Volatility is Your Friend… If Approached Correctly

Most investment strategies make money when the market is going up - that's easy. The great strategies, however, are those that avoid giving most of it back in down periods. It's natural in times of market volatility to think about going to cash or increasing your allocation to bonds. However, increasing your allocations to equities surprisingly may give you the downside protection you seek while providing better growth potential over the long term, provided you have the right strategy.

Beacon Pointe's recommended managers invest for stability and growth. They move beyond the constraints of index composition and rigid style characteristics, and focus instead on finding what they believe are the best investments for their clients. As a result, they tend to protect capital better than their peers when markets are negative, AND MORE IMPORTANT, in meaningful market downturns when most others are selling, they are able to put cash to work and buy stocks of great companies at prices well below their intrinsic value. Both of these investing traits allow them to compound growth faster than their peers over time.

Let's look at an example that highlights the importance of protecting capital in down markets. Take a look at Investment A and Investment B below. Which investment made more money at the end of the two-year period?

	Beginning Investment	Return in Year 1	Return in Year 2
Investment A	$100	-11%	20%
Investment B	$100	-38%	60%

If you said Investment A, you're right. If you chose B, then you need to understand the following explanation carefully. We are going to assume that each of these investments was made with an initial investment of $100.

	Beginning Investment	Return in Year 1 (%)	Value of Investment at End of Year 1	Return in Year 2 (%)	Value of Investment at End of Year 2	Total Return over 2 Years (%)
Investment A	$100	-11%	$89	20%	$107	7%
Investment B	$100	-38%	$62	60%	$99	-1%

Yes, Investment B had a huge return in Year 2 of 60%, but that 60% return was on $62, because of the destructive loss it sustained in Year 1. However, that 60%, as you can see above, does not even get this investment back to break-even over the two-year period! In contrast, Investment A returned just 1/3 of what Investment B returned (only 20%) in Year 2, but because it only lost 11% in Year 1, it returned a positive 7% over the two-year period and outperformed Investment B by a total of 8%. The key here is the downside protection.

Think of negative returns like digging yourself a hole. The more negative the return, the deeper the hole you dig for yourself and the harder it is to get out. Another way to say this is that the more negative the return, the higher the return must be to get back to break even, and to continue growing your investment again. Such large losses disrupt the compounding mechanism. For example, the mathematical reality of capital destruction means that:

- If you lose 10%, you need to make 11% to get back to even;
- If you lose 25%, you need to make 33% to get back to even;
- If you lose 33%, you need to make 50% to get back to even; and
- If you lose 50%, you need to make 100% to get back to even.

Investment A represents that of a prudent investor. He uses flat to up markets (i.e. Year 2) to grow his portfolio. His portfolio during these periods will often *not* capture all of the upside of the market. Nevertheless, he outperforms his peers over a full market cycle (i.e., a bull market and a bear market), because he protects capital so well in down markets (i.e. Year 1). This is the type of investing we favor at Beacon Pointe. Not only does it grow capital over full market cycles, but it does so in a way that minimizes risk (and anxiety!) while allowing our clients to meet their investment goals. Most investment strategies can make money when the market is going up - that's easy. The few great strategies, however, are those that avoid giving most of it back in down periods.