The Ups and Downs of a Volatile Market

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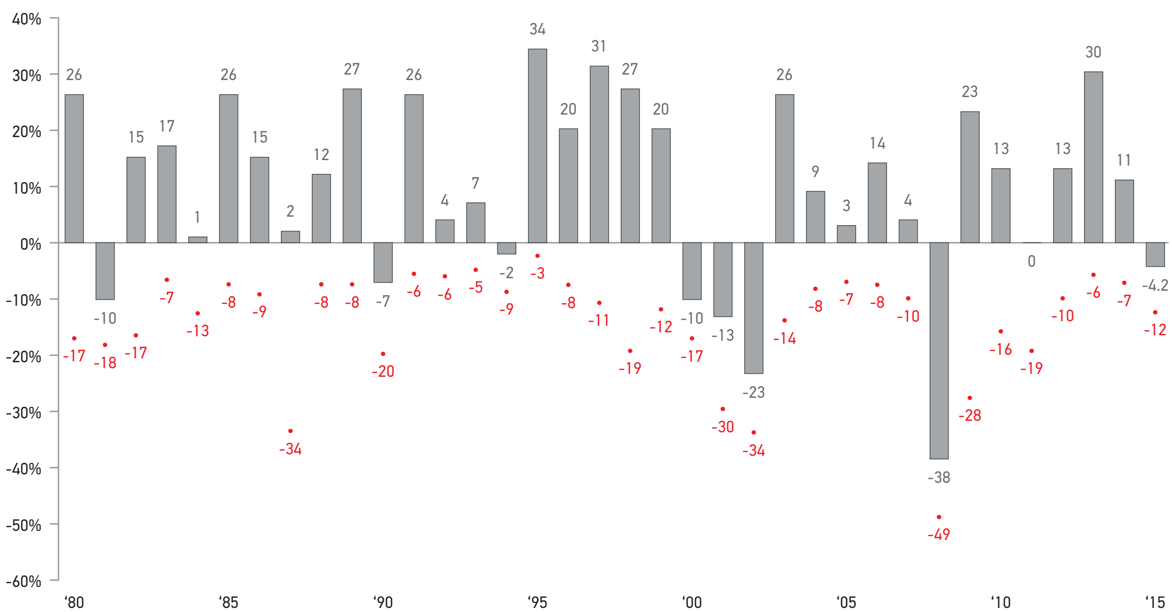
Market volatility, an inevitable part of investing, can arise abruptly and be fierce at times. As history has shown us, the causes and degree of downside market volatility can vary widely. In times of market distress, a disciplined investment approach is critical. In this paper, we will look at some measures of volatility with a historical perspective and review the best approaches to address corrections in the market.

We often hear about the VIX or CBOE Volatility Index spiking when the market is rattled by upsetting world events or disappointing financial or economic news. This index is a measure of investor sentiment and expectations of near-term volatility as conveyed by S&P 500 stock index option activity. Since 2011, the VIX has traded in the fairly narrow range of 10 to 26, but in late August 2015, the index jumped to 40.7 on news that China's economy was slumping. The uncertainty of the impact of China on global growth along with the Fed's impending tightening has had a negative effect on investor sentiment raising expectations for further volatility.

Historical Intra-year Declines of the S&P 500

Another measure of volatility, known as the intra-year decline, is defined as the largest loss measured from the highest point to the lowest point over the course of a year for an index, fund or portfolio. A drawdown can last days or even months during a year's timeframe. As seen in Chart 1, since 1980, the S&P 500 has had an average intra-year decline of 14.2%. The largest drawdown during that period was -49%, occurring during the financial crisis of 2008. In 27 years of the 35-year period shown, the S&P 500 turned around and produced a positive return by year-end, not including dividends. History has also shown that when the S&P 500 pulls back 10%, the typical recovery time averages 8 months. (J.P. Morgan, "Investing with Composure in Volatile Markets").

