

Working to Rebuild Assets:

# Keys to Managing Risk and Volatility

## EXECUTIVE SUMMARY

The stock market decline of 2008 shook the confidence of many investors including, perhaps, some of your own clients. Some may have reacted like deer caught in headlights—too terrified to move. Others may have joined the panicked stampede into money market funds, government securities, and cash, in many instances, upending their long-term financial goals and carefully crafted financial plans.

Now, more than ever, investors need your guidance and expertise to gain a more realistic perspective on short-term market moves and unrealized losses, and to help keep long-term damage at bay.

Seize this opportunity to demonstrate the value you bring to your clients by leading them from their state of fear and panic to one of perspective and rebuilding. Along the way, you can help them become smarter investors who can make more insightful choices regarding the addition of new money for investment and their asset allocation.

The following white paper, *Working to Rebuild Assets: Keys to Managing Risk and Volatility*, provides suggestions for helping investors visualize rebuilding based on the experience of investors in previous bear market recoveries. It also offers approaches for demonstrating the various concepts of investing as you lead your clients—new and existing—to their own personal vision of rebuilding.



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## Introduction

While it appears that some Americans have rediscovered the virtues of saving in the face of recent market volatility, the return to savings through conservative vehicles may indicate trouble ahead for those pursuing long-term financial goals. Current and prospective clients may need your guidance to appropriately rebuild and confidently pursue their investing futures.

You can help investors quell their fears by educating them about market ups and downs—and how mutual funds, in particular, can help manage risk and volatility over the long run.

You also have the opportunity to educate clients about the role strategies such as dollar-cost averaging and asset allocation can play in helping to generate investment returns. The virtues of these strategies tend to be a hard sell in times when investors are being dazzled by the easy returns of a bull market. But in the wake of what has been a truly historic crash, investors may be more willing to listen.

The message clients most need to hear should be about more than recovering lost ground. It should be an overarching message: that there is a natural flow to investing—that markets experience ups and downs. Most of all, it should communicate that investors can take proactive steps to achieve their short- and long-term financial goals.

The best way to deliver this message is by helping investors regain their perspective on investing. This paper provides you with the words, concepts, and historical data that can help turn your clients and prospective clients into investors who appreciate the importance asset allocation and diversification may play in managing their portfolios.

## Building Blocks—Factors That Impact Rebuilding

Some investors may be wondering if it's even possible to rebuild balances. Thankfully, for most, rebuilding is far from the insurmountable task it appears to be during market dips.

But before you can answer your clients' inevitable "How quickly?" question, it's important to understand that the speed of recovery to previous account balances depends on the interaction of three factors:

- **Account Size** – The investor's total fund balances at the market's high point, roughly January 1, 2008
- **New Money** – The existence and amount of new money being invested and the need to put money to work, rather than letting it pile up on the sidelines
- **Asset Allocation** – The asset allocation and future investment returns of their fund investments

### FACT:

*The U.S. savings rate, which hovered near zero from 2005 to 2008, reached 6.9% in May 2009. That is the highest level in 15 years, according to the Bureau of Economic Research.*

## ACCOUNT SIZE

Without a doubt, account size, is a key factor investors monitor to keep tabs on the health of their investment portfolios. And, with the recent market decline, the difference between pre- and post-crash account size may have left investors disenchanted and wondering what they should do next.

Good news—the general stock market and even many investors’ account balances are already showing signs of a recovery. Now is a good time to help investors understand that, **unless they are at the end of their investing lifecycle, account size is a point-in-time snapshot...not a finish-line reading.** In fact, many investors will find their race is far from over.

