Stock markets don’t reflect the underlying health of the economy. Or the financial security of the middle class. Or any other broader measure. **File photo** AP

PERSONAL FINANCE

Is stock market volatility here to stay?

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U.S. equity markets started off 2018 in high gear.

Fresh off a large corporate and individual tax cut passed in late December of 2017, the Dow Jones Average and S&P 500 Index each gained more than 5 percent in the month of January while the tech-heavy NASDAQ Index was up more than 7 percent.

With the month of February however, came significant market volatility we haven’t seen in years.

The Dow Jones average lost 1,175 points, or more than 4.5 percent one day in early February. Market swings have continued, with averages rising and falling by a few hundred points in a day becoming common. Is this volatility here to stay? How should you prepare your portfolio?

Since the financial crisis of 2007-2008, the U.S. economy had been growing slowly, with GDP in the 2 percent range. Interest rates fell to historically low levels and there was little inflation. The post-financial crisis economic expansion, although tepid, is among the longest in history.

That low-volatility environment seemed here to stay but there are signs we may be returning to a more normal economic environment.

The economy is growing at a higher rate — with GDP forecasts of 3 percent or more for 2018 — interest rates have risen sharply over the last several weeks and there are signs of rising inflation. Market volatility may be here to stay. A growing economy with higher interest rates and more inflation will probably lead to greater stock market fluctuation.

How should you prepare your portfolio? The best advice for long-term investors is to be patient and to ensure you have a diversified portfolio. Examining a chart of stock market returns on a daily or weekly basis will seen like a frightening drive through winding mountain roads. Stretching that time period out to a three-year or five-year basis will make the chart look more like a relaxing Sunday drive.

Being patient doesn’t mean ignoring your investment portfolio. I believe you should always know where your money is invested and how it’s performing. But you should not always react, especially by selling when you see a drop in the value of your portfolio.

It is important to re-balance your portfolio on a regular basis.

Over time, stocks should outperform bonds. An initial portfolio mix of 70 percent stocks and 30 percent bonds will become over-allocated in stocks over time. Left unattended, a portfolio such as this could have a mix of 80 percent or 90 percent stocks and 10 percent or 20 percent bonds. A portfolio this concentrated in stocks may have too much risk (and volatility) for most investors.

Having all of your portfolio focused in any single type of investment is not wise. Lack of diversification can lead to large losses over a short period of time. This is where diversification can help. Many times when one area of the stock market is doing poorly, another may be doing well. Having part of your portfolio perform positively when another part is not performing well will eliminate sharp declines in overall portfolio value.

Diversification involves spreading your investment dollars over multiple asset classes. Instead of just investing in U.S. stocks, a diversified investment portfolio may include cash, corporate bonds, U.S. bonds, foreign bonds, international stocks, real-estate, commodities and other asset classes.

The proper mix of different asset classes, which are actively managed and re-balanced, can add return and reduce risk in an investment portfolio.

The presence of bonds and cash has historically added safety to portfolios. Bonds typically pay interest so there is a positive return coming back to the portfolio at all times. Bonds also mature at face value so the bondholder is guaranteed, by the issuer, to receive their original investment back. These factors contribute to the safety of bonds and make them a desirable complement to stocks in a portfolio.

Patience and diversification will help the long-term investor deal with market volatility. And market volatility may be here to stay.

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