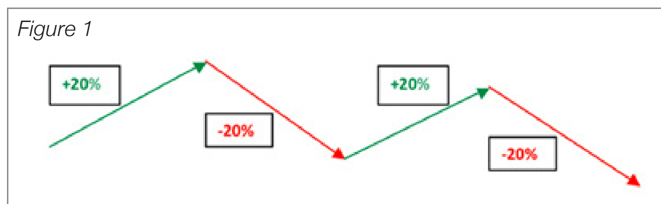
Why we manage for risk
and not just return

We play defense first and offense second to try to win the game

As an active money manager, we believe that risk management is the most important ingredient for investment success. While Wall Street talks about diversifying asset classes to manage risk, we add active management and strategic diversification to our defensive toolbox to combat market volatility.

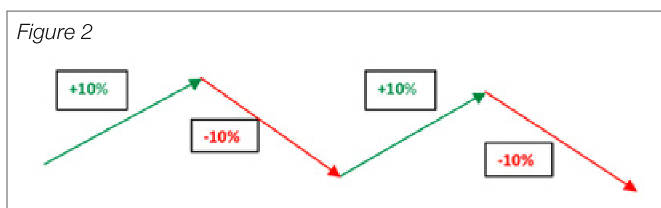
Let's start with a simple market environment. Since everyone seems to agree that a 20% increase in stock prices marks a bull market, while a 20% loss defines a bear market, let's assume for our example that the market rises 20% one year, then falls 20% the next and then repeats that, rising 20% and then again falling 20%. It would look something like *Figure 1*.

Figure 1



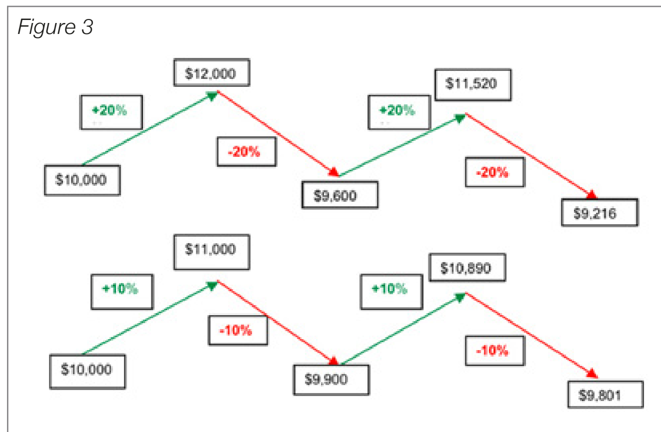
Now, what if you were a market timer—but weren't very good—and you were only able to avoid half of the loss on the downside and capture only half of the gains on the upside? Your client's account would look like *Figure 2* for the same market environment.

Figure 2



So the first scenario has a "buy-and-hope" investor holding on through two 20% market cycles, while the other has the 50-50 market timer avoiding half the market's losses but only capturing half the market's gains through the same two 20% market cycles. Which investor did better? We'll add the values along the way for an initial $10,000 investment in *(Figure 3).*

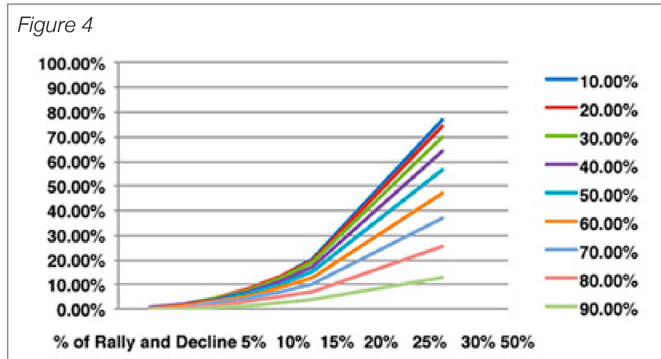
Figure 3



That's right—the so-so market timer's clients did better than one who bought and held in the same market environment. In fact, the market timer did 6.3% better. Yes, they both lost money, but when it came time for the market to rally, the timer only needed a 2% gain to get back into the black, while the buy and hoper at that point would still be in the red, as he would have needed a gain of 8.5% to get back into the black. So even though the timer only captured half the market's gains or losses, it would take the buy and hold investor more than four times the gain to catch up.

Interestingly, you get the same results whether the market cycles are 5% or 50% or anywhere in between *(Figure 4)*. And it doesn't matter whether the market timer's capture of the gains and sustaining of the losses equals 5% or 95% or anything in between. The result is ALWAYS the same – the active manager beats the buy and hold investors… as long as you evaluate it after a full market cycle.

Figure 4



The caveat is, of course, "as long as you evaluate it after a full market cycle." Why? Because, obviously, if you start out with a

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Sources (Figures 1-4): Flexible Plan Investments, Ltd.

gain and one investor gets 100% of it and the other achieves just half of it, the 100% investor is going to win if you stop measuring at that point In both of our examples, the buy and hold investor was ahead after the market made its first leg up, yet he trailed at every other juncture.