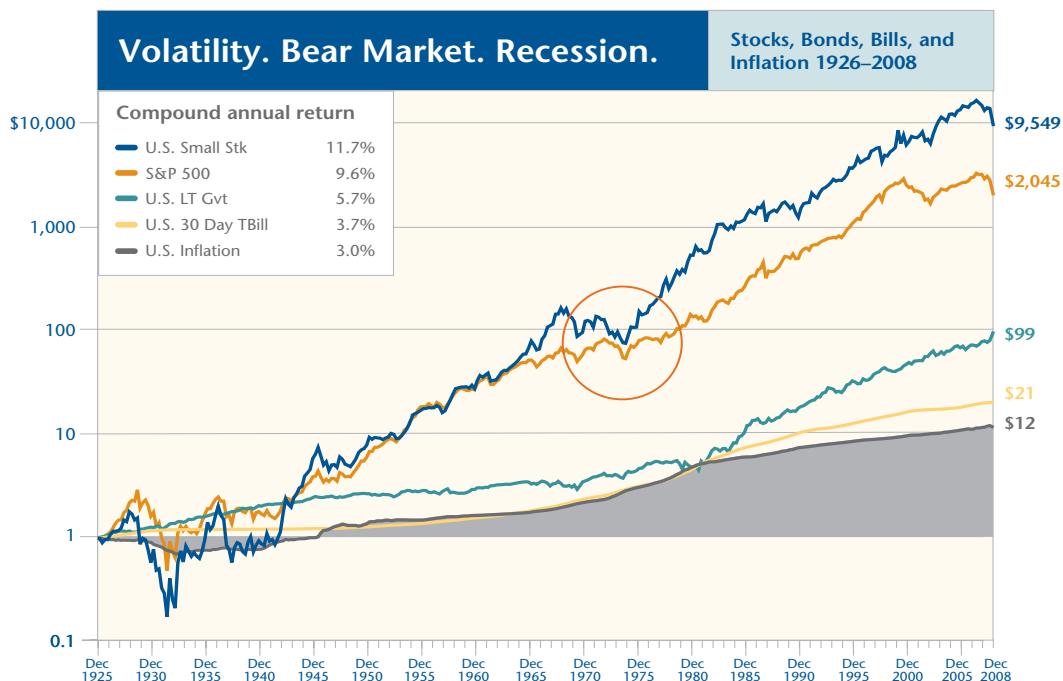
It’s also a good time to help investors understand that they are not completely at the mercy of the market. By working with you to revisit their investing goals and strategies, they can allocate their invested assets to better minimize the impact of future market declines and potentially maximize their portfolio’s participation in the upswings that may follow.

With this in mind, as you engage in client discussions about account size, consider the following points:

### For investors with less mature accounts:

- It is possible that any loss on invested assets may already have been offset, if their balances were low to begin with. **The lower the balance before the market decline, the faster the expected recovery time, assuming new money is still being added to the account.**
- **The real impact of the market selloff on these investors’ longer-term plans is likely to be more emotional than financial.** Seeing their balances drop, within the context of rabid media coverage and discouraging economic news, the real damage may be a fear of investing. Therefore, it’s critical to address their concerns and educate them on how the market works.

The following chart depicts how historic market declines have been followed by periods of sustained growth.



PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. Hypothetical value of \$1 invested at the beginning of 1926. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged, and individuals cannot invest directly in an index.

*25% of investors between the ages of 56 and 65 indicated they had more than 90% of their 401(k) money invested in equities at year-end 2007.<sup>1</sup>*

**For investors with more mature accounts:**

- These investors have likely experienced the most damage to their account size because they had the largest account balances. The damage may be compounded by the fact that 25% of investors between the ages of 56 and 65 indicated they had more than 90% of their 401(k) money invested in equities at year-end 2007.<sup>1</sup> **This allocation to equities, generally seen as more volatile than fixed income, magnified the impact of the market selloff at a time when these individuals could least afford it—as they approach retirement.**
- Despite the financial and emotional impact of the market crash, **retreating to conservative investments may not be the best strategy.**<sup>2</sup> As a financial professional, you have the expertise and tools to help investors assess their situation and chart the steps to recovery.

**NEW MONEY**

Investors may not fully appreciate that they can get their long-term goals back on track by stepping up their savings levels.

