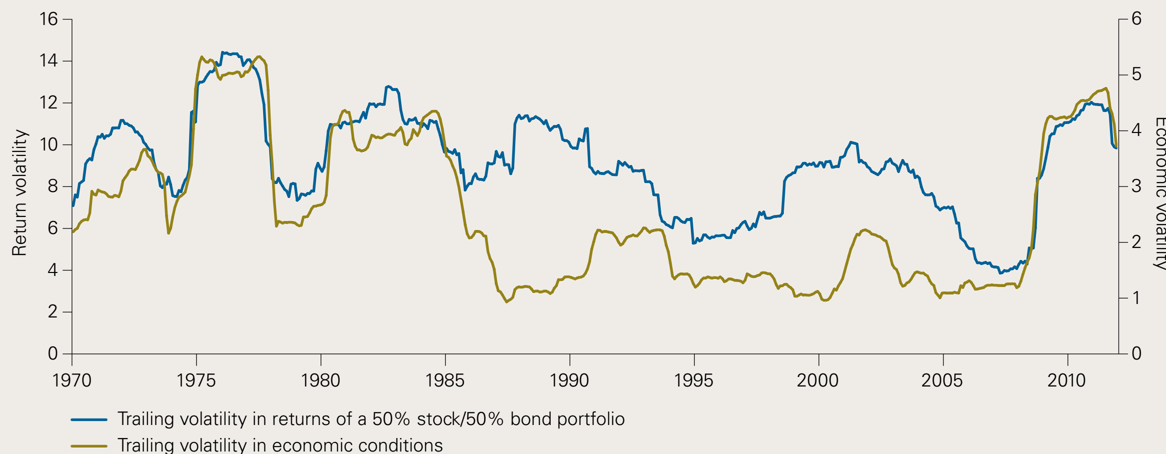
Vanguard®

Understanding asset allocation amid economic uncertainty

Correlation of U.S. economic volatility and financial market volatility, January 1970—February 29, 2012



- The chart to the left shows that periods of economic and financial market volatility tended to occur together during the last four decades.
- Despite the current economic and return volatility, many investors today seek lower portfolio volatility and higher yields.
- If you try to meet your spending needs based on income alone by increasing your allocation to higher-yielding bonds or dividend-paying stocks, your portfolio's volatility may increase.

Notes: Volatility in economic conditions is defined here as the rolling standard deviation (a measure of the dispersion of a set of data from its mean) over the past 36 months in the Federal Reserve Bank of Philadelphia's Aruoba-Diebold-Scotti Business Conditions Index, which is designed to track real business conditions at high frequency. Its underlying (seasonally adjusted) economic indicators—weekly initial jobless claims, monthly payroll employment, monthly industrial production, monthly personal income less transfer payments, monthly manufacturing and trade sales, and quarterly inflation-adjusted gross domestic product—blend high- and low-frequency information and stock and flow data. Financial market volatility is defined here as the rolling standard deviation over the past 36 months in the total returns of a hypothetical 50% U.S. stock/50% U.S. bond portfolio. Data shown are through February 29, 2012.

The long-term returns for our hypothetical portfolio are based on data for appropriate market indexes. For U.S. bond market returns, we use the Standard & Poor's High Grade Corporate Index from 1926 to 1968, the Citigroup High Grade Index from 1969 to 1972, the Lehman Brothers U.S. Long Credit AA Index from 1973 to 1975, and the Barclays Capital U.S. Aggregate Bond Index thereafter. For U.S. stock market returns, we use the S&P 90 from 1926 to March 3, 1957; the S&P 500 Index from March 4, 1957, to 1974; the Dow Jones Wilshire 5000 Index from 1975 to April 22, 2005; and the MSCI US Broad Market Index thereafter.

