Get Ready for More Market Turbulence

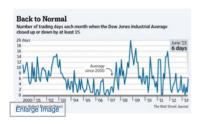
What's changed isn't the market's behavior but the much-increased volatility portfolio than ever before to be well-diversified.

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By MARK HULBERT

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To the casual observer, the stock market appears to be in turmoil once again. And though it calmed down this past week, heightened volatility is just one misplaced word from Ben Bernanke away. What should investors do?



The most important thing is to construct an especially large and diversified portfolio to immunize yourself from the gyrations exhibited by individual stocks. The corollary is that you should place only small bets on any one stock's prospects.

It is easy to see why June's market turbulence appeared to be so much

greater than usual. Of the 20 market sessions during the month, in 16 of them—or 80%—the Dow Jones Industrial Average closed up or down by at least 100 points. That is much higher than in previous months; in March, for example, just two trading days experienced swings that big.

You have to go back to November 2008 to find another month with that many 100-point moves.

A much longer-term perspective, however, shows that June's gyrations were hardly unusual. When we compare that month to the last several decades, for example, and focus as we should on percentage changes rather than the number of Dow points, the level of volatility was right in line with the long-term average.

Consider the number of trading sessions in which the Dow closed up or down by at least 1%. There were six such days in June, compared with an average of 6.4 a month since 2000. The average since 1896, when the Dow was created, is 5.2.

In other words, what is unusual about recent volatility isn't that June was abnormally high. It is that prior months were unusually low.

"While the market's volatility undoubtedly will fluctuate over the shorter term, there is no evidence to support the widely held belief that the stock market is more volatile today than at other points in U.S. history," says G. William Schwert, a professor of finance and statistics at the University of Rochester's Simon School of Business.

Audio

Mark Hulbert discusses market volatility with WSJ's Mathew Passy

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Even if the market's recent gyrations are merely average, some investors are worried that the increase in volatility means a market decline is more likely. And it is true that, in the past, some of the more volatile months have occurred

during bear markets. But according to a study of the Dow's volatility since inception conducted by the Hulbert Financial Digest, there isn't a significant correlation between the market's volatility in a given month and its performance in subsequent months.

That said, one stock-market pattern is worth noting: Periods of high volatility tend to be clustered together, suggesting the market's turbulence over the coming month is more likely to be closer to the level seen in June than earlier this year.

Allan Timmermann, a finance professor at the University of California, San Diego, draws an analogy to the turbulence that leads airline pilots to require travelers to take their seats and fasten their seat belts.

"If turbulence were to occur completely randomly, then this requirement would make little sense," he says. But it doesn't, which is why pilots can turn on the seat-belt sign after the first experience of such turbulence and turn it back off after the ride has been smooth for a while. "The same is true for the stock market." Mr. Timmermann says.

Those unwilling to tolerate as much volatility as seen in June, therefore, might want to reduce their equity exposure until the market is calm for several weeks.

Normally, you would want to temporarily park the proceeds in the bond market. But because the stock market's recent volatility has been associated with the threat of rising rates, the bond market itself may be too risky right now. If you do decide to increase your bond exposure, keep your maturities short. One possibility is the Vanguard Short-Term Bond (BSV +0.04%) exchange-traded fund, with an expense ratio of 0.1%, or \$10 per \$10,000 invested.

Another possibility is to temporarily hedge your equity exposure by buying one of the funds benchmarked to the CBOE's Volatility Index, or VIX, which gains in value as volatility heightens. The most widely traded is the iPath S&P 500 VIX Short-Term Futures exchange-traded note, with expenses of 0.89%.

Even though the overall market is no more volatile today than in prior decades, the

average individual stock is much more so. There are several reasons for this, according to John Campbell, an economics professor at Harvard University. "One is that the stock market is dominated by fewer conglomerates today than several decades ago, having been replaced by more focused companies specializing in a single industry or economic activity," he says. "Another is that companies have begun to go public earlier in their life cycle, when there is more uncertainty about future prospects."

Ironically, though, the greater volatility of the average individual stock hasn't translated into more volatility for the overall market. That is because individual stocks' gyrations largely cancel each other out. And that, in turn, is why it is so crucial for your portfolio to contain lots of stocks from different industries. "To be adequately diversified," Mr. Campbell says, "a portfolio would need to contain well more than the 15 to 20 stocks that, several decades ago, were thought to be sufficient."

For almost all individuals, this advice means investing in a broadly diversified mutual fund. An obvious choice is an index fund benchmarked to the overall market, such as the Vanguard Total Stock Market ETF, with an expense ratio of just 0.05%, or \$5 per \$10,000 invested.

Note carefully, though, that index funds won't immunize you from all volatility, just from the greater volatility exhibited by individual stocks.

To be sure, you can still invest in individual stocks as well, though to minimize risk, no one issue should represent more than 5% of your total equity portfolio. Since most investors typically own only a handful of stocks, this means allocating the bulk of your portfolio to an index fund and dividing up the remainder among those few stocks on which you want to place particular bets.

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