Adopting a dollar-cost averaging strategy can simplify this process for investors. The strategy requires that a fixed amount be invested regularly, regardless of market conditions. It limits the amount of shares being purchased at high prices and maximizes those being bought at low prices during market dips. This results in a simplistic means of market risk management by reducing the average cost basis of an investment. The advantage is that when the asset’s price recovers, that lower cost basis means it has less distance to travel before reaching break-even.\*

This is why continuing to add new money is so important and why even increasing the amount of savings in “bad” markets can be a wise move in the long run.

The Math of Dollar-Cost Averaging (DCA)			
	Amount Invested	Share Price	Number of Shares Purchased
April	\$100	\$10	10.00
May	\$100	\$15	6.67
June	\$100	\$20	5.00
July	\$100	\$15	6.67
Average Share Cost: \$14.11 ( $\$400 \div 28.34$ )			
Average Share Price: \$15.00 ( $\$10 + \$15 + \$20 + \$15 \div 4$ )			

**ASSET ALLOCATION**

How an investor chooses to allocate their assets also influences the time it takes to rebuild invested assets.

While an allocation that favors low-risk investments may seem prudent in the short run, it could be very costly over time due to the impact of inflation and performance differences of various asset classes.

\*Dollar-cost averaging does not guarantee a profit nor protect you from loss during a declining market. You should consider your overall investment objectives and your ability to continue investing throughout various market cycles before beginning this or any investment program.

<sup>1</sup> EBRI February 2009 Issue Brief

<sup>2</sup> EBRI February 2009 Issue Brief

Consider that if the rate of inflation averages 3% and a portfolio of short-term investments is generating returns of 2.5%, being conservative could become a more guaranteed way to lose money in the long run due to diminished purchasing power. This in turn could undermine one of an investor's ultimate savings goals—keeping pace with inflation.

The stock market, as represented by the S&P 500 Index, fell 37% in 2008, while the Barclays Capital U.S. Aggregate Bond Index gained 5.2% and the three-month U.S. Treasury Bill returned 1.4%. During that time, an investment in a fund that was allocated over different asset classes—such as target risk or target date funds—could have diminished the damage in comparison to an investment in a less diversified fund.\*

Market declines, therefore, provide financial professionals with an opportunity to demonstrate the value of asset allocation in mitigating the effects of volatility.

\*Asset allocation/diversification does not guarantee a profit or protect against loss.

