

Coping With Market Volatility

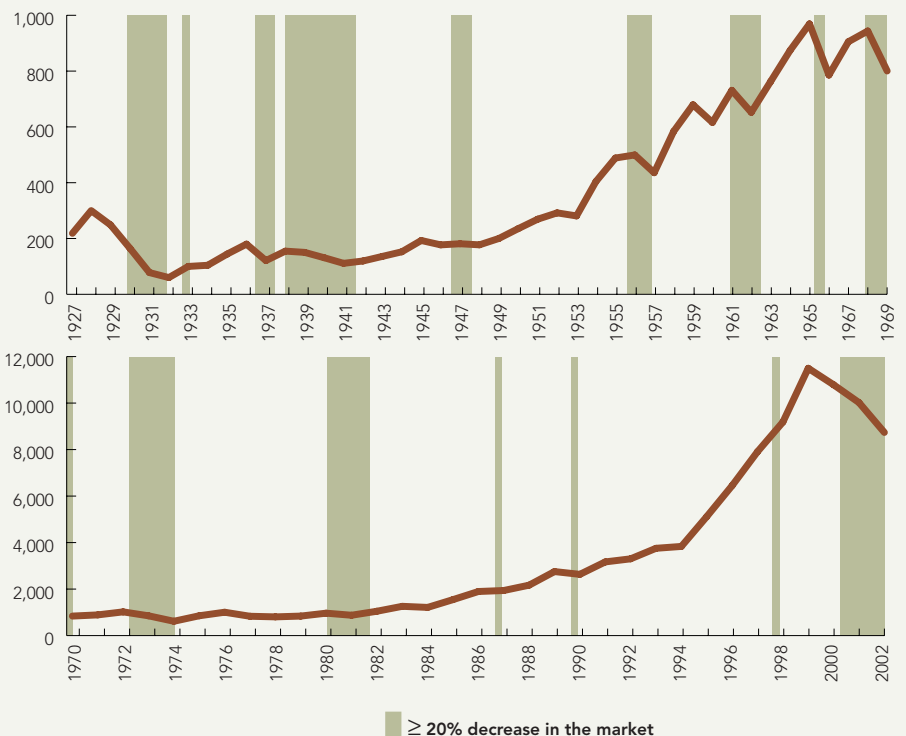
Domestic and international events—corporate accounting scandals, the war on terrorism, a nationwide crisis of consumer confidence—have dominated headlines recently...and taken their toll on the stock market. In response, investors have become concerned about the safety of their investment dollars. Many wonder if they should continue to leave their hard-earned money in the stock market or move into more conservative investments.

This *Viewpoint* Special Report addresses these concerns by putting recent events into an historical perspective. The insights and analyses here from Fidelity investment professionals point clearly to these conclusions: Taking a long-term view of the market can be a more effective strategy than trying to time it; diversifying your portfolio can help you weather unexpected market turbulence; and regular investing can help you smooth out the peaks and valleys while keeping you on track toward your investment goals.

No one can predict what the next few months in the stock market may bring—not even the financial experts. We hope this candid discussion of historical facts and expert insights can help you evaluate your situation and make sound investment decisions going forward.

BEARS LACK STAYING POWER

Historically, the market has been healthy much more often than it has been ailing, as you can see in this chart, in which drops of 20 percent or more in the Standard & Poor's 500® Index are indicated by the vertical bars. The mountain chart represents the annual growth of the Dow Jones Industrial Average since 1927.



Past performance is no guarantee of future results.
 Source: Dow Jones & Company, Inc., 8/26/02; FMR, 8/14/02.

HISTORICALLY, BULL MARKETS HAVE GREATLY EXCEEDED BEAR MARKETS IN DURATION AS WELL AS CUMULATIVE GROWTH.

