Volatility and Downside Management

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The coronavirus – and the attempt to control the virus by shutting down the economy – precipitated the fastest stock market* drop on record from the high in February to the nadir on March 23rd.

Both markets have recovered somewhat since then. An extremely quick stimulus response by the Fed and Congress and hopes of a vaccine resulted in both equities and bonds finding their feet.

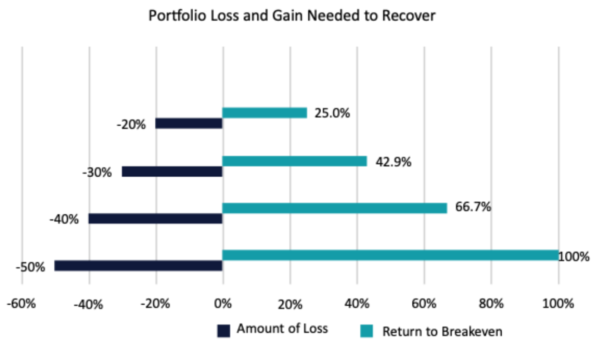
However, the recovery has just begun and there's a long way to go with the potential for volatility ahead. What will the next bout of volatility bring? We delve into the history of downside volatility and the timeline for recovery under several scenarios, and then discuss investment approaches investors can use to mitigate volatility.

THE HISTORY OF LARGE MARKET DECLINES

A review of past market declines can be valuable to an investor. While over the long-term stock market annual returns average 10%[1], large market declines in any given year are not uncommon. Since 1930, there have been eight years in which the stock market as represented by the S&P 500 lost between and 10 and 30%, and three years in which the market was down by more than 30%. Every decade except the 1990s saw a significant decline.[2]

LOSSES REQUIRE A LARGER RECOVERY TO RETURN TO EVEN

Recovering from a decline in your portfolio means that the assets have to grow in value by a larger amount than the loss to get the portfolio to "breakeven." For example, a 50% drop requires that the portfolio recover 100% over its present value to return to its starting point. The chart below demonstrates a range of losses and illustrates how much return is required to make the portfolio whole.



Source: Beacon Capital Management

HOW LONG DOES IT TAKE TO BREAKEVEN AFTER A DROP?

We've seen in the chart above that getting to breakeven requires a sustained period of positive return. The table below translates the return to breakeven period into years and assumes a stable 10% return in the years after a significant market drop.

For example, a 50% drop will take 7.3 years to recover. As the drops get steeper, recovery time starts to lengthen. As we've seen, the markets don't always achieve multiple consecutive years of positive returns – so recovery could take considerably longer.

Amount of Loss	Years to Breakeven at 10%
-50%	7.3
-40%	5.4
-30%	3.7
-20%	2.3

Source: Beacon Capital Management

INSTITUTIONAL INVESTOR PORTFOLIO MANAGEMENT TACTICS

How does this translate to portfolio management? Simply put, many investors are willing to forgo some of the capital growth upside of an investment if that means limiting the losses, and that can be a very powerful investment management concept. Certain investors have been managing these trade-offs for decades.[3]

Institutional investors, especially pension fund managers who need to generate income to pay off future liabilities, were early adopters of methods that limit losses. They have since been at the forefront of strategies that can simultaneously produce return while limiting downside risk.

How do they achieve this? The first step is effective portfolio diversification. This requires investing in assets that are not correlated to one another. A diversified portfolio can potentially achieve higher returns for a given level of risk. A portfolio is designed not to earn the highest possible return, but to earn the highest possible return for an investor's risk tolerance.

EXPANDING DIVERSIFICATION FOR TODAY'S MARKETS

One problem for today's investor is low interest rates. Previously, bonds were not only an effective hedge – a strategy that limits downside risk – but also could be a reliable source of income. In today's world, bonds are struggling to outpace inflation. As yields have been holding at very low levels for some time, investors have been looking outside of traditional fixed income options.

Many investors are turning to portfolios that incorporate alternative strategies. These include both liquid alternatives, which have a lower correlation to equities, or illiquid alternatives which can offer increased yield through the illiquidity premium. The alternative strategies also often offer increased diversification, as the instruments they invest in may be more diversified by sector and geography than traditional core bond portfolios.

VOLATILITY AND DOWNSIDE MANAGEMENT: A KEY PART OF YOUR INVESTMENT STRATEGY

Alternative investments can be an essential building block to mitigate equity market declines. Taking the historical impact of volatility into account when creating your investment plan and understanding the potential for an effective downside management strategy can not only have benefits for your portfolio, it can help you be a more sanguine investor as well.

To learn more about the volatility and downside management, please contact your financial professional.

* S&P 500

[1] Maverick, J.B. What Is the Average Annual Return for the S&P 500? Investopedia. February 19, 2020.

[2] Source: Standard & Poor's.

[3] Montier, James (2002) Behavioural Finance Wiley p21-22.