Is Your Portfolio Prepared for a Market Drawdown?

361 CAPITAL

Humans seem hard-wired to emphasize offensive gains—both in investing and sports. Basketball games are remembered by fast-break slam dunks, not the steals that create them. Investing is no different. Bull markets command attention causing investors to focus more on the gains in their portfolios, and less on the portfolio's ability to protect, in the event of a market drawdown.

Investors often forget the understated—but crucial—role protection from market drawdowns plays in determining long-term outcomes. Yet the ability to pare back losses during the inevitable downturns that come with investing, actually matters more to the end goal than eking out every bit of a bull market's gains.

As the current U.S. equities bull market crosses ten years—the longest run ever—the importance of mitigating loss is worth remembering. This article details why goal-oriented investors should place more emphasis on playing defense and minimizing drawdowns to their portfolio.

A Long Way Down, an Even Longer Crawl Back

Bear markets are unavoidable for anyone investing over the long haul. How a portfolio weathers those downturns has a critical impact on the investor's end destination. This is because steep market drops create large holes from which to dig out. As the loss grows, so too does the return needed just to get back to the original, pre-downturn starting point. Consider the math: A loss of 10% requires just an 11% gain to recover, while a 50% loss requires a 100% gain to recover and a 60% loss requires an even more daunting 150% gain to simply return to even.

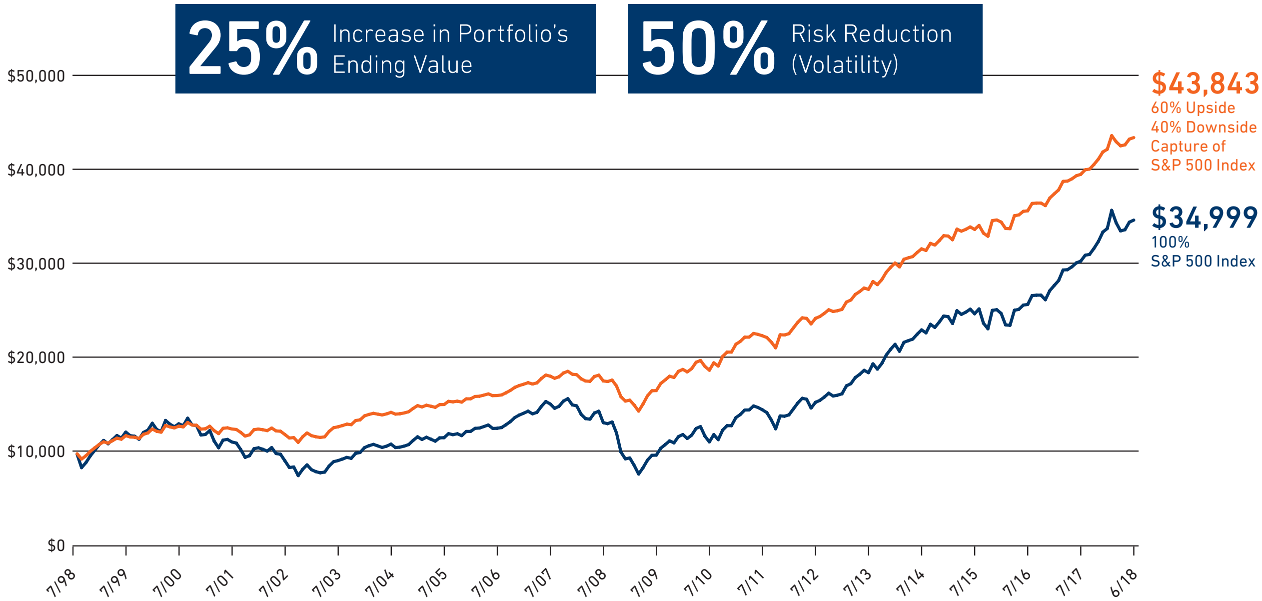
The chart on the next page demonstrates how important it is to limit drawdowns, and shows that minimizing loss may be more important than fully participating in the market's gains.

The blue line represents the performance of the S&P 500 Index. It shows where a portfolio would end if it participated in 100% of the market's gains, but also took full part in its losses.

KEY TAKEAWAYS

- Minimizing drawdowns has a bigger effect on long-term returns than capturing all the market's upside.
- Investors must consider drawdown risk as they near retirement as they may not have time to rebound from significant losses.
- Lesser drawdowns mean an easier and quicker recovery after down markets—potentially leaving your clients in a better position to compound returns when things bounce back.

