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Don't throw in the towel; you can navigate volatility

On Aug. 24, the Dow Jones Industrial Average fell more than 1,000 points within the day. This sort of volatility is what makes investors nervous—and question their commitment to their long-term investment strategies. Selling out of the market during downturns, however, is one of the most damaging actions an investor can take. This raises the question of how to reduce volatility in portfolios so that investors are not tempted to throw in the towel at inopportune moments.

Certainly there is no way to completely avoid stock market volatility. After all, finance theory teaches us that it is the very risk of the market that allows for potential returns. Yet, there is evidence that undue market ups and downs can be mitigated through thoughtful portfolio construction.

Traditionally, investment portfolios have been limited to stocks, bonds and cash. But there are numerous other asset classes that investors can use. Hedge funds, in particular, have become a popular choice over the last 10 to 20 years.

The promise of hedge funds is that they will earn superior returns, reduce risk, or both. The evidence supporting these claims is sketchy at best. From 1995 through today, hedge funds have provided returns that are roughly in line with those of a traditional 60 percent stock and 40 percent bond portfolio. Interestingly, the correlation of returns between the traditional portfolio and hedge funds has been around 74 percent.

That means that three-fourths of the returns of hedge funds can be attributed to the returns of traditional asset classes. It makes you wonder if paying the often exorbitant fees of many hedge funds is worthwhile when you can get almost the same returns using basic stock and bond market index funds. The typical hedge fund fee structure includes a 2 percent annual management fee and 20 percent of excess profits, whereas index funds could be purchased with annual fees of less than 0.10 percent.

Hedge funds have had lower volatility than a more traditional portfolio, at least if you believe the data. The problem is that much of the hedge fund data is subject to

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well-documented statistical biases. Historical returns are overstated and risk is understated, very significantly it turns out. Many of the spectacular hedge fund meltdowns of the past are not reflected in the data, making returns look more stable than they actually are.

Worse, hedge funds don't seem to offer much protection in a down market. During 2008, when the stock market plunged, hedge funds lost roughly the same amount as a 60 percent stock and 40 percent bond portfolio.

Certainly there are good hedge funds available, but trying to find them in advance can be tricky. What's more, the dispersion of returns in the hedge fund world can be quite wide, so selectivity is key, and the price for picking wrong can be high. The media have been full of stories of hedge funds that have suffered large losses in the recent volatile market. This illustrates how risky these investments can be during times of market turmoil, when investors need risk control the most.

Just because hedge funds are not the panacea they have been made out to be does not mean investors have to blindly accept stock market volatility. There are options to help mitigate the market's rough patches.

High-quality bonds and cash are the two best hedges against stock market declines. Typically there is a flight to quality when stocks head south, benefiting Treasury bonds and other high-quality fixed income instruments. Cash also is a stabilizing investment. Both investments are very good at reducing portfolio risk. But both bonds and cash offer anemic returns currently, making them less attractive replacements for stock allocations.

As another approach, alternative asset classes are often touted as the solution to reducing volatility. I think of hedge funds as alternative strategies, but there are alternative asset classes that can provide decent potential returns while dampening risk.

Commodities, real estate, emerging market stocks and bonds, infrastructure investments, and bank loans, among others, are all examples of alternative asset classes. Each could have its place in a diversified, long-term portfolio, but unfortunately, none of them offer the protection that investors seek when the stock market declines in earnest.

The problem is that some of the same factors that impact the returns of stocks also affect the returns of all these asset classes. All of them are exposed to economic fluctuations, and all of them have some sensitivity to inflation, just like the stock market. Economic recessions and slowing growth impact not just business profits (which influence stock prices), but also the cost of capital, credit risk, and demand for commodities.

There are some alternative investments that have had success at mitigating portfolio returns during bear markets, such as managed futures funds and catastrophe bonds. Managed futures funds invest in derivative instruments, primarily futures contracts. These are agreements to buy or sell assets, typically commodities, at a fixed price in the future. Managed futures funds buy or sell futures contracts generally by following trends in the market. Because they can earn money in both upward and downward trending markets, these funds have been historically defensive.

Catastrophe bonds are issued by municipalities that want protection against natural disasters, such as hurricanes in Florida. These municipalities issue bonds to investors who are willing to accept an often hefty premium payment in exchange for assuming the risk of the hurricane. This can be risky as an investment, as eventually a severe hurricane will come along. By building a portfolio with exposure to many different risks (e.g., hurricanes in Florida,

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earthquakes in California or ice storms in Europe), it is possible to diversify much of the danger away, though some volatility still exists. Catastrophe bond funds can thus offer a steady stream of returns with no economic exposure.

There are certainly other alternative asset classes that can help provide risk control as well. The key is to look for investments that have unique drivers of performance. Investments that will ebb and flow along with the economy likely won't protect you in a down market. During 2008, however, there were really only a few asset classes that didn't lose money. High-quality bonds rose roughly 5.5 percent, managed futures funds rose 18.3 percent, and catastrophe bonds rose 2.5 percent.

Looking for investments that combine solid return potential with the ability to control downside risk is the holy grail of portfolio construction. But most investments that are more esoteric involve higher costs and often are not tax efficient. Pay particular attention to costs, and hold these in qualified retirement accounts if possible.

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