

Endurance: It's not about who can go the fastest. It's about who can slow down the least.

From the start, the motto of Endurance Investment Strategies, Inc. has been, "It's not about who goes the fastest. It's about who can slow down the least." From a sports perspective, there is an obvious difference between sprinters and marathoners. Sprinters are fast. But in a marathon, being a sprinter doesn't help you. In fact, it may seriously hurt your performance since sprinting burns up too much energy, causing you to slow down later in the race. The same can be said of many endurance activities where it's more important to avoid hitting the dreaded "wall" of fatigue than it is to maximize speed and power.

"Sprinters are fast. But in a marathon, being a good sprinter isn't always helpful."

The motto reflects the guiding philosophy of Endurance Investment strategies, Inc. where avoiding large losses is more important than achieving high returns. It is derived from one of the most pernicious facts of investing: losses can hurt you more than gains can help you. This is such a foundational lesson of investing that it's a shame that many brokers and investment advisors often seem all but blind to it.

This article will simply lay out the problem and illustrate how this can affect investors. There are ways to address this issue. But those who are interested in learning more about how we can address this issue should read my other articles on "Risk Management for Individual Investors" and "Volatility: Your (Crazy) Best Friend," found on my website.



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Let's start by quantifying things a bit. Pretend that you have \$1m to invest in a portfolio of various investments. You are nearing retirement and are looking at a 20-30 year time horizon where, in a few more years, you expect to be taking withdrawals from the portfolio to supplement your income. Rightfully, you note that you need to be mindful of inflation so you allocate the vast majority of the portfolio to a broadly-diversified basket of mutual funds invested in stocks.

Due to bad timing (bad luck), in year 1, you experience a common event where stock prices drop by 30%. Your \$1m portfolio is now worth \$700,000. But you're patient. You set your statements aside for the next year and try to ignore the talking heads on the news who are predicting the end of the world.

A full year later (2 years after your initial investment), as if by magic, you hear that stock prices gained 30%. You should have made up your losses and now have at least what you started with a couple of years ago, right?

Unfortunately not. Here's the math:

| Starting Value | Year 1: Lose 30% | Year 2: Gain 30% |
|-----------------|------------------|------------------|
| \$ 1,000,000.00 | \$ 700,000.00 | \$ 910,000.00 |

In losing 30% and then gaining 30%, you're still down 9% from where you started 2 years prior. For you to get back to your initial investment amount of \$1m, you would have needed a gain of about 43% in year 2, not merely 30%. This is why many people in the investment industry call losses and gains asymmetrical – a 30% gain is not a mirror image of a 30% loss. They are unequal and increasingly so as losses deepen.

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Part of the difficulty in realizing that gains and losses aren't mirror images is because when losses are small, it's hardly noticeable. Look at the graph below. On the X axis is the loss you sustain in one year. The Y axis shows the percent gain needed the next year just to get back to even.

Notice that the line is not straight – it's curved. For each incremental loss, you'll need greater and greater returns just to get you back where you started. Getting a 5.3% return after sustaining a 5% loss doesn't seem too hard. But how about an 81.8% gain after a 45% loss? How about a 100% gain (doubling in value) after a 50% loss? Those are much more difficult to pull off. The worse the loss, the greater the return you'll need just to get back to even again. I've left off the entire right-hand side of the graph (-55% to -99%) because by the time you sustain more than a 50% loss, the numbers are too depressing to print and far too optimistic to put into writing.



To make matters worse, seeing a third to a half of the value of your portfolio get wiped out is a rather common occurrence when you're invested in stocks and other equity-like investments. Thankfully, it doesn't happen most years. But since the start of the 21st century, I can think of several events where stocks lost a third or even nearly half of their value in a rather short period of time. Going through recent history, it's safe to say that a drop of 20% or more tends to happen about twice in a decade, on average. Not with any regularity or predictability. In fact, good luck calling it before it happens. But big drops are to be expected and, for that matter, something we may as well make some plans to address.

But isn't this just how things work? Don't we need to accept higher amounts of volatility and risk in order to achieve better returns? This is certainly the standard wisdom in the investment world and is generally true. This is embedded into ideas like Modern Portfolio Theory and part of nearly every risk tolerance questionnaire that individual investors receive from investment advisors and brokers.

But is this actually true? Does volatility actually benefit investors in the long run? Not always. Sometimes, lowering your risks can actually boost your performance over time. Consider the following two portfolios:

| | Starting Value | Year 1 Value | Year 2 Value | Year 3 Value |
|---|----------------|-----------------|-----------------|-----------------|
| | | <i>Gain 20%</i> | <i>Gain 20%</i> | <i>Lose 20%</i> |
| A | \$ 1,000,000 | \$ 1,200,000 | \$ 1,440,000 | \$ 1,152,000 |
| | | <i>Gain 5%</i> | <i>Gain 5%</i> | <i>Gain 5%</i> |
| B | \$ 1,000,000 | \$ 1,050,000 | \$ 1,102,500 | \$ 1,157,625 |

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Portfolio A has 2 consecutive years of stellar 20% returns, followed by a 20% loss. This portfolio has an ending result of \$1,152,000. Not bad, though certainly a wild ride.

But Portfolio B had 3 years of rock-steady 5% returns over the same time. Clearly, this investor was playing it much safer. Yet the ending value was \$1,157.63 – marginally higher than the riskier portfolio. What gives?

The answer, of course, is that Portfolio A experienced a significant loss while Portfolio B did not. By taking on more risk, Portfolio A achieved a *lower* compounded return than Portfolio B with its safer profile.

This is a paradox, for sure. In any one year, it may not look that way. Indeed, it's often hard to be satisfied with a measly 5% return if you see everybody else getting 20%. But over time, losses matter much more than gains. Sometimes, those losses can hurt more than the gains can help.

And this is why when it comes to managing a portfolio over long time horizons, it's not about who can go the fastest. It's about who can slow down the least.

About Matt White

Matt White has been a practicing Financial Advisor since 2007. He serves middle- class families as they save, invest and plan for their futures.

Final Thoughts

This is the simple math behind the core philosophy of Endurance Investment Strategies, Inc. To learn more about how investors can address this problem, please visit my website at endurance-investments.com/learning.



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