A Quick History of Bulls and Bears

Downward fluctuations are an inevitable part of investing. Since 1950, American investors have experienced more than 29 market corrections, which are defined as declines of 10% or more. Bear markets, which are decidedly less frequent than corrections, are defined as declines of 20% or more. Investors have experienced 10 bear markets in the last 50 years, based on intraday extremes in the Standard and Poor's 500® Index (S&P 500®).¹

Until recently, the longest and deepest of these modern bear markets had been the difficult 22-month stretch from January 1973 through October 1974 when the market dropped 48%. But the current bear market, which began in March 2000, has lasted nearly 30 months, dropping 50% through July 2002.

There have been other bleak periods since 1950, including the 18-month decline from November 1968 through May 1970 (-36%) and the short but wrenching bear market from August to December 1987 (-34%). The average duration of bear markets in the last half century fell between these extremes, usually lasting about 13 months, with an average decline of -27%.

Historically, bull markets have greatly exceeded bear markets in duration as well as cumulative growth in the S&P 500®. Of the 10 bull markets from 1950 through 2002, three stand out as notable. Post-war peace and prosperity gave investors an 87-month stretch from June 1949 to August 1956, over

THE EXPERTS WEIGH IN

Q: What would you tell investors who have watched the value of their portfolios slide recently?

Peter Lynch, vice chairman, Fidelity Management & Research: I'm not an economist, but I do look at history, and history would say this is a time to be a buyer rather than a seller. Since March of 2000, we've had a decline of over 40% in the S&P 500® and over 80% in the Nasdaq. There have been six 40% declines in the stock market since 1900, including the very dramatic 1929–1932 market. In each case, if you had bought stocks or invested in equity mutual funds after those 40% declines, you would have ended up a very happy individual five years and 10 years later, adjusted for inflation.

Scott Kuldell, director, Strategic Advisers, Inc.*: Of course, dismissing every 1,000 or 2,000 point move in the market is easier said than done. But volatility—the tendency for a security or market to rise or fall sharply in price in a short-term period—is what enables investors to enjoy returns higher than those generated by lower-risk investment options. This is very natural behavior for the stock market.

Indeed, risk is an inextricable part of investing. There's investment risk: the risk that your stock will plummet; liquidity risk: the risk that you won't be able to quickly turn your investment into cash; and inflation risk: the risk that time and rising prices will erode the value of your money. Of course, if you're investing for the long term, I believe the biggest risk is not being in the market at all. Still, it's important to continually evaluate your investment choices and their inherent risks—as well as your own risk tolerance.

*Strategic Advisers, Inc. is a Fidelity Investments company.

which the market increased 267%. During the “Reagan Years,” from August 1982 through August 1987, the market grew 229%. But even those eras pale in comparison to the remarkable 94-month stretch from October 1990 through July 1998, when the S&P 500® increased 302%. This unprecedented increase is freshest in our collective memory, obscuring the reality that the merely average bull market—which alone would be reason to celebrate—lasts 50 months with an increase of 133%.

The most recent market plunge began with internet and technology stocks during the

spring of 2000. These investments, which hit their peak when the Nasdaq Composite Index® (the Nasdaq),² dominated by tech stocks, had a record-high close on March 10, 2000. But then the tech bubble burst: By August 1, 2002, the Nasdaq had lost three-fourths of that value. Also by that date, market malaise—fueled by continued corporate scandals, uncertainty born of terrorist attacks, and falling consumer confidence—had spread to other sectors.

¹The Standard & Poor's 500® Index, an unmanaged market capitalization-weighted index of common stocks, is a registered service mark of The McGraw Hill Companies, Inc. and has been licensed for use by Fidelity Distributors Corporation and its affiliates.

²The Nasdaq Composite Index® is a market capitalization-weighted index that is designed to represent the performance of the National Market System, which includes over 5,000 stocks traded only over the counter and not on an exchange.