The orange line represents a portfolio that participated in 60% of the S&P 500's gains, but experienced only 40% of the S&P 500's downside during market declines. Over time, investors would be much closer to reaching their investment goals with the more defensive approach.



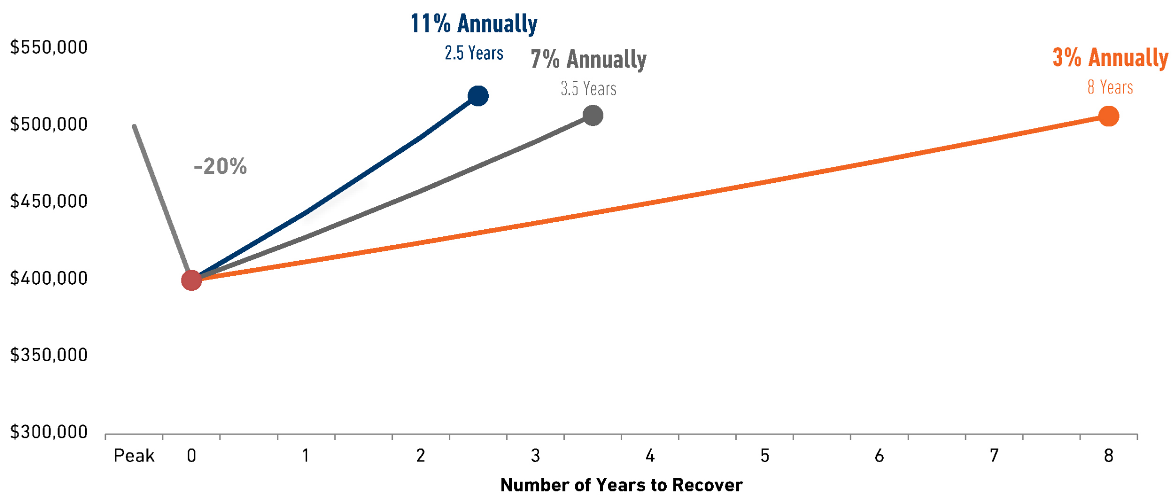
Past performance does not guarantee future results. The blue line represents a hypothetical $10,000 investment in the S&P 500 Index. Source: Morningstar. Data from 07/1998 - 06/2018. Volatility as measured by standard deviation.

Recovery Time Matters for Most Investors

Recovering from a drawdown is even more daunting when one considers the time it takes to get back to the starting line after a large loss. The chart below shows the time to recover after a 20% market drop under different performance scenarios. For young investors just starting out, the time to recovery is perhaps less concerning. Not so for their older counterparts, however. Older, and even middle-aged investors, must carefully consider drawdown risk to avoid large losses as they near retirement.

No Time to Lose

Investors may not have time to rebound from significant losses.



