Financial Perspectives
Be **Secure**. Be **Certain**.

WIN MORE BY LOSING LESS

> *"Because of the way our brains work, most of us worry that normal corrections will turn into an outright market crash. At that time our instincts are to dump stocks. Surely, many investors sell and tell themselves they will "wait out the volatility" on the sidelines. A confident few likely even shorted the market. However, history shows this is the most classic mistake investors make. So, kudos to those who held on to their long positions and those who bought the dip!"*

This is always the "*mantra*" written during ebullient periods in the stock market when "*investment risk*" is disregarded in the pursuit of gains. It is during these times where markets "*only seem to go up*" that statements such as "*investing is about 'time-in' the market rather than 'timing' the market*" are made. Such statements are generally regretted in the not-so-distant future.

There is a major point of clarification that needs to be made here. I completely agree that investors **cannot** be "*all in*" or "*all out*" of the market on a consistently correct basis. However, it is at this point in the discussion that some analyst pulls out a chart showing how poor your investment returns would have been if you had missed the "*10-best days in the market.*" You know the one I am speaking of.

While that bit of information is true, what is never discussed is what happens to investor returns when they capture market losses. The table below shows the damage done to an investor's portfolio during a market drawdown and the subsequent return required to get "*back to even*."

Starting Value	% Draw Down	$ Loss	Ending Value	% Return Back To Breakeven
$100,000	10%	$10,000	$90,000	11.11%
$100,000	15%	$15,000	$85,000	17.65%
$100,000	20%	$20,000	$80,000	25.00%
$100,000	25%	$25,000	$75,000	33.33%
$100,000	30%	$30,000	$70,000	42.86%
$100,000	35%	$35,000	$65,000	53.85%
$100,000	40%	$40,000	$60,000	66.67%
$100,000	45%	$45,000	$55,000	81.82%
$100,000	50%	$50,000	$50,000	100.00%
$100,000	55%	$55,000	$45,000	122.22%
$100,000	60%	$60,000	$40,000	150.00%
$100,000	65%	$65,000	$35,000	185.71%
$100,000	70%	$70,000	$30,000	233.33%
$100,000	75%	$75,000	$25,000	300.00%

Even a modest 10% correction requires an 11.11% gain just to get back to even. A 50% loss, like those that were experienced in 2000 & 2008 market sell-offs, require a 100% return. How often do 100% return opportunities present themselves? This is why "*getting back to even*" has never been a worthwhile investment strategy.

[Note: The most important commodity lost during such a period is "time." Time is the one asset in all portfolios that can never be replaced or recovered. Once it is lost, it is gone forever.]

Conversely, being "*all in the market all the time*" is just as poor of a strategy, as bullish prognosticators forget about the importance of capital destruction as it relates to portfolio returns over time. What you have likely heard is:

> *"Losses, sometimes big ones, are just part of investing in the stock market. If you aren't prepared to lose big you can't win big and therefore shouldn't invest in stocks."*

Why should I need to be prepared to lose a large amount of value from my portfolio? Why can't I at least apply some simple risk management tools, combined with a lower volatility portfolio allocation model, to create returns over time with a lower risk of major drawdowns? After all, is this not one of the most basic tenants of investing: "*buy low/sell high?*"

Managing the Risk

There are no great investors of our time that "*buy and hold*" investments. Even the great Warren Buffett occasionally sells investments. True investors buy when they see value and sell when value no longer exists.

While there are many sophisticated methods of handling risk within a portfolio, even using a basic method of price analysis, such as a moving average crossover, can be a valuable tool over the long term holding periods. Will such a method ALWAYS be right? Absolutely not. However, will such a method keep you from losing large amounts of capital? Absolutely.