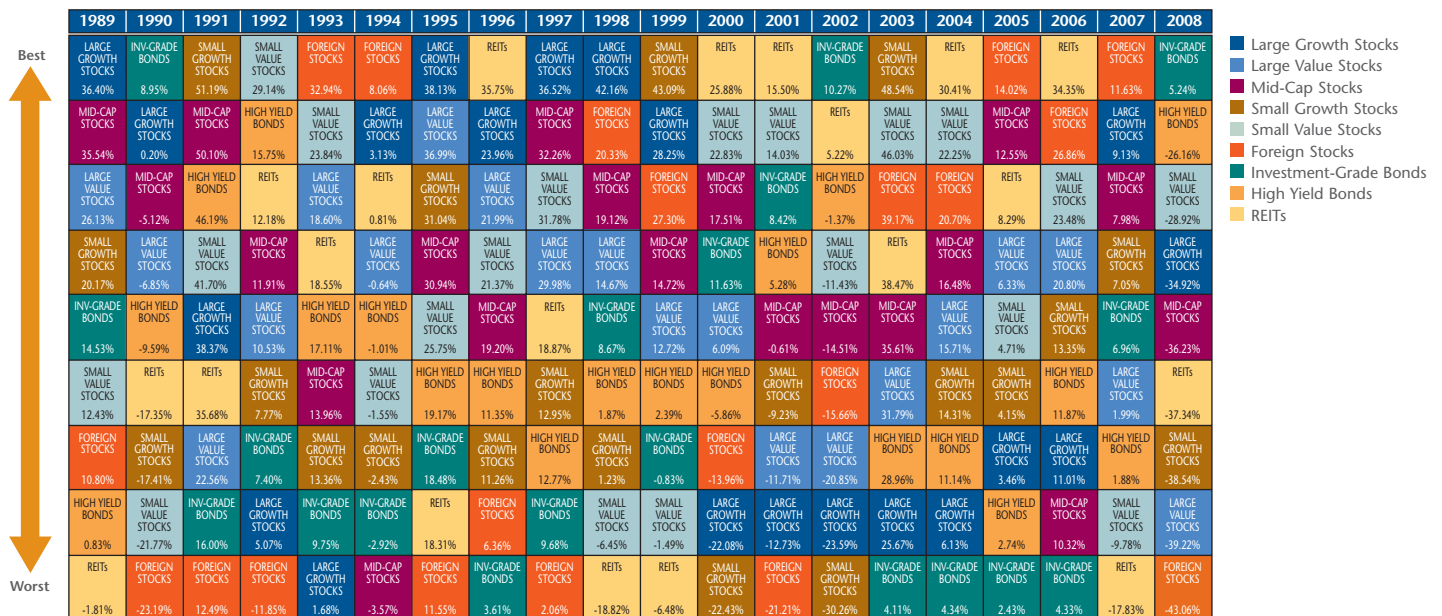
## RECOVERY TIME EXPECTATIONS

The length of time it may take to rebuild portfolios to better withstand market volatility and achieve long-range goals will depend on:

- How much ground needs to be retaken
- The amount of new money the individual investor can contribute
- How they allocate their investable funds over asset classes

In order to begin the process of recovery, you may need to convince the individuals you meet with that it can be done. And to do that, you may need to lead them through rebuilding steps—to the recovery of their perspective on investing and of their understanding of how the stock market works.

A useful tool for doing this can be found in the following chart. It depicts the dispersion of annual returns and the emotional roller coaster investors would experience if they were to remain invested in just one asset class.



Sources: Ibbotson Associates and Morningstar. Small value stocks are represented by the Russell 2000® Value Index; small growth stocks are represented by the Russell 2000® Growth Index; large value stocks are represented by the S&P 500/Barra Value Index for 1989–2005 and by the S&P 500/Citigroup Value Index for 2006–2008; large growth stocks are represented by the S&P 500/Barra Growth Index for 1989–2005 and by the S&P 500/Citigroup Growth Index for 2006–2008; mid-cap stocks are represented by the S&P MidCap 400 Index; foreign stocks are represented by the MSCI EAFE Index; REITs are represented by the FTSE NAREIT All REITs Index; high yield bonds are represented by the Barclays Capital U.S. Corporate High-Yield Index; investment-grade bonds are represented by the Barclays Capital U.S. Aggregate Bond Index. This material has been obtained from sources generally considered reliable. No guarantee can be made as to its accuracy. Not intended to represent the performance of any particular investment. Indices are unmanaged, and one cannot invest directly in an index. PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

## Steps to Rebuilding

The massive 2008 market decline has created an opportunity for financial professionals to motivate and educate investors to rebuild and to better position their invested assets to withstand certain effects future market declines may provide.

