

Independence ADVISORS, LLC

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Risk, Volatility and Opportunity

The current renewed volatility in financial markets is reviving unwelcome feelings among many investors—feelings of anxiety, fear, and a sense of powerlessness. These are completely natural responses. Acting on those emotions, though, can end up doing us more harm than good.

The increase in market volatility is an expression of uncertainty. The sovereign debt strains in the US and Europe, together with renewed worries over financial institutions and fears of another recession, are leading market participants to apply a higher discount to risky assets. The current level of anxiety among investors is reminiscent of the events of 2008, when the collapse of Lehman Brothers and the sub-prime mortgage crisis triggered a global market correction. This time, however, the focus of concern has turned from private-sector to public-sector balance sheets.

The value of any investment (public or private) is heavily influenced by the return that investors require for making the investment. When perceived risk increases, investors sensibly require higher rates of return from the investment. This pushes prices down and pushes expected returns higher in order to induce investors to provide capital.

Therein lies the opportunity. Those investors with the ability to accept risk and invest capital when others flee from stocks have historically benefitted in the form of higher returns.

As for what happens next in today's economy and markets, no one knows for sure. That is the nature of risk. But there are a few points all investors can keep in mind to make living with this volatility more bearable. We believe that understanding the following bullet points is the key to gaining the confidence that is required to navigate any uncertain environment and in the end, to profit from the reactions of others.

- Markets are unpredictable and do not always react the way the experts predict they will. The recent downgrade by Standard & Poor's of the US government's credit rating, following protracted and painful negotiations on extending its debt ceiling, actually led to a strengthening in Treasury bonds.
- Quitting the equity market at a time like this is like running away from a sale. While prices have been discounted to reflect higher risk, that's another way of saying expected returns are higher. And while the media headlines proclaim that "investors are dumping stocks," remember someone is buying them. **Those people are often the long-term investors.** There is a buyer for every seller.
- Market recoveries can come just as quickly and just as violently as the prior correction. For instance, in March 2009—when market sentiment was last this bad—the S&P 500 turned and put in seven consecutive months of gains totaling almost 80%. This is not to imply that a similarly vertically shaped recovery is in the cards this time, but it is a reminder of the dangers for long-term investors of turning paper losses into real ones and paying for the risk without waiting around for the recovery.
- Never forget the power of diversification. While equity markets have had a rocky time in 2011, fixed income markets have flourished—making the overall losses to balanced fund investors a little more bearable. Diversification spreads risk and can lessen the bumps in the road.



- Markets and economies are different things. The world economy is forever changing, and new forces are replacing old ones. For example, the IMF noted in its April 2011 World Economic Outlook that while advanced economies seek to repair public and financial balance sheets, emerging market economies are thriving. A globally diversified portfolio takes account of these shifts.
- Nothing lasts forever. Just as smart investors temper their enthusiasm in booms, they keep a reserve of optimism during busts. And just as loading up on risk when prices are high can leave you exposed to a correction, dumping risk altogether when prices are low means you can miss the turn when it comes. As always in life, moderation is a good policy.

The market volatility is worrisome, no doubt. The feelings being generated by the volatility are completely understandable. But through discipline, diversification, and understanding how markets work, the ride can be made bearable. At some point, value will re-emerge, risk appetites will re-awaken, and for those who acknowledged their emotions without acting on them, relief will replace anxiety as they earn higher returns and their portfolios increase in value.

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Disclosures

Although investors may form their expectations from the past, there is no assurance that future investment results will model historical performance.

Indexes are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

Stocks offer a higher potential return as compensation for bearing higher risk. However, this premium is not a certainty, and investors should not expect to consistently receive higher returns from stocks. In fact, market history shows extended periods when stocks did not outperform bonds.

Diversification neither assures a profit nor guarantees against loss in a declining market.

A bond portfolio designed for income also carries significant risks, including default and term risk, call risk, and purchasing power (inflation) risk. Foreign securities also are exposed to currency movements.