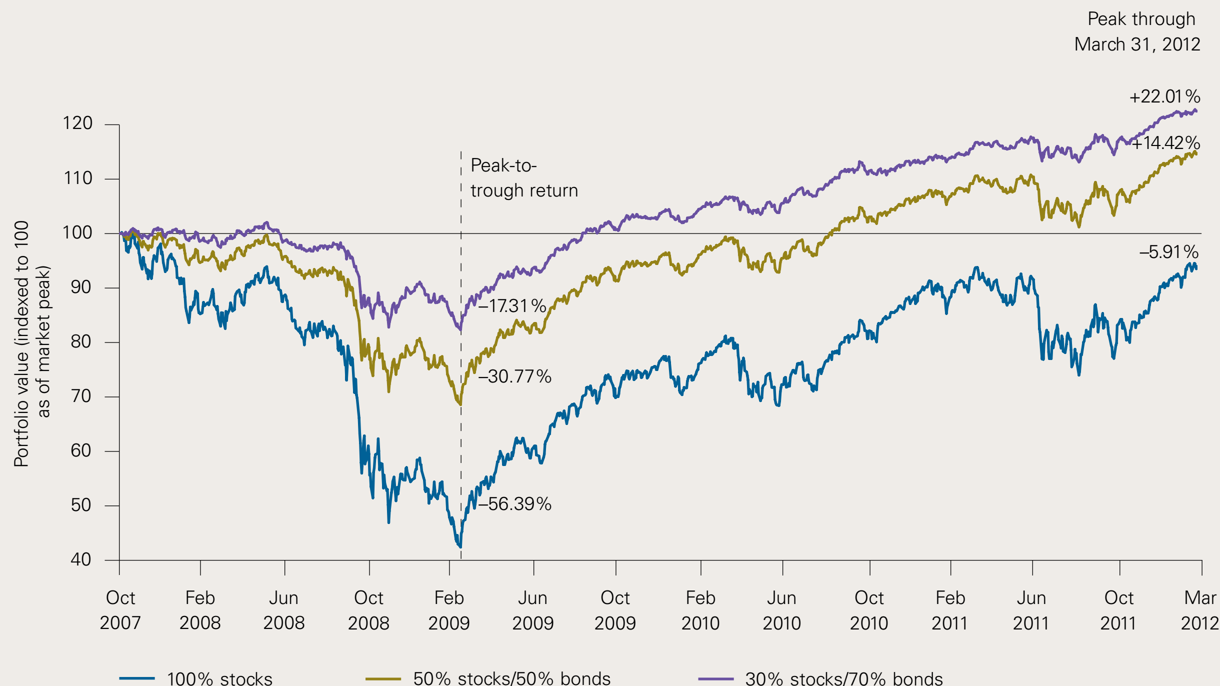
Sources: Barclays Capital, Thomson Reuters Datastream, and Vanguard calculations based on data from the Federal Reserve Bank of Philadelphia and index returns.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, since you cannot invest directly in an index.

(continued on reverse)

A balanced, diversified investor has fared relatively well

A comparison of performance since the start of the financial crisis



Note: Stock returns represent a blend of 70% U.S. equities and 30% international equities; bond returns represent U.S. bonds only. Returns are based on the broad-market indexes listed below the chart on the reverse, plus for international stock market returns, we use the MSCI EAFE Index from 1970 through 1988, and a blend of 75% MSCI EAFE Index and 25% MSCI Emerging Markets Index thereafter. Data are from October 9, 2007, through March 31, 2012.

Sources: Barclays Capital, Thomson Reuters Datastream, and Vanguard calculations based on index returns.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, since you cannot invest directly in an index.

- Consider your portfolio's total return rather than simply its income potential—that is, the yield to maturity on a bond fund or the dividend yield on a stock fund.*
- Above all, be realistic about expected returns based on prevailing market conditions.
- The chart to the left shows how an allocation to bonds provided downside protection, even during the low-yield environment that we have experienced since 2008.
- If you feel locked in to your assumptions about your portfolio's expected rate of return or your targets for spending, then you may need to increase your savings rate. Alternatively, you could allocate more assets to stocks, but you would have to bear greater downside risk and probably higher portfolio volatility.

*The yield to maturity for a bond fund is the rate of return you would receive if the fixed income securities held by the fund were held to their maturity dates. Dividend yield is the dividend income earned by stocks, expressed as a percentage of the aggregate market value (or of net asset value, for a fund). For a fund, the dividend yield is based solely on stock holdings and does not include any income produced by other investments.

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