The chart below shows a simple moving average crossover study. What is clear is that using a basic form of price movement analysis can provide a useful identification of periods when portfolio risk should be **REDUCED**. Importantly, **I did not say risk should be eliminated; just reduced.**

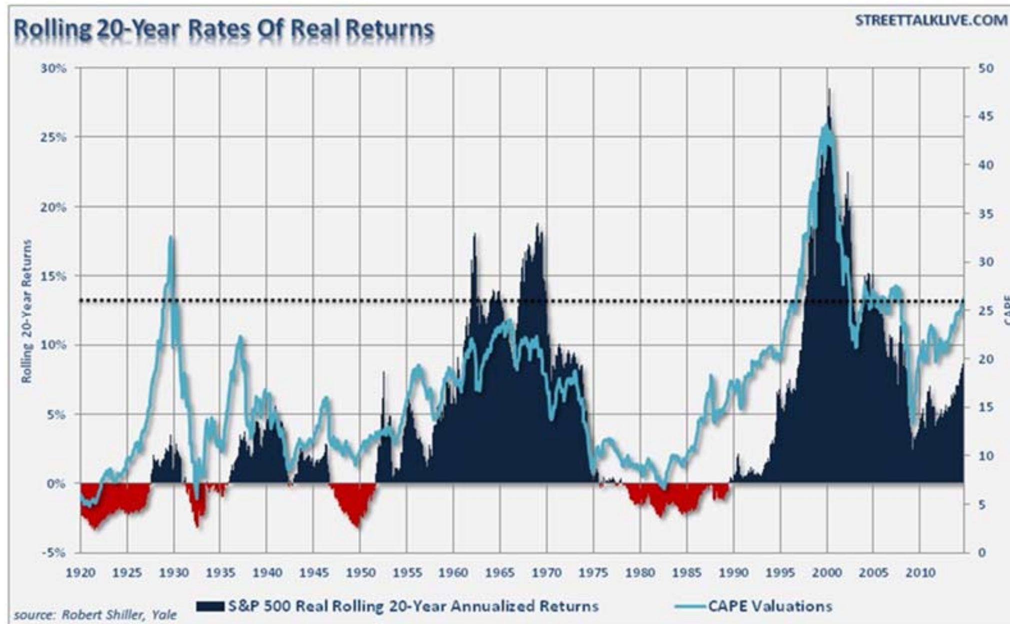
Again, I am not implying, suggesting or stating that such signals mean going 100% to cash. What I am suggesting is that when "*sell signals*" are given that is the time when individuals should perform some basic portfolio risk management such as:

⇒ *Trim back winning positions to original portfolio weights.* ***Investment Rule: Let Winners Run***
⇒ *Sell positions that simply are not working (if the position was not working in a rising market, it likely won't in a declining market).* ***Investment Rule: Cut Losers Short***
⇒ *Hold the cash raised from these activities until the next buying opportunity occurs.* ***Investment Rule: Buy Low***

Missing the 10 Worst Days
The reason that portfolio risk management is so crucial is that it is not "*missing the 10-best days*" that is important, rather it is "*missing the 10-worst days.*" The chart below shows the comparison of $100,000 invested in the S&P 500 Index *(log scale base 2)* and the return when adjusted for missing the 10 best and worst days.

Clearly, avoiding major draw downs in the market is key to long-term investment success. If I am not spending the bulk of my time making up previous losses in my portfolio, I spend more time **compounding my invested dollars towards my long term goals.**

