WAY2WEALTH

Why Downside Protection Matters

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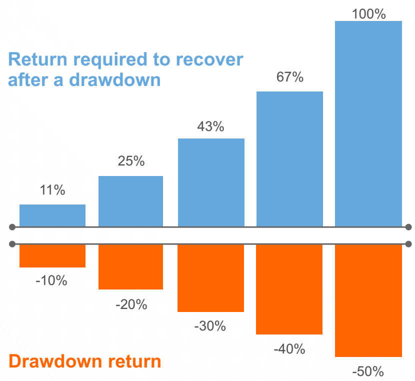
Amid ongoing worries on coronavirus spread and slumping growth domestically as well as worldwide, the macroeconomics and geopolitical outlook remains highly uncertain—suggesting that an environment of historically low interest rates, sluggish growth and high global liquidity, market volatility may linger well into 2021. This uncertainty presents a challenge for investors who are looking to generate attractive returns while preserving capital during periods of market volatility,

Against this backdrop, preserving capital i.e. downside protection. is equally if not more important than seeking the growth of capital. In other words, avoiding losses appears to be more important than achieving gains.

Losing less means requiring less to bounce back

The chart below shows the historical returns required to recover after a drawdown. The returns investors need significantly increase as losses deepen after a period of underperformance. For instance, a drawdown of 20% requires a return of 25% to recover, whereas a drawdown of 50% would need 100% to regain ground. This example demonstrates that a percent of excess return in a down market is worth more than a percent of excess return in an up market. To achieve long-term growth, it is inherently important to not only grow the upside, but it is even more important to protect the downside.



Source: Russell Investments Blog

Investment strategies that provide both potential upside and downside protection can enable investors to weather market changes and stand better chances of outperforming benchmarks. With Valuations on price-to-earnings (P/E) multiples appearing stretched, one can reduce risk in the portfolio only through *Asset Allocation*.

How diversification through asset allocation may help during times of uncertainty

In recent years, advisors have consistently advocated investors to consider a multi-asset approach to investing for a multitude of reasons. We believe that by doing so it puts clients on a smoother path toward meeting their goals. For retail investors, there are Multi asset allocation funds which are a part of the hybrid category. The fund invests in three asset classes; debt, equity as well as gold. In western markets, multi-asset funds invest in assets ranging from debt, real estate, gold, commodities, equity, hedge fund, and private equity. As per norms, the fund should invest a minimum of 10 percent in each of the asset classes.

While the objectives of multi-asset strategies may vary, some are designed specifically to help provide investors with better downside protection while providing the growth they require. Thus, these funds can be a good option for conservative investors who do not wish to take a high risk in investments yet want an equity exposure in their portfolio.

A multi-asset approach can help achieve these goals through three main phases:

Formulating an asset allocation strategy:

Asset allocation is the heart of portfolio construction. In the portfolio construction phase of a portfolio, an asset allocation will help to capture the allocation in-between equity and debt —along with other asset allocation strategies—that are modelled by an advisor depending on his client's risk profiling. An advisor adopts a differentiated approach to diversification that is designed to deliver growth, and, perhaps more importantly, to minimize the big downward dips.

Constructing the Portfolio:

When the portfolio is built, a multi-asset approach can create a base for long term goal achievement. Incremental allocations in the portfolio can be used to gain exposure to high-conviction investment opportunities. Asset classes follow different cycles over different time periods and right asset allocation will lead to optimal returns through portfolio diversification.

Measuring the performance:

As the range of multi-asset approaches and strategies continues to broaden, advisors need to apply increasingly sophisticated metrics to assess return, risk and value added in comparison to 60/40 portfolio benchmark.

After the portfolio is built, a true multi-asset approach means continuing to dynamically manage that portfolio. This dynamism across asset classes is intended to help manage downside risk and gain exposure to high-conviction investment opportunities.

The bottom line

Combining all these levers, a multi-asset approach may help investors with downside protection.

It's understandable that so much of the world is chasing growth. Growth is enticing. But we believe savvy investors will focus on what the data tells us. And the data shows that protecting against downside just may get you more *bang for your buck.*

According to a Study by Roger Ibbotson & Paul Kaplan in 2001 "More than 90% of the portfolio returns are based on asset allocation decisions".