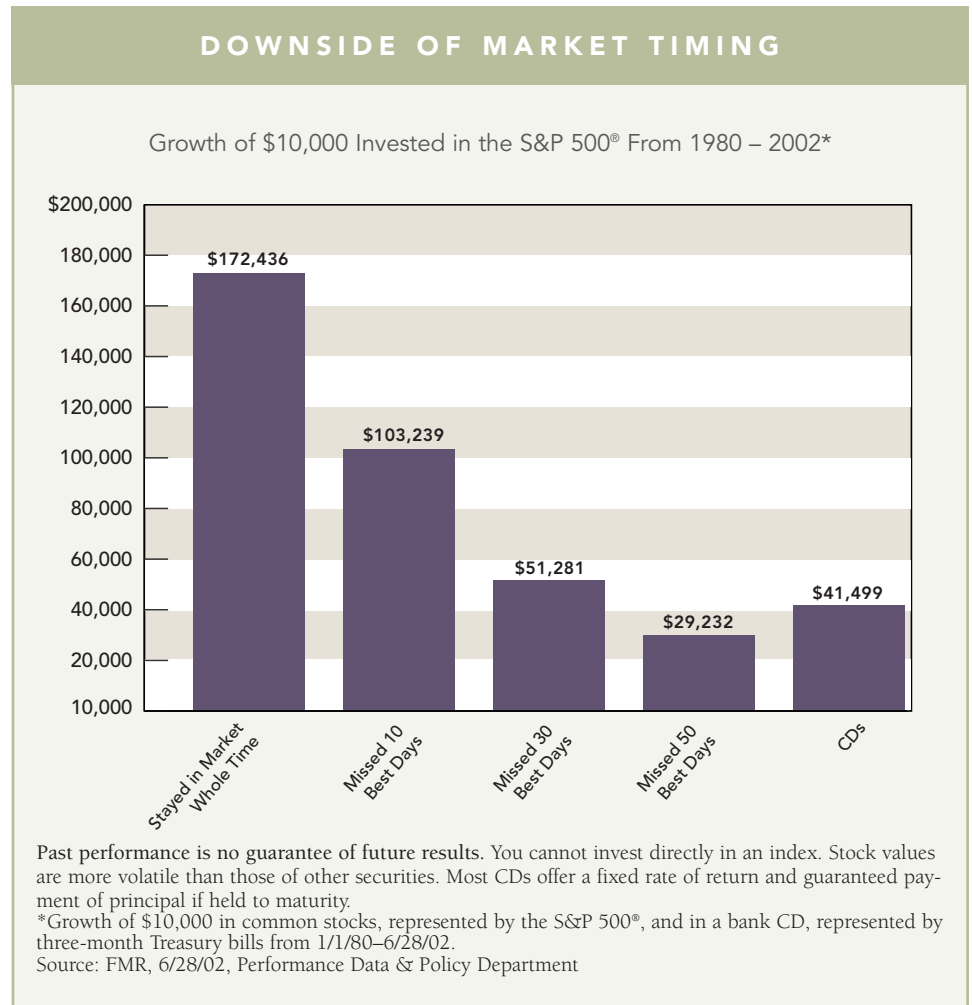
THE AVERAGE BEAR MARKET IN THE LAST HALF CENTURY USUALLY LASTED ABOUT 13 MONTHS, WITH AN AVERAGE DECLINE OF -26.8%.

Time Is More Important Than Timing

History can help put things in perspective, but it can't tell us what may happen next. Even experts can't predict the market with any degree of consistency. Yet many investors engage in market timing—shifting money in and out of the investment markets in an effort to capitalize on rising prices and avoid downturns. An example of market timing is an investor who reacts to predictions about an impending market downturn and moves his money from a stock fund to a money market fund to avoid a loss or lock in gains. Another common example is an investor who delays investing until the market “settles down.” But market timing can be futile because it requires two things: knowing the right time to buy and the right time to sell. If you're off on either side of the equation, you may miss out on the biggest potential gains. And historically, returns for the different asset classes have become less volatile when held for longer periods of time, as the chart on page 6 illustrates.

After the stock market crash of 1987, for instance, when the S&P 500® plummeted to a low that history revealed as one of the best buying opportunities in the past 20 years, did retail investors jump in? No, they did just the opposite: in 1988, they redeemed nearly \$15 billion in stock mutual funds. It was a tough lesson. That same year, the S&P 500® returned an average of almost 17%. A decade later, in 1999, the S&P 500® returned 21%. Market timers should have sold at that high too, before the market fell to -9% in 2000. Instead, they put \$188 billion into stock mutual funds, \$31 billion more than they did the year before.