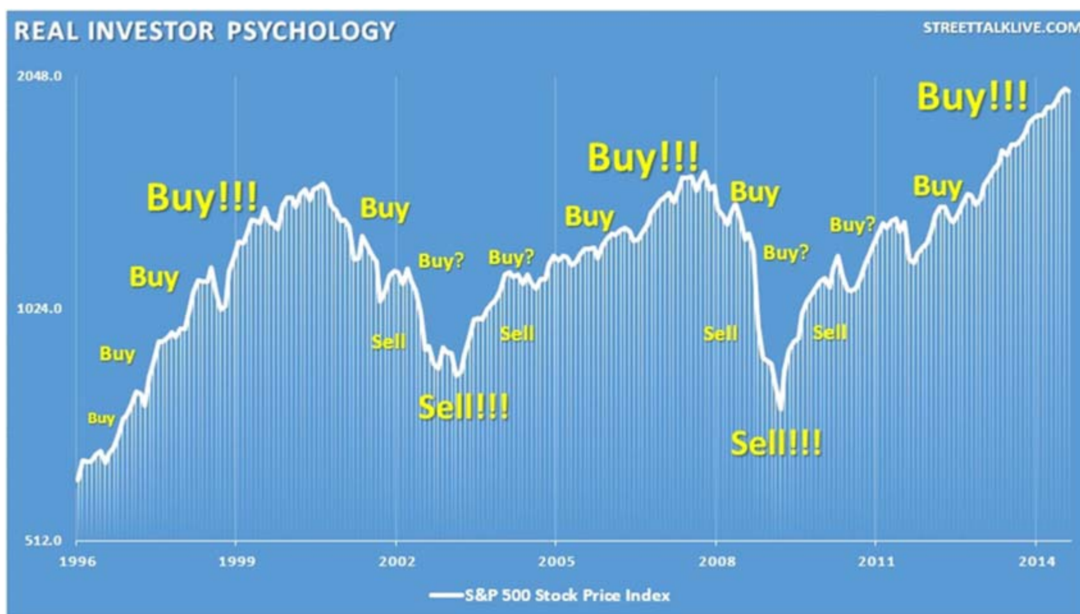
You Can't Handle the Volatility
Despite the mainstream attempt at convincing you that it is "*time in the market*" (otherwise known as buy and hold) that matters, the reality is that there have been many periods in history where you simply "*ran out of time.*" As shown below, when adjusted for inflation, there are several 20-year periods where market returns have resulted in either low or negative outcomes.

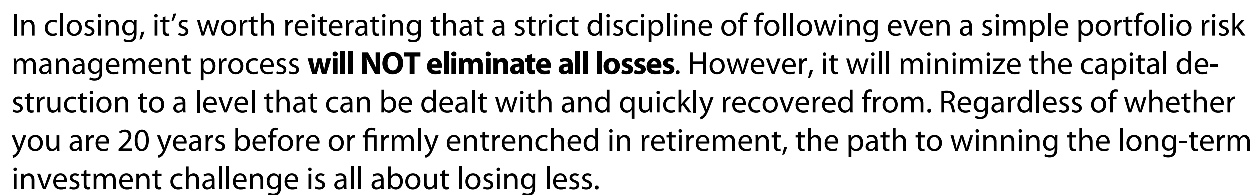


Of course, such dismal forward returns **have only occurred when the starting 10-year cyclically adjusted P/E ratio was above 23x earnings.** Based upon history, being in the market any point higher than this suggests that "*time in the market*" may not be as beneficial over the next 20-years.

More importantly, it is the "*human factor*" that leads to the poorest of outcomes over time. When markets are strong and trending positively, the emotion of "*greed*" leads a diminishment as to the understanding of risk contained within portfolios. Even the worst possible investment mistakes are masked by a strongly rising prices. (It is near the peak of these periods when articles espousing "*this time is different*" and chastising those that "*missed the rally…*")

However, it is only after a significant decline in prices, and a large amount of capital destruction, that individuals "*panic sell*" to stop the "*pain of loss*" as the risk in portfolios is realized. This is where investors do the most damage to their long-term goals. The following "*investor psychology*" chart makes the message agonizingly clear.




In closing, it's worth reiterating that a strict discipline of following even a simple portfolio risk management process **will NOT eliminate all losses**. However, it will minimize the capital destruction to a level that can be dealt with and quickly recovered from. Regardless of whether you are 20 years before or firmly entrenched in retirement, the path to winning the long-term investment challenge is all about losing less.

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