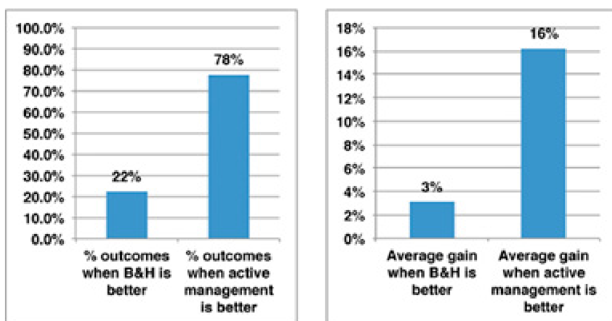
Playing with numbers can be fun and, it is said, you can prove anything with statistics. So I noodled around with these numbers for quite some time and found that part of the secret is that the amount of gains captured and losses sustained is assumed to be symmetrical, i.e. equal. That's why when you combine it with the mathematics of losses (you know, when you lose 50% it doesn't take a 50% return to get back to breakeven, it takes a 100% gain), it ALWAYS works.

But we know that in real life not all things are symmetrical. You might get 60% of the gains but only avoid 40% of the losses. So I did some more research and did the math.

It turns out that active management's outperformance is mostly a function of the size of the rally and decline and the amount of the gains captured. When testing gains captured and losses avoided in 10% increments from 20% to 60% for the gains and 40% to 80% of the losses, I found that any time we've had a rally and decline of over 50%, the active management beat buy and hold, regardless of the capture or avoidance percentage. And it seems avoiding just about any percent of the loss results in a superior result.

But when you drill down into the few times buy and hold does better, buy and hope most often wins when we are not looking at 20%-plus bear market declines but rather the 5%, 10% or 15% cycles, and then only when the gain captured is less than 50%. Looking at all of these percentages and various rally and decline percentages, we came up with these graphs.

Figure 5

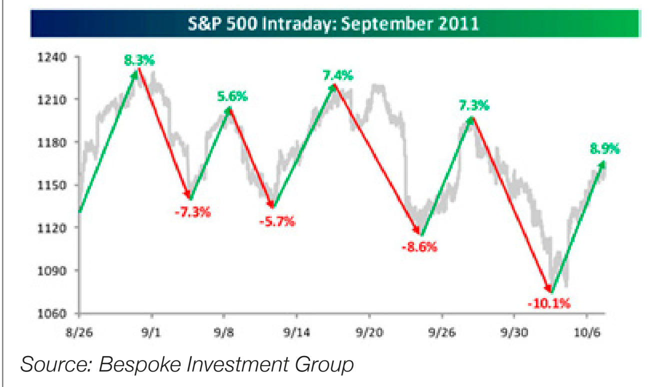


Source: Flexible Plan Investments, Ltd.

The research embodied in *Figure 5* clearly demonstrates that active management has an overwhelming advantage over buy and hold. It outperforms more often and it does so when it really counts.

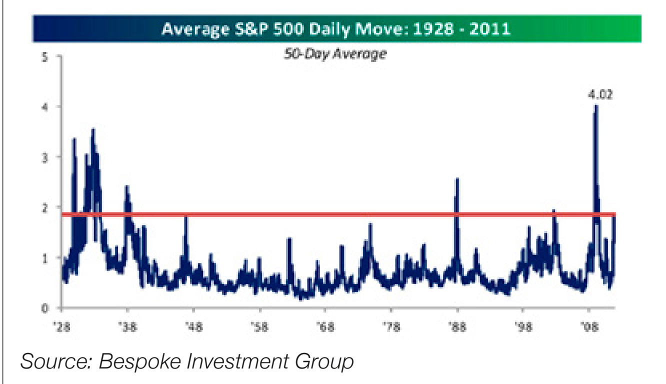
Now, of course, all of this discussion is not simply academic. This last quarter had one of those 15% declines and many market indices declined in bear market percentages (more than 20%). And the price action was very volatile, as *Figure 6* below shows. Even on a daily basis, the number of 1% up and down days was soaring, and on a thirty-day count (*Figure 7*) was at levels rarely seen in the last 80 years.

Figure 6



Source: Bespoke Investment Group

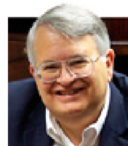
Figure 7



Source: Bespoke Investment Group

To deal with such volatility, it is necessary to do more than just actively invest. As we've been preaching for over fifteen years, the best defense is to combine portfolios matched to responses to our suitability questionnaire, with active management and strategic diversification. We do this with most of our suitability based strategies.

In contrast, the buy and hold argument seems like believing you'll win a football game just because you're ahead at halftime. That is why they play the whole game, isn't it?



Jerry Wagner
President, Flexible Plan Investments

PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.

Inherent in any investment is the potential for loss as well as profit.
A list of all recommendations made within the immediately preceding twelve months is available upon written request.

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