The chart above offers another perspective on market timing. Let's say that in 1980 you



invested \$10,000 in a portfolio of stocks similar to those in the S&P 500® and just left it to grow with dividends reinvested. By June 2002, your investment would have been worth \$172,436.

Now let's say that, instead of staying invested for the entire 20 years, you tried to gauge the market. There's a big downside to trying to do this. If you accidentally missed the 10 best days, your investment over 22 years would be worth nearly \$70,000 less! Similarly, had you missed not just these 10 days, but the 30 best days of the market by

staying on the sidelines, your total would drop by more than \$120,000 to \$51,281. Worse, if you missed the best 50 days—less than 1% of the total 7,300 days in 22 years—you would have underperformed the rate of a less-risky bank CD.

The lesson here is that short-term reactions to market conditions—in either direction—generally do not work. While you can win big if you have a perfectly calibrated crystal ball, the risk is that you may get it considerably wrong.

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Staying the Course

Consistently investing a fixed amount of money in stocks or stock funds, regardless of the market's movements, tends to yield far superior results to keeping your money in cash investments. This tactic, called "dollar-cost averaging"³ can reduce your cost per share because you end up buying more shares when prices are down and fewer shares when prices are high. This can lower your overall cost basis. According to Peter Lynch, vice chairman of Fidelity Management & Research, and former Fidelity Magellan® Fund manager, "Gyrations in price won't derail a dollar-cost averaging strategy. You're

buying stock or stock mutual funds at cheap rates when the market falls and expensive rates when the market rises."

As the chart below demonstrates, an investor who buys stocks or stock mutual funds on a regular basis over the long term has generally fared better than a gun-shy investor who stayed in cash for the same time period.

Asset Allocation Is Key

The best way to protect yourself from the unpredictability of the market may be to strategically diversify⁴ your holdings among the three main types of investments—a process called asset allocation. When you divide your total holdings

among the asset classes of stocks, bonds and short-term investments, you lower the risks associated with having all your money in only one type of investment. You also have the opportunity to determine how much of your money you may need to invest for the short term and how much you can afford to put in higher risk, longer term growth-oriented investments.

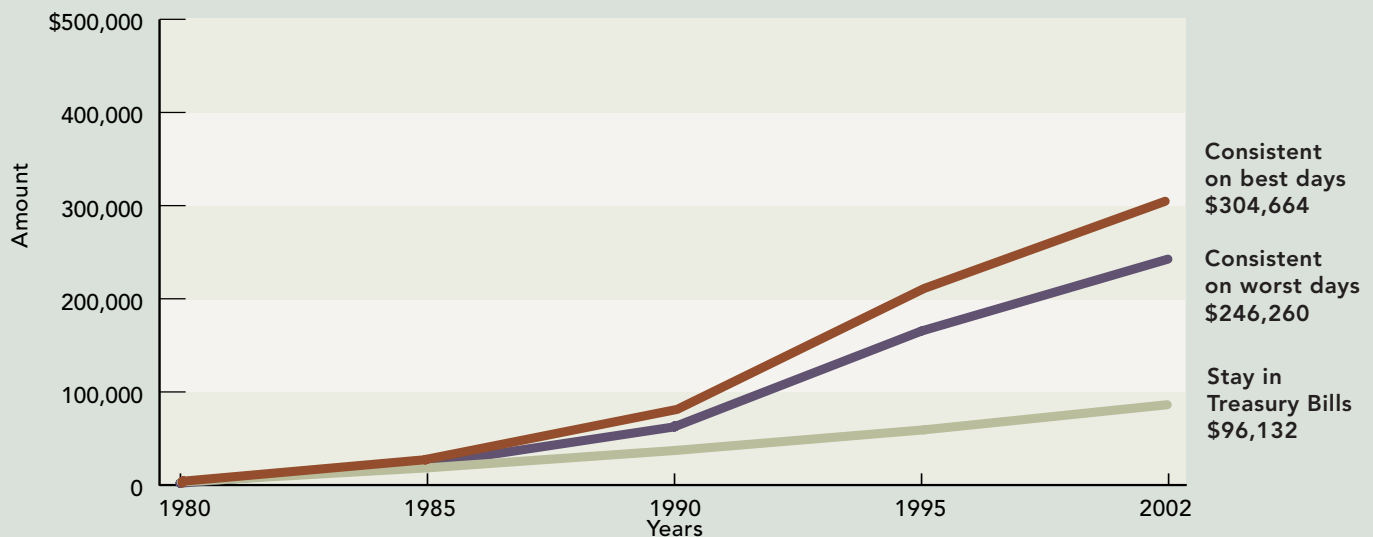
³Periodic investment plans do not assure a profit or protect against loss in a declining market. For the strategy to be effective, you must continue to purchase shares both in market ups and downs.