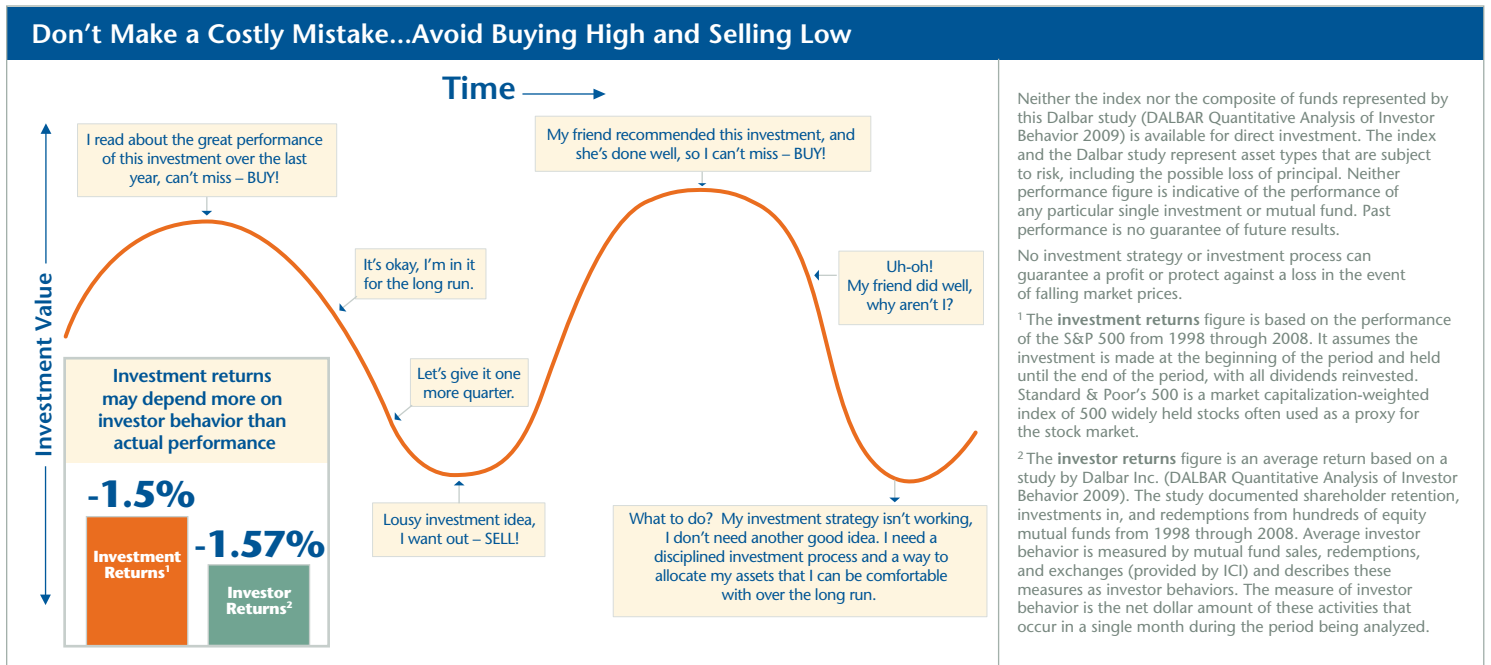
You can help investors:

- Move from an emotional mindset to a rational one
- Shift from passive acceptance to active rebuilding
- Refocus attention from short-term performance to long-term goals

## EMOTIONAL TO RATIONAL

Investors need your help to set realistic goals and to take a sound approach to reaching them. You can help them understand that, even in the wake of an historic sell-off, it may be possible to stay on track for realizing their goals. Simply sticking to their plans—if they were properly invested to begin with—or making minor budget adjustments can help them reach their investing goals.

By guiding clients toward more realistic expectations regarding the future, you can help them realize that extreme measures are rarely necessary in protecting portfolios—they needn't sell everything. Nor is trying to time the market the answer—the likely success of which is illustrated below:



Providing simulations of “recovery” often helps illustrate the point that recovery is possible. There is a great deal of art to this, since it requires making assumptions about the future rate of inflation and future market returns. But, financial professionals can do this easily by using a simple savings projection calculator.

**For instance, consider two hypothetical investors who held onto their portfolios throughout the recent market declines, but cease adding savings to them.**

	Investor with less mature account	Investor with more mature account
01/01/08 balance	\$20,000	\$200,000
12/31/08 balance	\$13,700	\$137,000
Annual addition to account	—	—
Hypothetical annual rate of return (appreciation and not subsequent withdrawals)	8.00%	8.00%
Expected inflation rate	3.10%	3.10%
Years to rebuild to 01/01/08 level after accounting for inflation	7 years, 10 mos.	7 years, 10 mos.

**Now consider those same two investors, if they continue to contribute to their savings at a rate of \$5,000 a year.**

	Investor with less mature account	Investor with more mature account
01/01/08 balance	\$20,000	\$200,000
12/31/08 balance	\$13,700	\$137,000
Annual addition to account	\$5,000	\$5,000
Hypothetical annual rate of return (appreciation and not subsequent withdrawals)	8.00%	8.00%
Expected inflation rate	3.10%	3.10%
Years to rebuild to 01/01/08 level after accounting for inflation	1 year	4 years, 9 mos.

