It’s Not What You Make But What You Keep That Counts

Saturday’s With Jim

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Dear Friends,

Today we discuss the critical factor of when we invest and how we neutralize the downside of investing at market highs. Skip to the last section if you find investment examples a slog.

Explaining Sequence of Return Risk

Sequence of return risk is most powerful at the beginning of a series of years of either rising or falling market prices. We take sequence to mean the order of a market trend (up or down) over several years. Sequence of return risk exists because returns are compounded from year to year; a prior year’s value feeds into the new year’s beginning value. An example below shows how sequence of return risk can ruin our investing experience. The example shows wealth accumulating, but sequence of return is probably most dangerous for retirees as they withdraw money from their investment accounts.

Take a $100,000 initial investment at a market low which grows to $300,000 over a ten-year bull market. That’s a nice 200% gain, but suppose the account is down 50% in a bear market. That will leave just $150,000 - only a $50,000 profit.

The same $100,000 invested at a market top loses $50,000, or half of the principal in an ensuing bear market. Suppose the next bull market raises the balance by 200% as in the prior example. The investor gains $50,000, equal to the gain in the above example. So, where is the sequence of return risk if the total market cycle gain is the same whether starting at the beginning of a bear or a bull market?

Not Just Mathematical

How many of us can withstand cutting our capital in half right out of the gate? How many of us would have the confidence that we could regain our money and then some in a coming bull market? It’s one thing to see a profit severely sliced, but it’s another to see our capital cut into deeply. What if we could find a way to neutralize sequence of return risk?

Beating Sequence of Return Risk: Invest Conservatively at Tops, More Aggressively at Bottoms

Leaving aside the important question of how we'll identify market tops and bottoms, let's see how our $100,000 might fare if our stock/bond allocation varies with the risk that the markets are presenting to us. In attempting to maintain a level risk exposure for our accounts, we hold more stocks when market risk is low and lighten up on stocks when market risk is high.

Suppose we're conservative as we invest at the market top, dropping capital from $100,000 to $75,000 at the low. In the ensuing bull market, we ratchet up risk as permitted by our investment policies and gain 175% rather than the 200% gain the market provides. We always want to have at least a slightly lower exposure to risk than the unmanaged stock market has. We'll end up with $206,250, beating the market by $56,250 (a bit more than one third) – and with lower overall risk. As seen from the above example, we don't need to match the market's performance in a bull phase to get a very respectable return. But we do need to excel in bear markets; falling less in bear phases is the cornerstone of our investment strategy.