⁴Diversification does not ensure a profit or guarantee against loss.

STICKING WITH STOCKS AND DOLLAR-COST AVERAGING

The following chart illustrates a hypothetical \$2,000 investment made on 6/30/80 in the S&P 500® with an additional \$2,000 investment each year on the worst possible day to invest (the market high) and the best possible day to invest (the market low). This is compared with a \$2,000 investment in six-month U.S. Treasury bills.

The lesson? Even the most unlucky investor would have prospered had he or she continued to invest and hold throughout up and down periods. Dollar-cost averaging in stock investments, even on the worst possible date each year, has been far more profitable than keeping your investment dollars in cash or cash equivalents.³



Source: FMR 6/28/02. Performance Data & Policy Department. Past performance is no guarantee of future results.

This chart is for illustrative purposes only and does not represent actual or future performance of any investment option. You cannot invest directly in an index. U.S. Treasury bills are backed by the full faith and credit of the U.S. Government and maintain a stable value (if held to maturity). Stock prices are more volatile than those of other securities.

ASSET ALLOCATION FOR THE AGES

As you determine your personal asset allocation strategy, consider your financial objectives, time horizon, and risk tolerance.

That being said, the current state of the market may have shown you something about your risk tolerance. You might not have realized how much risk you could—or couldn't—tolerate until now, when you're actually experiencing a prolonged down market. If this kind of situation jangles your nerves, consider adjusting your investment strategy to a more conservative allocation—no matter what your age.

Your next step is to diversify within each asset class by investing in different types of securities in that class. For example, you might put some of your stock allocation in a large-cap stock or stock fund (which provides immediate diversification), and some in a small-cap stock or stock fund. With your bond allocation, you can choose a high quality bond fund or you may want to “ladder” your bonds—investing in bonds with a range of maturity dates to match a specific pattern or timing of future cash flows.

Your asset allocation is a uniquely individual decision, based on balancing your long- and short-term goals with your tolerance for risk. You wouldn't, for example, put 100% of your money in a large-cap stock fund and expect it to produce significantly higher returns in just two years without worrying about market drops. On the other hand, neither would you invest everything in a money market fund and expect it to generate double-digit returns over 20 years, even if its relative stability lets you sleep more soundly.⁵

Once you've determined your asset allocation, re-evaluate it at least once a year to be sure it's still in line with your investment goals and comfort with risk. Remember that whether your investment portfolio is aggressive, moderate or conservative, chances are that over 10 years, there will be five stock market corrections.

⁵An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the fund.

If you have short-term financial goals (within two years), you should move that earmarked money from stocks to short-term instruments like cash, CDs or money market funds.

