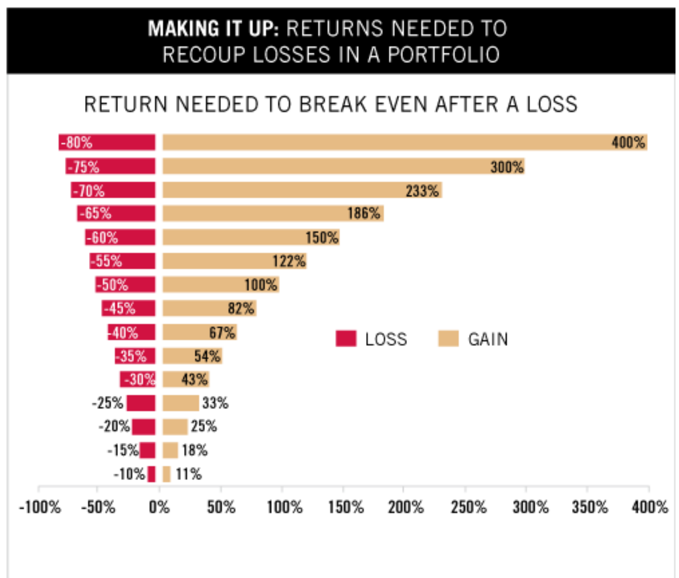
SECURITY NATIONAL BANK
WEALTH MANAGEMENT

The Importance of Lower Downside Participation

The recent market turmoil has reinforced the need for downside protection. Investors must incur some risk in order to realize an adequate return and stay on track with their financial goals. Higher returns usually also mean higher chances of a loss. Investors generally feel the pain of loss much more acutely than they enjoy the thrill of a gain. When stocks suffer large losses some investors give-up, throw in the towel and sell. They are unable to stay committed to their long term investment strategy.

Downside protection strategies aim to reduce the frequency and/or magnitude of losses. Large percentage losses require even larger percentage gains for the portfolio to fully recover (see chart below). Similarly, larger losses can mean it takes more time for the portfolio to be made whole.

For example, the S&P 500 index fell 49% between August 2007 (when the sub-prime mortgage crisis started) and February 2009. It took four years, as the market rallied 98%, to fully recoup those losses. Notice that the following gain was nearly twice as large as the size of the fall. For investors with shorter time horizons (such as those nearing retirement, or about to liquidate college savings funds), this can present a real financial planning problem. If you have a big setback, you'll need some pretty hefty returns to recover your investment within your time horizon.



Source: https://andersen.com/newsletter/2010/september/images/lossreturnchart.gif

There are a number of ways to mitigate losses during a bear market. The most common of which is through diversification and asset allocation. Diversification is the simplest way to reduce return volatility. A mix of investments, such as stocks and bonds, that tend to not move up and down in lock sync with each other, helps reduce volatility. This is because stocks and bonds often benefit from different economic environments such that when stocks fall in value, bond prices often rise. One of the most common portfolio allocations holds 60% in stocks and 40% in fixed income or bonds, which often provide lower, but more stable returns over time. This mix helps shield investment portfolios from large losses because bonds may rise in value when stocks sell off, reducing total portfolio losses. This helps the investor stay invested and avoid trying to time the market. If the investor is a bit more conservative, she often increases the percent invested in bonds, say 50% versus the standard 40%.

At SNB Wealth Management, we strive to get people in the right mix from the beginning. This helps keep our investors invested so they don't miss opportunities when the market turns around. We also go a step further, our first question when we select a stock or mutual fund is how will it react in a bear market? In aaddition, we avoid companies with too much debt. If a company has too much debt, it is likely to be hit hard during a recession.

By managing to the downside risk, we help investors stay on course with their investment strategy which helps them avoid common behavioral biases, such as panic selling at the market bottoms or panic buying at market tops. Avoiding behavioral traps such as these helps our clients accomplish their long-term investment goals.

We have been providing a series of weekly updates for the past several months with the goal of keeping you informed of what we're seeing, watching, and thinking. We hope these communications have been helpful as we navigated these turbulent times together. The market has recovered markedly since we began writing these updates, so we will be transitioning to a less frequent publishing schedule in the coming weeks. However, we are always ready to meet with you via phone and online video conferencing. Please do not hesitate to contact us about your investment needs. Even as our team has been working remotely due to the new social distancing imperative, each investment officer has the ability to service your needs and manage your portfolios.

Thank you,

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