Large Drawdowns Have Psychological Impacts

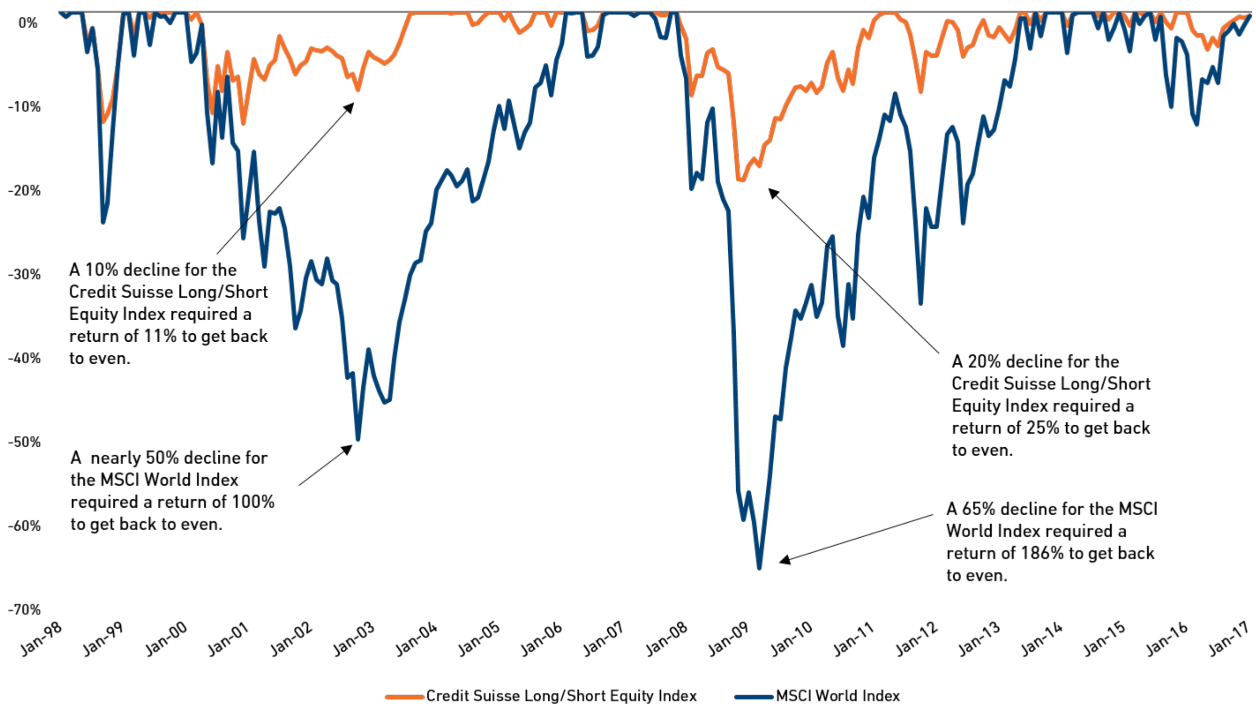
As the first chart shows, minimizing drawdowns has a bigger effect on long-term returns than capturing all the market's upside. The chart doesn't account for investor behavior after large losses, however. That behavior may amplify the drawdown's impact.

Large losses can scare investors and push them to the sidelines at precisely the wrong time, causing them to miss the market's rebound. If losses are less severe, it can keep the investor on track with their allocation to equities that is needed to meet their long-term goals.

Long/Short Equity Strategies Help Play Better Defense

Investors can make their portfolios more defensive by adding strategies that experience smaller drawdowns during severe downturns. Long/short equity strategies may offer a unique way to achieve that goal, because they help minimize drawdown but still allow clients to participate in equity markets' upside. By going long, the strategies gain ground when markets rise but, as the chart below shows, historically long/short equity strategies had experienced much smaller losses in bear markets than a typical long-only strategy.

Managing the Downside



Source: Morningstar. Data from 1/1/1998 to 1/1/2017.

Conclusion

In an offensively-minded world, the importance of a good defense is easy to overlook. But strategies that minimize drawdown play an important role within all client portfolios. Lesser drawdowns mean an easier and quicker recovery after down markets—potentially leaving your clients in a better position to compound returns when things bounce back. Minimizing drawdowns can also discourage some of the behavioral mistakes often associated with bear markets, such as running to the sidelines and missing an equity market rebound.

As your clients near retirement, they will be unlikely to remember their portfolios' performance during a bear market while they're enjoying the post-game celebration. However, you can be confident knowing the unsung heroes played their part when it was needed most.

For more:
Call 866.361.1720 or visit 361capital.com.

About 361 Capital

361 Capital is a leading boutique asset manager focused on alternative and behavioral-based equity solutions that seek to deliver meaningful alpha, manage risk and offer diversification potential to investor portfolios. Founded in 2001, we offer a suite of investment products including Long/Short Equity, Managed Futures, Market Neutral, Macro, as well as Small, Mid and Large Cap Equity.

The S&P 500® Index is a commonly recognized, market capitalization weighted index of 500 widely held equity securities, designed to measure broad U.S. equity performance.

The MSCI World Index is a free float adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The index includes reinvestments of dividends, net of foreign withholding taxes.

The Credit Suisse Long/Short Equity Hedge Fund Index which is a subset of the Credit Suisse Hedge Fund Index that measures the aggregate performance of dedicated short bias funds.

Indexes are unmanaged and it is not possibly to invest in them directly.

Standard Deviation is a statistical measurement of performance fluctuations. Generally, the higher the standard deviation, the greater the expected volatility of returns. **Drawdown** is the peak-to-trough decline during a specific record period of an investment, fund or commodity. A drawdown is usually quoted as the percentage between the peak and the trough.

April 2019

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