Avoiding large losses is the Secret to Successful investing in A Bear Market

The past two years have made investors forget about the drubbing they took in 2008. The S&P Index was down a smooth 37% while the NASDAQ followed up with a 40% loss in value. There's no doubt that the past two years, 2009-2010, have been very good for equity markets. As measured by the S&P 500 Index, returns have been 26.5% and respectively 14.8%, for 2009 and 2010. That is a compounded return of 45.1% for the two years combined. [1]Many investors tend to believe that a portfolio loss of 40% followed by cumulative returns of 50% easily recover from the losses and produce gains. "WRONG!" Why? Let's see what percentage gain is required to overcome investment losses. Although the gains were larger than the loss, the gains were on a considerably smaller amount of principle. Therefore it requires a GREATER positive return, relative to the negative return that reduced the portfolio value, to get the portfolio back to even.

Investment Loss	Gain Required to Get Back to Even
-10%	11%
-20%	25%
-30%	43%
-40%	67%
-50%	100%
-60%	150%

Below you will find two separate portfolios and their subsequent returns over three years.[2]

Portfolio	A	B
Starting Value	$100,000	$100,000
Year 1 Return	-35%	-2%
Year 2 Return	+25%	+25%
Year 3 Return	+15%	+2%
Ending Value	$93,437	$124,950

In portfolio A, even though the simple addition of the three separate years returns a positive number, the portfolio ending value is still below its staring value. In portfolio B, the lack of significant draw-down during year 1 more than compensates for a lower investment return in year 3. As investors we get focused on short-term results, with little regard to overall consistent returns from all years.

[1]Hanlon Investment Management 1/14/2010
[2]Rate of return in this table is for illustrative purposes only and does not imply or guarantee that your investment will achieve these results nor do these figures represent the returns of any particular investment. These figures are hypothetical and do not take taxes into account. Actual rates of return on your investment will vary.

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Mark W. Thompson/Wealth Partners Inc., 6855 South Havana Street, Suite 420, Centennial, CO 80112   303-790-7443