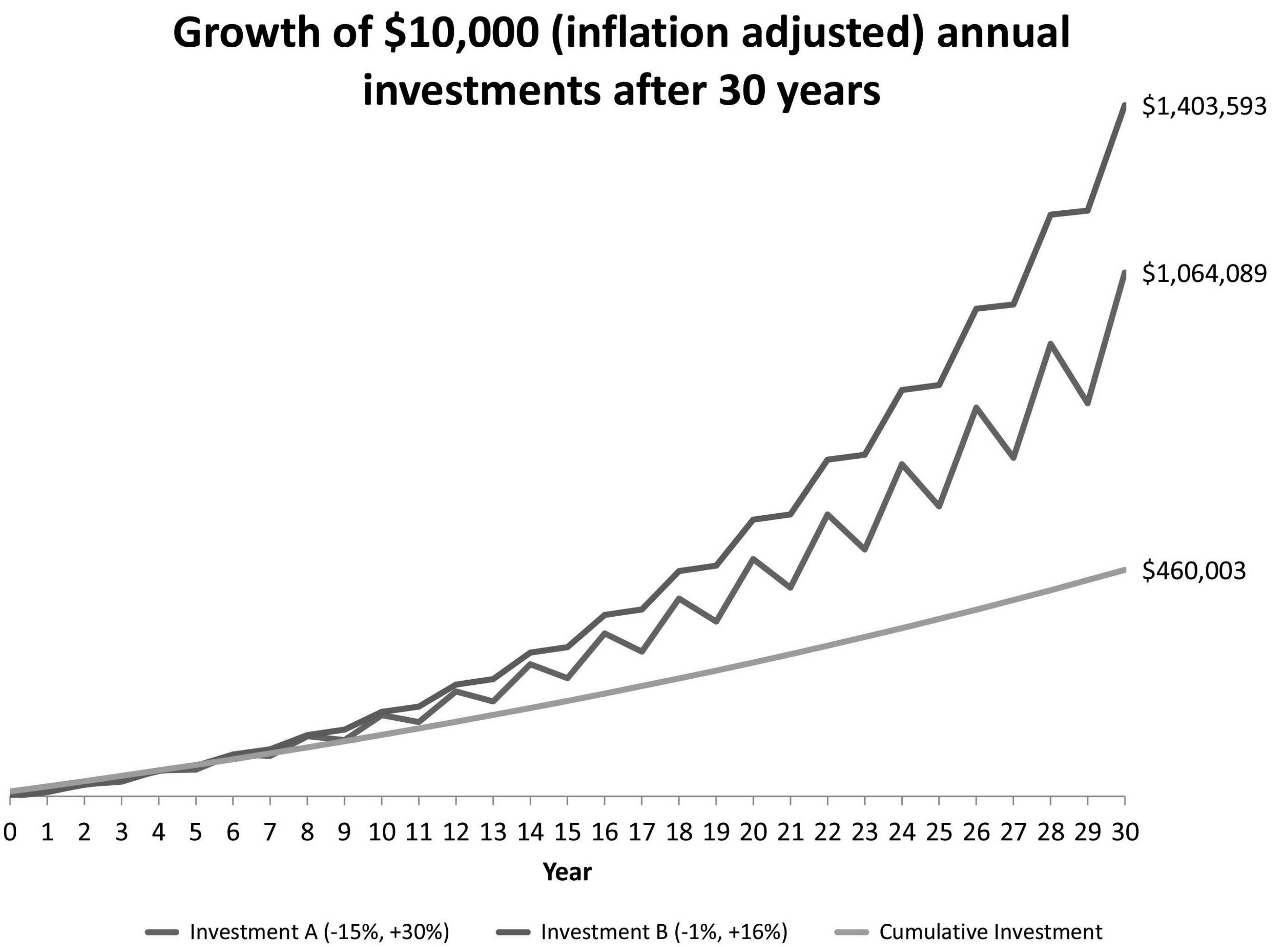
If you've read my articles over the years, then you know what I am going to say next. Yes, DIVERSIFICATION! Diversification is not a new concept, but it wasn't until 1952 that Harry Markowitz, now a Nobel Prize winner, gave us a mathematical framework to evaluate diversification at the portfolio level.



Diversification isn't perfect. It won't protect against a loss or guarantee a gain. It also can have negative emotional side effects. If you are truly diversified:

- your portfolio will always hold some losers — and we all hate holding losers — and
- your portfolio will always underperform the top asset classes — and we all hate underperforming.

But since it is impossible to accurately predict which investments will be winners and which will be losers in any given year, diversification is really the only way I know of to reduce the volatility of your investment portfolio.