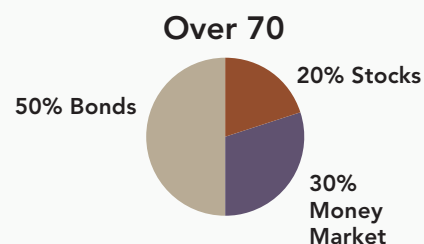
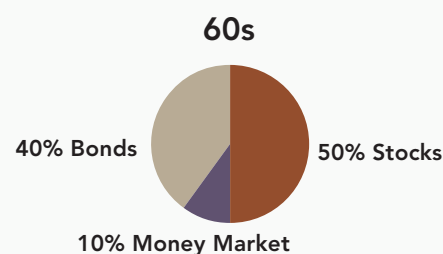
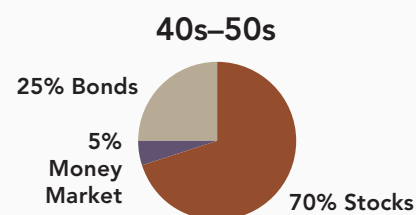
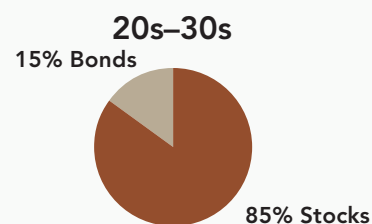
You're in your 20's or 30's. You'll retire decades from now, so time is on your side. The years may smooth out the effects that market fluctuations may have on your portfolio.

You're in your 40's or 50's. Retirement isn't around the corner, but it isn't decades away, either. Big-ticket items like a wedding or college tuition may also be looming. You need to maintain the potential for high returns and also add a degree of stability to your portfolio.

You're in your early 60's. When it comes to making up for potential losses in your portfolio, time is no longer on your side. You need to protect your nest egg from dips in the market, and also maintain the potential for high stock returns—which you'll need to carry you through retirement.

You're over 70. A good portion of your portfolio should be in stable, income-producing investments, but you should also continue to invest for growth to try to combat inflation.

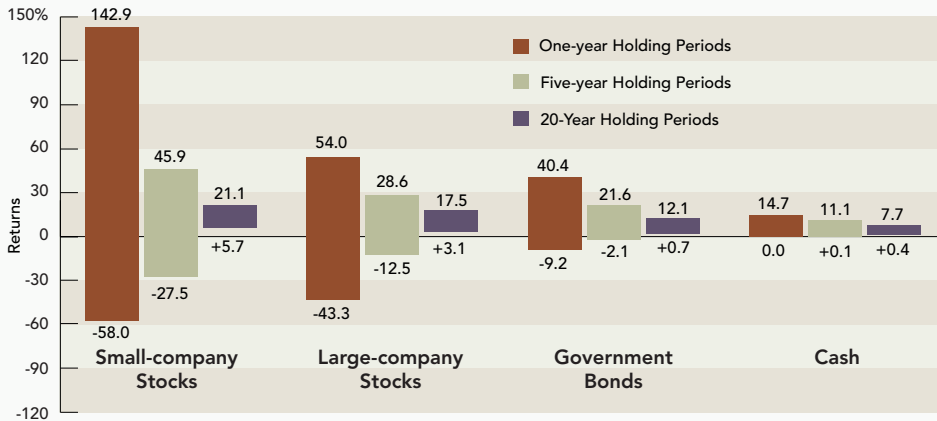
Short-Term Goals



These suggested asset allocations are intended to provide you with general information. They are not to be considered specific investment advice. Your investing decisions should be made based on your own unique personal and financial circumstances and risk tolerance.

LONG-TERM INVESTING CAN CUSHION VOLATILITY

This table illustrates that, historically, the returns for various asset classes, particularly stocks, become significantly less volatile when held for longer periods.



Source: Ibbotson Associates. All rights reserved. Used with permission. This chart is for illustrative purposes only and is not indicative of any investment. Each bar shows the range of compound annual returns for each asset class over one-, five-, and 20-year holding periods over the time frame 1926-2001. The average return represents a compound annual return over the period 1926-2001. Small company stocks are represented by the fifth capitalization quintile of stocks on the NYSE for 1926-1981, the performance of the Dimensional Fund Advisors, Inc. (DFA) Small Company Fund for 1982-March 2001, and the performance of the DFA U.S. Micro Cap Portfolio thereafter. Large company stocks are represented by the Standard & Poor's 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general. Government bonds are represented by the 20-year U.S. Government Bond. Treasury bills are represented by the 30-day U.S. Treasury bill. An investment cannot be made directly in an index. Past performance is no guarantee of future results.

