WEALTHMANAGEMENT AUGUST 2014

THE VALUE OF DOWNSIDE PROTECTION

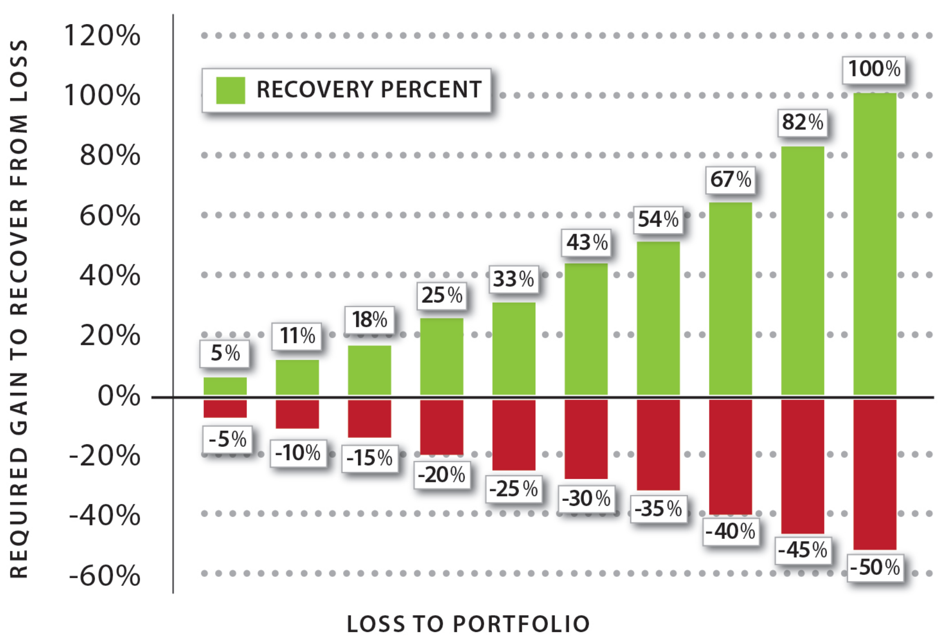
MAKING MONEY VERSES NOT LOSING MONEY.....

Small losses are typically not a problem for an investor with a mid to long-term time horizon, in fact, it's a basic fact of life. No matter your time horizon severe losses can become difficult to recover from if your portfolio lacks risk controls. As the chart below illustrates, it only takes an 11% gain to recover from a 10% loss. If this occurred, in many cases you could get back to even within a year or two.

In the unfortunate event you suffer a large loss it can take many years for your portfolio to recover. Simple math shows us it takes a 100% gain to recover from a 50% loss. Effective hedges and building fully diversified portfolios may help reduce catastrophic losses in order for your portfolio to have a better chance of meeting your objectives.

The below chart was constructed by using basic math. Larger losses require larger gains in order to recover. Smaller losses only need small gains. Plus, small losses are healthier for the mind. Small loses make it easier to stay committed to your plan and not get deterred or discouraged.

LOSSES VERSUS GAINS



BUY AND HOLD.....AND THE LIKELIHOOD OF RECOVERY:

We can see from either chart that a portfolio loss of 35% requires a 54% gain to restore the portfolio back to even. Historically speaking, how long has it taken the S&P 500 to generate a 54% gain? From 1970 through 2013, the S&P 500 Index has never had a one-year return in excess of 54%. The largest one-year return was 37.58% in 1995, followed by 32.5% in 2013 and 31% in 1991. Therefore, based on historical returns of the S&P 500 Index over the past 40 years, a loss of 35% will require much, much more than one year to recover and it still has only a 93.5% chance of a full recovery after 10 years.

As shown in the chart below, the S&P 500 Index has a 17.8% chance of gaining 54% (as a cumulative percentage return) within a contiguous two-year period and thus recovering from a 35% loss. The probability of fully recovering from a 35% loss increases to 34.2% over a holding period of three years. All of these loss recovery estimates are based on the performance of the S&P 500 Index over the past 40 years, from 1970 to 2013. They assume that no money is withdrawn from the account during the recovery period and that no additional money is invested. Taxes and inflation have not been considered in this analysis. And, as always, past performance is not a guarantee of future results.

Portfolio Loss	Needed cumulative gain to restore loss	Percentage chance* of recovery from loss within...					
		1 YEAR	2 YEARS	3 YEARS	4 YEARS	5 YEARS	10 YEARS
-10 %	11.1%	52.5%	74.4%	81.6%	78.4%	77.8%	93.5%
-20%	25%	25.0%	48.7%	68.4%	67.6%	72.2%	93.5%
-35%	54%	0.0%	17.9%	34.2%	56.8%	61.1%	93.5%
-50%	100%	0.0%	0.0%	7.9%	13.5%	36.1%	80.6%
-65%	186%	0.0%	0.0%	0.0%	2.7%	5.6%	61.3%

It makes sense that smaller portfolio losses, such as 10%, are more quickly recovered from. The S&P 500 Index generated a single-year gain of 11% or more (11% being the minimum gain needed to restore a portfolio following a loss of 10%) in 25 separate years between 1970 and 2013. Therefore, based on historical return patterns, there is a greater than 50% chance that the S&P 500 could recover from a 10% loss within one year.

More serious losses require longer recovery time, and this might not be feasible. For instance, a portfolio invested completely in the S&P 500 Index that loses 50% has a 0% chance of recovery within one or two years.
At WT Wealth Management we are always reviewing the downside risk to our portfolios. With our TimeBand approach to portfolio construction we always have the option of using “hedges” in the Tactical Allocation Band to lessen the downside participation of any given portfolio. No portfolio is immune from losses, it’s a fact of life for any investor, but limiting a portfolios downside makes for a smoother ride in the long run.

DISCLOSURE

An investment in the fund(s) is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.

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In addition to the normal risks associated with investing, narrowly focused investments, investments in smaller companies, sector ETF's and investments in single countries typically exhibit higher volatility. International and Emerging Market ETF's investments may involve risk of capital loss from unfavorable fluctuations in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume. Bonds and bond funds will decrease in value as interest rates rise. A portion of a municipal bond fund's income may be subject to federal or state income taxes or the alternative minimum tax. Capital gains, if any, are subject to capital gains tax. Diversification and asset allocation may not protect against market risk or a loss in your investment.

At WT Wealth Management we strongly suggest having a personal financial plan in place before making any investment decisions including understanding your personal risk tolerance and having clearly outlined investment objectives.

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