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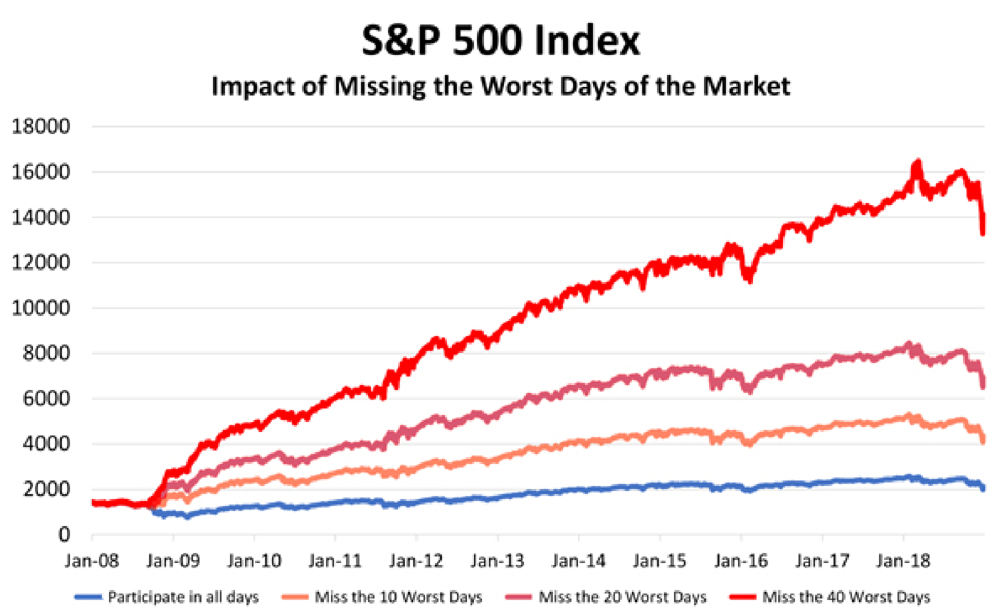
Managing Risk in Uncertain Markets Has Costs, But Creates Potential

The challenge of successful investing comes down to balancing risk and return. How much risk is there in the market? Do we strive to achieve the greatest return, or do we take a more conservative stance and chance underperforming in rising markets?

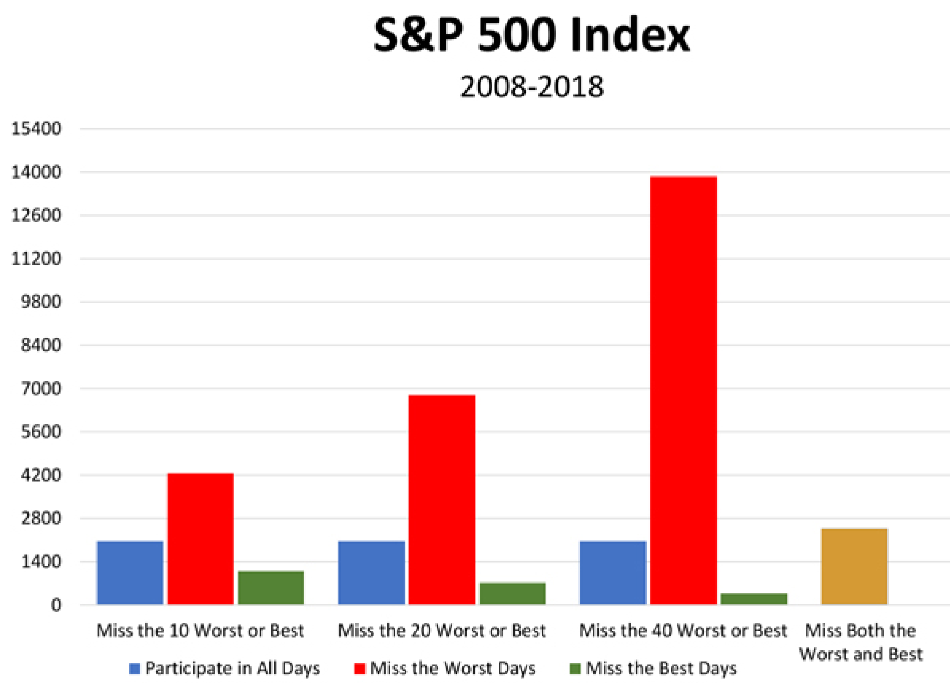
Active management is based on one of the realities of investing that is rarely emphasized in media coverage of the financial markets – markets tend to take a step backward for every two steps forward. When that back step happens can determine the long-term success of a portfolio. In the early stages, you have time to recover. The closer you are to retirement, the harder it is to regain your financial security. It comes down to the mathematics of gains and losses. If you lose 50% of the value of your portfolio to a down market, you need to earn 100% to recover from the loss. Preserve the value of your portfolio in declining markets, and instead of requiring gains to make up losses, you build portfolio value as the market recovers.

The argument against actively managing your portfolio and striving to take a more conservative positions during periods of high risk is commonly titled – Missing the Best. If by attempting to limit risk you miss the best days of the market, your performance will suffer. The flip side of the argument is typically overlooked – what if you miss the WORST days of the market?

The graphic below illustrates what would happen to the value of your portfolio if you were to miss the worst 10, 20 and 40 days of the market from 2008 through 2018. The blue line represents a buy-and-hold position.



Looking at the difference in portfolio value on a bar scale shows the impact of missing down days in the market even more vividly.



The results shown in these graphics are hypothetical and statistically impossible to achieve. They are presented to show potential, not reality. Past performance is never indicative of future returns. A different time period would show different results.

Before you take these results to heart, you need to realize that they are statistically impossible. The odds of missing just the 10, 20 or 40 best and worst days over an 11-year period with more than 2770 trading days makes winning Powerball look easy. Adding to the difficulty is that history shows the best days tend to closely follow the worst days. Sometimes they occur back to back. If an investor misses one, chances are he will often miss the other as well.

What the data does show is that avoiding down days in the market has an outsized impact on returns. In the last column of the bar chart, the impact of missing BOTH the best and worst days outperforms a buy-and-hold position. This occurs regardless of whether you look at 10, 20 or 40 days. Why? Because recovering from losses means starting with less money to benefit from the days of good returns.

Naturally no investment strategy is perfect and not all trades will be profitable but preserving gains in down markets requires an active approach. The less value a portfolio loses, the better it is positioned to recover faster and take greater advantage of a bull market.

Brian R. Carruthers, CFP, CMT

BCA
BRIAN CARRUTHERS & ASSOCIATES

Your Conservative Advisory Firm Since 1990
301 Forest Avenue
Laguna Beach, California 92651-2115 USA
Telephone: 1-949-464-1900
www.gobcafunds.com
brian@gobcafunds.com