Chart 1: S&P 500 Intra-year declines vs. calendar year returns[1]
Despite average intra-year drops of 14%, annual returns positive in 27 to 35 years



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Lowering Volatility Through Diversification

A diversified portfolio with exposure to a variety of asset classes will weather market downturns with much less volatility. An asset class, such as fixed income, can be a safe haven when stocks are faltering. Chart 2 illustrates various asset class returns from 2000 through 2014. Here, one can see the randomness of asset class performance in any given year. The boxes in the chart that are connected by a line represent the "Asset Allocation" portfolio. This portfolio is a combination of all of the asset classes presented in the table, structured with the best risk-adjusted return potential and rebalanced annually. Combining asset classes including cash, fixed income, domestic and international equity asset classes, and alternative assets with the appropriate weights, lowers the volatility of the overall portfolio, allowing for greater compounding of returns over time.

Maintaining Discipline During Market Volatility

During periods of market disruption, when fear of further losses is present, an investor may be tempted to sell assets and move to cash holdings. In the short run, liquidating assets may appear to be a wise decision when markets continue to slide downward; however, the real challenge is identifying (and executing) the point at which to reinvest before the markets rebound, which often occurs without warning at any hint of positive news. Another consideration for liquidating assets in a taxable portfolio is the amount of capital gains taxes one will incur by doing so. In short, attempting to time the market can derail a portfolio, resulting in permanent losses.

Identifying ways to take advantage of market corrections can provide some benefits in a portfolio. A pullback allows one to put idle cash to work at more attractive levels than before the dip. One can also reposition or rebalance a portfolio for improved return potential. In addition, actively harvesting tax losses in a taxable portfolio can lower your tax bill. A downside in the markets can also provide a better understanding of one's tolerance for risk, which may require a change in asset allocation.

World events, changes in monetary and fiscal policy, and unexpected economic and earnings news will continue to shake up markets. Maintaining focus on one's objectives and having the discipline to weather the markets' ups and downs will ultimately reward investors in the long run.

Chart 2: Asset class returns[2]

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	YTD	15-yrs '00 - '14 Ann.	15-yrs '00 - '14 Vol.
Comdty. 31.8%	REITs 13.9%	Comdty. 25.9%	EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	Fixed Income 1.1%	REITs 12.7%	REITs 22.3%
REITs 26.4%	Fixed Income 8.4%	Fixed Income 10.3%	Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Cash 0.0%	High Yield 8.7%	Small Cap 21.8%
Fixed Income 11.6%	Cash 4.1%	High Yield 4.1%	DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	High Yield -1.9%	Small Cap 7.4%	EM Equity 21.5%
Cash 6.1%	Small Cap 2.5%	REITs 3.8%	REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Asset Alloc. -4.4%	EM Equity 7.4%	Comdty. 18.4%
High Yield 1.0%	High Yield 2.3%	Cash 1.7%	High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	REITs -4.5%	Fixed Income 5.7%	DM Equity 17.6%
Asset Alloc. 0.0%	EM Equity -2.4%	Asset Alloc. -5.9%	Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	DM Equity -4.9%	Asset Alloc. 5.3%	Large Cap 17.2%
Small Cap -3.0%	Asset Alloc. -3.9%	EM Equity -6.0%	Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	Large Cap -5.3%	Large Cap 4.2%	Asset Alloc. 13.7%
Large Cap -9.1%	Large Cap -11.9%	DM Equity -15.7%	Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -7.7%	DM Equity 3.0%	High Yield 11.7%
DM Equity -14.0%	Comdty. -19.5%	Small Cap -20.5%	Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -15.2%	Comdty. 2.7%	Fixed Income 3.4%
EM Equity -30.6%	DM Equity -21.2%	Large Cap -22.1%	Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -15.8%	Cash 1.9%	Cash 1.0%

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*[1] Chart provided by JP Morgan Asset Management. Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. *Returns shown are calendar year returns from 1980 to 2014 excluding 2015, which is year-to-date. Guide to the Markets – U.S. Data are as of August 31, 2015.*

[2] Chart provided by JP Morgan Asset Management. Source: Barclays Capital, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management. Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Barclays Global HY Index, Fixed Income: Barclays Capital Aggregate, REITs: NAREIT Equity REIT Index. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Barclays Capital Aggregate, 5% in the Barclays 1-3m Treasury, 5% in the Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. All data represents total return for stated period. Past performance is not indicative of future returns. Data are as of 9/30/15. Annualized (Ann.) 15-yrs returns represent period of 12/31/99 – 12/31/14. Guide to the Markets – U.S. Data are as of September 30, 2015.