Q: Are stocks and stock mutual funds too risky? Should I be buying bond funds instead?

Lynch: I believe in stocks. If you look at the returns of the last 72 years, stocks are the undisputed champs. Despite periods of turbulent economic and political climates, stocks have triumphed. They've outgained money markets, savings accounts, Treasury bills, corporate bonds, government bonds and junk bonds...by a lot!*

Still, diversification has been, and always will be, a critical component to a sound investing strategy. Of the 21 years in which stocks have had negative returns since 1929, medium-term government bonds had positive returns in 19 of them. I'm not saying that bonds perform better than stocks, because we know, over time, that's not the case. But it makes a pretty good argument for diversifying into a wide range of stocks, bonds and cash if you think the market is in for tough times. And don't get caught in the trap of false diversification within stocks: A lot of people bought a number of technology funds and technology stocks, but that constituted their entire stock allocation. When the Nasdaq declined, all those holdings went down together.

Kuldell: Stocks and stock funds are important options for investors looking to grow their assets and keep ahead of inflation. But they should be part of an overall asset allocation strategy. Investors must concentrate on their overall portfolio and how it's performing, rather than focusing on whatever individual piece of the portfolio is performing poorly. I remember when investors were very concerned about high-yield bonds in 1990, then worried about international mutual funds in 1991. It's only natural to scrutinize whatever part of your portfolio is not performing well. But having a long-term strategy allows you to stay the course through tough times because there's always an asset class that's performing poorly.

*The prices of stocks are more volatile than those of other securities.

Q: What is a reasonable long-term growth rate to expect?

Kuldell: I think it's a natural thing to hope the performance of the late 1990s occurs again. We saw survey results a couple of years ago indicating that people expected the S&P 500® to return about 18% a year in perpetuity, but that's just impossible. The math doesn't work that way. Historically, over longer periods of time, the stock market tends to perform about as well as corporate earnings do, and earnings typically grow around 9% a year.

Lynch: While past performance is no guarantee of future results, over the past 50 years, corporate profits have grown 9% annually—despite nine recessions. Even assuming a less-aggressive 7% growth rate going forward, corporate profits could double in about 10 years. And from today's levels, that means they could quadruple in 20 years and grow eight-fold in 30 years. As long as the market stays in a price-to-earnings ratio (P/E) range of 10 to 20 times earnings, I believe it should move in a direction that pleases investors, with ups and downs along the way. That's why I'm optimistic. And that's why you should have a longer-term investment horizon when investing in the stock market.

History has shown that the stock market goes up and then comes down—and vice versa—over and over again. A difficult pill to swallow, especially when the market is in a down phase. But the more you know about the cyclical nature of the economy, the less it's ebb and flow may jangle your nerves.

The National Bureau of Economic Research (NBER), whose job it is to officially date the phases of the business cycle, reports that since 1926 we've experienced 13 complete economic contractions. On average, they have been fairly short, lasting for just over a year. But expansions have enjoyed a much longer lifespan, stretching to an average of four-and-a-half years apiece over the same time period.

Translation: When the economy appears to be in a permanent funk, investors should consider the likelihood that in time, the economy will snap out of it. Likewise, when the economy is booming, investors should be aware that good times don't generally last forever.

Maintaining a practical outlook on the market can help you keep your cool when you're bombarded with financial news—negative and positive—on television, radio, in print, online, and at the office water cooler. It could mean the difference between sticking with a carefully crafted investment strategy based on your individual goals, time frame and tolerance for risk—or jumping on the latest bandwagon.

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*Investment results may vary.

Unless otherwise noted, all data was compiled by FMR, August 2002.

Past performance is no guarantee of future results.

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