Reducing Equity Market Volatility Using Long/Short Equity

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

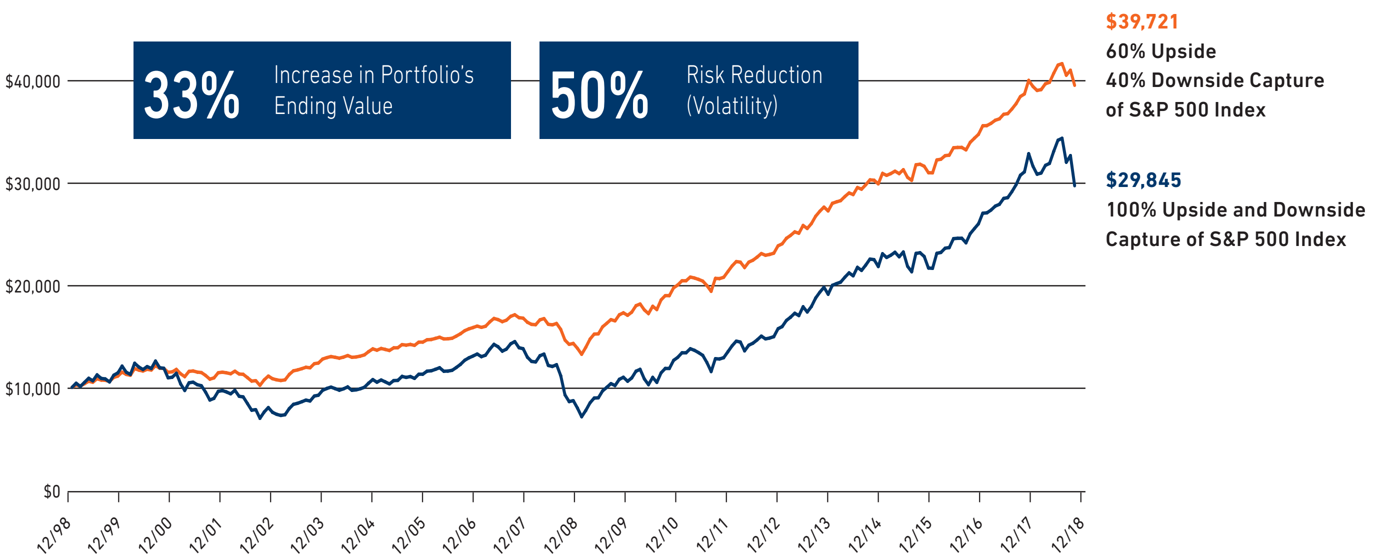
As the current U.S. equity bull market crosses 10 years—the longest run ever—the importance of mitigating loss is worth remembering. This article details why goal-oriented investors should place more emphasis on playing defense and minimizing drawdowns to their portfolio.

A Long Way Down. An Even Longer Crawl Back.

Market corrections 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 below demonstrates how important it is to limit drawdowns, and mitigate volatility in an effort to enhance a clients dollar-weighted return.

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 100% of its losses. 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 closer to reaching their investment goals by reducing wild market swings.



Past performance does not guarantee future results.
Source: Morningstar. Data from 07/1998 - 12/2018. Volatility as measured by standard deviation.

KEY TAKEAWAYS

- Minimizing drawdowns may have 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.

Enhanced Return Potential

Hedged equity strategies, such as Long/Short Equity, that maintain a lower net equity exposure, while pursuing alpha, can play a vital role in an investor's portfolio. This is achieved by minimizing downside risk in the event of a downturn, while still offering equity market participation and enhanced return potential over the long term.

When implemented as part of an integrated portfolio strategy, allocations to Long/Short Equity provide investors with the potential to capture equity-like returns while managing volatility and drawdown risk compared to a long-only equity approach. As a result, Long/Short Equity may improve a client's overall experience—keeping them invested across market cycles so that portfolio assets can continue to work and the power of compounding can be fully realized over the long term.

Summary

Long/Short Equity strategies seek to capture equity-like returns while managing downside risk—enhancing the overall risk/return profile of an investor's portfolio. 361 Capital's Long/Short Equity strategies, sub-advised by Analytic Investors, take advantage of the low volatility anomaly by owning lower risk stocks and shorting higher risk stocks, and dynamically allocating to high predicted alpha stocks to generate meaningful alpha from both long and short exposures.

For additional viewpoints:
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.

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