Experts Advise Investors to Accept Short-Term Volatility

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They point out that volatility is the price investors pay for potential returns.

With financial market headlines dominated by events in Greece and China, market volatility has led to significant equity price swings in recent weeks.

Despite the ups and downs, investment managers and strategists overwhelmingly urge retirement plan advisers to counsel participants to remain invested and level-headed. They also say it is critical for advisers to consistently underscore the benefits of buy-and-hold investing so that when fluctuations do occur, the rationale and unyielding approach to investing has been firmly set.

"Volatility is the price you pay for good investment returns," says Paul Blease, director of the CEO Advisor Institute at OppenheimerFunds in Dallas. "If you don't want volatility, you will get a low, below-inflation rate return. I tell my clients that the ticket to high returns is being able to handle volatility." In fact, Blease, along with Brian Levitt, senior investment strategist with OppenheimerFunds in New York, have written a book, "Compelling Wealth Management Conversations," specifically to give advisers reasons they can give to investors to stay invested based on three principles of sound investing. These are "consistency, courage and balance."

"If you cannot exercise courage, you will underperform in life, and the same is true of your investment portfolio," Blease says. "We want to help clients understand that when you have those downdrafts, if you can't exercise courage, you don't belong in the markets."

Susan Viston, client portfolio manager at Voya Investment Management in New York, agrees that managing the "psychological missteps" of investing is an important function of advisers. "Investors are more susceptible to that during heightened market volatility. Investors 10 years or less from retirement are probably the most vulnerable to market events, and it is even more important for them to stick with their long-term investing goals based on their risk tolerance and horizon. While they need to significantly reduce their equity exposure as they reach retirement, reacting to short-term headline news can harm their long-term goals."

NEXT: Chasing performance doesn't work

Viston points to a report from Dalbar published earlier this year, "21st Quantitative Analysis of Investor Behavior," which suggests the average equity mutual fund investor underperformed the S&P 500 by 8.19 percentage points in 2014, with the average investor earning 5.50% compared with the S&P 500's 13.69% return. In 2014, the average fixed-income mutual fund investor underperformed the Barclay's Aggregate Bond Index by 4.81 percentage points (gaining 1.16% versus 5.97%).

The gap between the 20-year annualized return of the average equity mutual fund investor and the 20-year annualized return of the S&P 500 widened for the second year in a row from 4.20% to 4.66% due to the large underperformance of 2014, Dalbar said. "No matter what the state of the mutual fund industry—boom or bust—investment results are more dependent on investor behavior than on fund performance," Dalbar says. "Mutual fund investors who hold on to their investments have been more successful than those who try to time the market."

John Kulhavi, managing director with Merrill Lynch in Farmington Hills, Michigan, agrees that remaining invested in the stock market is a sound approach, especially for those retirement plan participants with a long time horizon. "Historically, over any reasonable period of time, stocks outperform bonds," Kulhavi says. "Earnings drive stock prices. In between earnings, we may face economic and international challenges, but they are historically short lived and are good buying opportunities."

As far as what is transpiring in Greece and China, Kulhavi says that Greece represents 1% of the Europe's GDP and 0.03% of the world's GDP. "What happens there is negligible," he says. While the Greek economy contracted 25%, unemployment has risen to 20%, and it will be hard for it to pay back the $352.7 billion in debt that it owes to the European Union and the International Monetary Fund, "it has little impact on our country."

China is a bit of a different story because of our exports to its neighbors, Kulhavi says. Putting fears of the economic contraction in China in perspective, he notes that "everyone is worried that their GDP growth will drop." China only represents 7% of our exports, he adds, but 50% of our exports go to emerging markets. "They do business with China, so it could have some impact."

NEXT: Volatility is here to stay

Whether it's Greece or China, markets are always going to face volatility, Levitt says. "There has been a greater than 5% market correction every year going back to 1980," he says. "Yet if you look at most calendar years, 26 out of the past 34, the stock market has been positive. Investors get worried, yes, but long-term investors who overlook political and economic factors and who stick with the principles of investing do quite well."

Kulhavi notes that in the 10 years between 1995 and 2014, there was a lot of volatility, the worst of which was the 37% decline in the S&P 500 in 2008. "Yet, if you stayed fully invested, $1 then would be $6.50 today," he says. This is why Merrill Lynch advisers spend 75% of their time managing portfolios and the rest managing emotions, he says.

Blease concurs: "There is always headline risk. You can't find a six-month period of time in the country's history when there wasn't a reason to worry. Don't allow the headlines to drive your investments."

There will always be factors threatening the market, agrees Judy Ward, senior financial planner with T. Rowe Price in Baltimore. That's why it is important that "investors focus on the factors they can control: how much they are saving and to be properly allocated according to their time horizon and risk tolerance," Ward says. Advisers are in a great position to help investors have a

balanced allocation they can stick with during periods of stress. "Advisers should tell them they have their best interest at heart and can help them through these periods of volatility."

However, Mike Chadwick, president of Chadwick Financial Advisors in Unionville, Connecticut, is not a big proponent of buy-and-hold. In the event of a market downturn, he may reallocate his clients' portfolios. "I will not sit back and watch a client's portfolio get decimated," he says. He also approaches investing for those who are 10 to 20 years away from retiring more cautiously. That said, Chadwick notes that market downturns present buying opportunities. "Volatility is a double-edged sword. That is when the best opportunities are available," he says.

NEXT: The challenges of a 30-year retirement

While some advisers like Ward and Chadwick say that plan participants with only 10 or 20 years until they retire should scale back their equity exposure, others, like Blease, point out that as longevity is increasingly, investors may have no other choice but to maintain a fairly high exposure to equities. A 65-year-old retiring today needs to support a 25- or 30-year-long retirement, he observes.

And as to whether a severe market correction like 2008 could threaten investors' and retirees' portfolios again, Kulvahi doubts it for two reasons: "The derivatives that the banks traded are now restricted, and the government has raised capital requirements on the banks."

The government also exercised sound fiscal and monetary policies in the Great Recession, having learned lessons from the Great Depression, Blease says. "During the Great Depression, the Fed withheld capital from the system. As a result, 50% of all of the banks in the country failed. Businesses couldn't operate, leading to massive unemployment," he says. "In the Great Recession, we liquefied the market and kept the banks open. Only 0.6% of banks closed. This kept people employed. Compared to the Great Depression, it was a cakewalk."

The bottom line is that because downturns and market pressures do occur, advisers must address the need to stick with the markets with their participants "throughout market cycles, so that when the bout of volatility occurs, those conversations have already taken place," Levitt says.

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