The figures are for illustration purposes only and do not reflect the performance of any Principal product. The “years to rebuild” figure does not reflect actual market performance, but rather reflects time frames of continued year-over-year growth with no negative annual performance. Criteria: Assumes an annual 8% rate of return with no annual negative returns. Market activity historically has not performed in this manner. Items such as investment selection/market activity/asset allocations/expenses would dictate actual returns of an investor’s portfolio. **IMPORTANT NOTE: The projections or other information generated in this illustration are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Investing involves risk, including loss of principal.**

Performing simulations like this can help make the points that:

- Investing can be a self-healing process
- The “healing” can be sped up through continued savings

The answer to emotion, therefore, is to provide a rational look at the “damage.” Revisiting long-term goals and working through “what if” scenarios with the client’s own data can also go a long way toward demonstrating that losses, especially unrealized losses, need not derail an investor’s goals. Gaining control over emotions and personal finances can enable investors to take a more sound approach to investing.

#### PASSIVE TO ACTIVE

Investors may need reminding that saving is a long-term proposition. As such, assets need to be managed throughout one’s lifetime and, at the very least, reviewed annually.

*Investors may need reminding that saving is a long-term proposition.*

You can help motivate those prone to inaction by demonstrating the potential impact of adjustments in their:

- Savings levels
- Consumption levels
- Lifestyle choices
- Allocation to investments

**Asset allocation is under the control of an investor.** You can help investors assess their individual risk tolerance level, tempering their expectations for future portfolio returns and translating that into an appropriate asset allocation strategy. As a first step, help investors revisit a risk assessment to determine if changes should be made. You can also run simulations to help investors understand how small changes in the amount they save or in their asset allocation can impact the probability of achieving their long-term goals.

Demonstrate your value and build client relationships by motivating investors to take—or resume—action.

#### SHORT-TERM TO LONGER-TERM THINKING

An effective way to motivate individuals may be found in confronting the mechanics of bear markets and the role time plays in taming their ultimate effect on portfolios. The charts which follow can help you explain the need for patience and the development of a long-term perspective.

12 Months Ended	Trailing 12-Month Return	Next 1-Year Return	Next 5-Year Return (Annualized)	Next 10-Year Return (Annualized)
Sept. 1974	-38.9%	+38.1%	+16.8%	+15.5%
Sept. 2001	-26.6%	-20.5%	+7.0%	—
March 2003	-24.8%	+35.1%	+11.3%	—
May 1970	-23.3%	+34.8%	+7.2%	+8.2%
Aug. 1988	-17.8%	+39.0%	+15.8%	+17.0%
Oct. 1962	-14.9%	+35.3%	+14.3%	+10.6%
July 1982	-13.6%	+59.2%	+29.6%	+19.2%
Sept. 1966	-12.0%	+30.6%	+8.7%	+6.9%
Dec. 1957	-10.8%	+43.4%	+13.3%	+12.9%
Sept. 1990	-9.3%	+31.3%	+17.2%	+19.5%

Source: Wilshire Associates

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

For instance, it is hard to see a bear market reaching bottom. However, the above historical chart of market activity offers proof that, eventually, all bear markets have ended, and the U.S. market appears to have resumed its upward slope.

While bear markets never end soon enough, on average,\* they last about 15 months and decline an average of 28 percent. The first point to make with clients is that, historically, bear markets have ended, and only those who sold what they had while the market was in a freefall actually locked into that loss. Those who held may have experienced unrealized losses, but as the market recovered, many of those losses shrunk. This may have enabled them to come through the financial storm with less dramatic and traumatic results than those who panicked.

The next point to make is that bear markets tend to end quickly and dramatically. Ned Davis Research also found that, on average, 41 percent of the one-year recovery return is captured within the first three months of a market's bottom. This means that unless an investor can precisely determine when a market is bottoming and has been sitting out the selling by investing in cash, then they will forgo that bounce-back and may defeat the purpose of their cautionary selling.

