Professional investors face a daunting challenge: how to generate real returns sufficient to meet the needs of clients over the next decade or so, while protecting against the inevitability of bear markets and black swans. We believe that this will be the defining challenge for the advisory industry over the next decade, and it won’t be easy to overcome. We’ve learned over time that it’s not enough to have a plan; you have to follow through.

The Dangers of Investing Complacency

Risk management isn’t simply about judging the probability of a loss, but also the magnitude.

A False Sense of Security

It’s not surprising that investors may have been lulled into a false sense of security with the market experiencing historically low volatility in 2017. However the volatility that emerged in 2018 should have reminded investors that risk management is boring until it’s not; just ask any security guard or TSA official. And risk management isn’t simply about judging the probability of a loss, but also the magnitude of a loss should one occur.

Ten years have now passed since the stock market bottomed out during the financial crisis. U.S. equities have annualized at between 16.9% for the largest companies (based on the Russell Top 200 Index) and 18.7% for mid-sized companies (based on the Russell Mid-Cap Index as of 12/31/2017), with micro-cap and small-cap stocks falling in between. These outsized gains, along with our temporal distance from the pain felt during the crisis, have made it increasingly difficult to stay invested in risk-mitigating strategies.

The Importance of Limiting Loss

However, last year ushered in a new period where volatility will be more in line with historic levels (i.e., much higher than previous years), requiring investors to remain diligent about risk management. While equity valuations continue to rise along with uncertainty over interest rates, investors need to consider what changes are necessary to position themselves for potential increases in volatility in the coming years. As we’ve pointed out many times, the math of a big loss is daunting.

KEY TAKEAWAYS

• While sustained volatility has been absent for an extended period, investors need to consider what changes are necessary to position themselves in the years to come.

• Risk management should be of primary concern given equity valuations and interest rates.

• Investors should be assessing the risks in their portfolios now, and explore strategies that have the flexibility to go both long and short.
54 percent decline when all was said and done. To put this into context, a loss of 10 percent requires an 11 percent gain to recover. However, as the loss grows, so does the size of the return needed to recover. Indeed, a 50 percent loss requires a 100 percent gain to recover and a 60 percent loss requires a 150 percent gain just to get back to even.

The Gains Required to Recover from a Loss

The Risk to Retirement

With market indices once again hitting all-time highs and pre-retirees all too eager to ride the equity wave, the issue of complacency—and danger—is apparent. Too many investors fail to realize that it’s not only about the loss of monetary resources, but also the loss of time in which to make them back. For young investors just starting out, its impact is negligible. Not so for their older counterparts, one reason sequence-of-return risk rises with time, and at its highest just before retirement.

A $500,000 Portfolio’s Recovery From a 20% Decline
The Time is Now

While we don’t know what 2019 will bring, investors should be assessing the risks in their portfolios now, before the next downturn begins, and explore strategies that have the flexibility to go both long and short. If the concern is equity market volatility, then long/short equity or equity market-neutral strategies should be considered. If rising default rates in the bond market are worrisome, consider long-short credit strategies. If you are searching for a source of returns that has a low correlation to traditional assets, consider managed futures funds. But whatever you do, remember this, protection from adverse market events needs to be in place prior to the occurrence of those events in order to be effective. If the due diligence report on that long/short equity fund you’ve been “watching” is gathering dust on your desk when the market takes a 20% hit, it won’t matter that you started to prepare, only that you failed to implement.

For more insights:
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.

Russell Top 200 Index is a benchmark index for U.S.-based large-cap stocks; the average member has a market cap above $100 billion. The index is reconstituted annually to account for new members and growing companies.

Russell Mid-Cap Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index. You cannot invest directly in an index.

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