Why Losses Really Do Matter

Everybody who told us that the steep market drops earlier this month wouldn't last can rightly claim they're right. When the S&P 500 was down 7.4% during a two-week selloff, there was no way to know whether we'd have to endure more of the same. Staying the course turned out to be exactly the right strategy, but that doesn't mean that we shouldn't be concerned about downside risk. In fact, during the downturn, all of us should have been working hard to keep our portfolios from falling as far and as fast as the American indices.

Isn't this a contradiction? There is no contradiction between holding on during market downturns and building portfolios that are unlikely to keep pace with a bear market free-fall. You hold on because no living person knows when the stock markets will recover, but history tells us that they always do seem to recover and eventually deliver returns that are higher, on average, than the returns you get when the money is safely stored under your mattress.

But you also pay attention to downturns because the further your portfolio falls, the harder it is to recover. There's actually a rational reason why you tend to fear losses more than you enjoy your gains.

The mathematics show the asymmetrical effect of losses vs. gains. If your $1 million portfolio loses 10%, falling to $900,000, then it requires an 11.11% gain to get you back where you started. It doesn't seem fair, but that's how it is. A 20% loss requires a 25% gain, and if your portfolio were to drop 40%, you'd need a subsequent 66.67% gain to climb back to your original $1 million nest egg.

Chances are, you know how we fortify portfolios against losses: we include a variety of different types of assets--including bonds which, against many market predictions at the start of the year, are actually delivering positive returns almost all the way across the maturity spectrum. We include foreign stocks, which haven't exactly been knocking the lights out this year, but which may, someday, offer strong gains when the U.S. markets are weakening. All of these different movements tend to have a calming effect on the portfolio's returns, not always in every circumstance, but fairly reliably over time.

The result? A smoother ride puts more money in your pocket. If an investor experienced returns of +20% and -10% in alternate years over the next 20 years, a $100,000 portfolio would grow to just under $216,000. If a more diversified investor experienced a smoother ride of 10% a year, her portfolio would grow to

just under $673,000. The power of steady compounding is a marvelous thing to see. The drag of losses can be debilitating to a portfolio's growth.

You won't experience either of those trajectories, of course. But if you can somehow avoid the worst of the market's falls, even if it means never beating the market during the up-cycles, you raise your chances of long-term success. If you can do this and remain invested through a lot of uncertainty, like we experienced earlier this month, chances are you'll enjoy better long-term returns than a lot of the "experts" you see screaming at you to buy or sell on the cable finance channels.

Oh, and that 7.4% drop? The S&P 500 will have to go up 7.99% to recover the ground it lost in that two-week period.

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