*41% of the one-year recovery return is captured within the first three months of a market's bottom, according to Ned Davis Research Inc.*

\*According to Ned Davis Research Inc., an independent research firm.  
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Worst Stock Market Return Periods from August 1988 to March 2003				
12 Months Ended	Trailing 12-Month Return	Next 1-Year Return	Next 5-Year Return	Next 10-Year Return
Sept. 2001	-26.6%	-20.5%	+7.0%	—
March 2003	-24.8%	+35.1%	+11.3%	—
Aug. 1988	-17.8%	+39.0%	+15.8%	+17.0%
July 1982	-13.6%	+59.2%	+29.6%	+19.2%
Sept. 1990	-9.3%	+31.3%	+17.2%	+19.5%

Source: Wilshire Associates

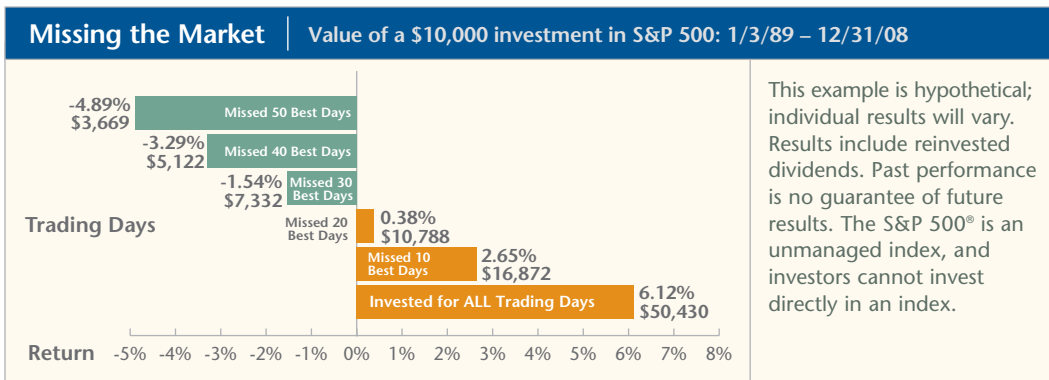
Source: Wilshire Associates

- The trailing 12-month returns were sorted from worst to best. Adjacent 12-month periods were not considered.
- The trailing 12-month returns are compounded total monthly returns for the S&P 500 as reported by Wilshire Associates. The 5- and 10-year returns are annualized total returns. Investors cannot invest directly in an index.

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

Additionally, the chart above demonstrates that the worst 12-month stock market declines historically have been followed by periods of even greater recovery. While the chart demonstrates historical results, this look back provides a glimpse into how previous recovery cycles have unfolded. It also underscores a key point about markets when they have been in an extended bull run. Bear markets happen with some regularity, but all is not grim.

While being able to avoid the worst market days would be optimal, missing the best trading days—many of which will occur in the initial stages of a recovery—may be more damaging to portfolio returns. Just how damaging they can be is illustrated in the chart below.



Source: Ned Davis Research, Inc.

## Conclusion

Now, more than ever, investors need your guidance. And now, more than ever, opportunities abound for financial professionals willing to engage investors to help them understand:

- How choices regarding saving and asset allocation make a difference
- How developing an historical perspective can quell investor emotions
- How long-term financial goals can remain on track regardless of market volatility

Along the way, you have the opportunity to instill an appreciation for the role asset allocation plays in performance and especially in mitigating the impacts of market volatility during market dips.

Ultimately, by taking on these opportunities to educate clients, you can lead them to realize their objectives and to appreciate the value you add in helping them achieve those objectives.

Now is an excellent time to engage investors in “rebuilding” conversations. With the tools available from Principal Funds, you have the support you need to make such conversations worthwhile.

*For more information about how the Principal Funds can help you lead your clients to their own recovery, please contact your Principal Funds wholesaler, or call our Sales Support Hotline at 800-787-1621.*



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