WHY WE FOCUS ON LOSS AVOIDANCE

DAVID GATTI
Chief Investment Officer

"An ounce of prevention is worth a pound of cure."
Benjamin Franklin

DEFENDING CAPITAL AS A PRIORITY

Our focus at RPg around risk and risk management starts with the simple question of "how much can I lose in a short period of time?" followed by: "how rough of a ride will it be?" As a means of exploring a view that is different from the traditional buy-and-hold philosophy, our attention at RPg is drawn to avoiding loss. Our thought leadership is designed to shift paradigms into dynamic views around risk, risk management, and the impact of accelerated volatility during extreme market events. We believe market volatility rises and enters a new regime when the market declines. The journey of shifting this paradigm is not a smooth one as the embedded thought around how risk is defined has been engrained in our industry for decades along with the benchmark-centric buy-and-hold approach to investing.

A common theme defending the buy and hold strategy is focusing on the effects of missing the 10 best days of market performance and how that would impact portfolio performance. But the best days are only one side of the story. What would happen if you miss the 10 worst days of the market?

Missing the 10 best days of market performance will in fact lower portfolio returns. From 1928 through 2011, a $1 investment in the S&P 500 would have grown to over $71[1] adhering to a buy and hold strategy that captured the performance of each and every day. However, if you missed the 10 best days of market performance in those 84 years, $1 would have grown to just over $23[1]. Herein lies the basis for the buy and hold philosophy to not miss the 10 best days.

At RPg we believe long-term investment success is determined by positive compounding on gains. With that in mind we looked at the experience of an investor who missed the 10 worst days for the same period (1928-2011). We found that $1 investment in the S&P 500 would have turned into over $226, more than 3X the buy and hold investor.

RPg asset management
Defending Capital. Redefining Risk.

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We focused on studying the impact on portfolio returns when missing the 10 worst days, but fully recognize that stopping there is also only part of the story, and can be just as misleading as only looking at missing the 10 best. How is an investor to know when the best and when the worst days will be to be able to participate in the best and avoid the worst? Predicting when these days will occur is extremely difficult – if not impossible.

From 1928 through 2011 A $1 investment in the S&P 500 would have grown to over $71[1] adhering to a buy and hold strategy.

If you missed the 10 best days of market performance in those 84 years, $1 would have grown to just over $23[1].

For an investor who missed the 10 worst days for the same period (1928-2011), that $1 investment in the S&P 500 would have turned into over $226, more than 3X the buy and hold investor.

Growth of $1 in the S&P Index December 31, 1927 - December 31, 2011

[1]Sources: Bloomberg L.P., Invesco, Morningstar, Inc. All rights reserved. Past performance cannot guarantee comparable future results. Cash results are based on the Ibbotson U.S. 30-Day T-Bill Index.

It should come as no surprise that many of the worst performance days hit during bear markets. However, interestingly so did many of the best performance days. As a rules and momentum based asset management firm, that if we're seeking to avoid bear markets, we're going to miss our share of the 10 worst and 10 best days given the proximity of the best and worst days.

10 best and 10 worst

The S&P 500 Index's highest and lowest days of performance have typically occurred during bear markets and in proximity to each other, making it virtually impossible to avoid the worst days while capturing the best days.

10 Best days		10 Worst days	
Date	Return (%)	Date	Return (%)
10/30/1929	12.53	10/28/1929	-12.94
6/22/1931	10.51	10/29/1929	-10.16
10/6/1931	12.36	11/06/1929	-9.92
8/8/1932	9.26	10/5/1931	-9.07
9/21/1932	11.81	7/20/1933	-8.88
3/15/1933	16.61	10/18/1937	-9.12
4/20/1933	9.52	9/3/1946	-9.91
9/5/1939	11.86	10/19/1987	-20.47
10/13/2008	11.58	10/15/2008	-9.03
10/28/2008	10.79	12/01/2008	-8.93

Source: Bloomberg L.P. Data as of December 31, 2011. Past performance cannot guarantee comparable future results.

Additionally, investors should be acutely aware of their investment needs and their personal timetable. Although $1 turned into over $71 from 1928 – 2011, many investors don't have 84 years to invest. Depending on an investor's investment goals and timetable, they may not have enough time to recover from the next bear market – even with help from the best days. This is where the paradigm shift needs to come into focus. Defining risk from the viewpoint of how much an investor can lose in a short period of time, or "maximum drawdown," aligns our goals to the investor's goals of loss avoidance. This creates an investment eco-system where investors can make calculated decisions about their investment plan rather than making reactive decisions during a time when they likely don't even want to think about investing.

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Loss	Necessary gain to recover from loss
-10%	11.1%
-20%	25.0%
-30%	42.9%
-40%	66.7%
-50%	100.0%
-60%	150.0%

Tactical Investing

Tactical investing can involve quantitative models that are used in an effort to reduce volatility and limit losses. Many strategies look and sound logical and have mass appeal especially at times when investors have fresh memories of significant market declines and multi-year bear markets that decimated portfolio values. In addition to adjusting asset allocation in anticipation of changing market conditions, ETF strategists may utilize sectors, sub-sectors, country rotation, leveraged strategies and many other combinations and strategies. With the S&P 500 trading at or near all-time highs, now may be a good time to speak with us about a thoughtful approach to tactical investing.