Investing in Funds: A Monthly Analysis, November 2009

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The Cruel Math Of Big Losses

Why the recent stock-market surge makes the case for low-volatility funds

OR NO-VOLATILITY LIKE PAUL RENFROE ADVISES

By Karen Damato

This year's robust stock-market advance has done a lot to bolster investors' psyches. Too bad many people's portfolios still haven't recovered from last year.

The average diversified U.S.-stock fund has gained 21% so far in 2009, according to Lipper Inc., and plenty of individual funds are up twice as much. But in most cases those returns haven't brought people's stock-fund holdings back to their values at the start of 2008, let alone their higher values at the stock-market peak, in October 2007.

The culprit is what money manager and newsletter editor Daniel Wiener calls "the tyranny of the mathematics of loss": When you suffer a very large loss, you need a gigantic gain to get back to where you started.

If an investment declines 10%, it takes about an 11% gain to break even (assuming you don't pump in additional dollars). If the drop is 20%, you need a 25% gain to recover. A fall of one-third requires a rebound of 50%. And if your investment falls by half, "you need a double," or a 100% return, says Mr. Wiener, the New York-based editor of the Independent Adviser for Vanguard Investors. The recovery percentages grow exponentially because you have so few dollars working for you after a big loss. JUST TO BREAKEVEN!!

Last year, the average diversified U.S.-stock fund was down 37.5%—requiring a 60% advance to break even—and plenty of funds were down 50% or more. Investors looking at this year's performance listings should know that some big gainers are volatile funds that were big losers last year; thus, investors' holdings may still be worth far less than they were in late 2007.

Goal Reminder WRONG! IT'S POSSIBLE!

It's impossible to avoid losing some money when you are an investor. But the harsh math of 2008 and 2009 is a reminder of a key goal that most investors should strive for: avoiding the largest losses. Many investors trimmed their overall losses last year by holding bond funds and other investments along with stock funds. Investors also can seek out funds that have been good performers over time, and that have been less volatile than their peers. PAUL RENFROE

"A manager who limited losses last year goes a huge way to helping investors accumulate wealth over time and meet their long-term goals," says Don Phillips, a managing director at research firm Morningstar Inc. "It's the kind of victory that often goes unnoticed" amid the gloom of losing money, he adds.

As an example, Mr. Phillips points to Charles Dreifus, whom Morningstar picked as its Domestic-Stock Manager of the Year for 2008. Last year, the **Royce Special Equity** fund he manages returned a negative 19.6%—painful, to be sure, but much less than the 32% loss of its average small-

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"We are always more concerned about how we do in a down market than an up market," Mr. Perkins says. If you don't lose a lot in a downturn, he says, "that allows the up years to really take hold" and compound the value of people's accounts

Less Pressure OR LOSE ZERO!

When you lose less in down periods, you are under less pressure to try to maximize returns in up periods, Mr. Sloan notes. That's a good thing, he says, because trying to maximize returns in the good times "gets people into trouble," such as when they reach for lower-quality, higher-risk companies. AIM Charter is

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but never have ANY risk of market loss?
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