3EDGE ASSET MANAGEMENT

In Investing, Defense Still Wins Championships

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2020 has certainly been a roller coaster of a year for investors. We have experienced the dramatic decline in equities from mid-February through mid-March as the coronavirus spread across the globe, followed by the ensuing equity market rally beginning at the end of March as governments and central banks came to the rescue, pushing the major U.S. equity indices to recent record highs. Sometimes, it seems as though market volatility may be one of the few things that investors can count on. In such an environment, as investors struggle with what comes next, the capacity to play both offense and defense when investing may be essential.

What do we mean when we say that in investing defense wins championships?

You may have heard the common refrain from some investment advisors to “hang in there” even when the market is at or near record highs as it is now, and even during periods of material market corrections such as from mid-February through mid-March of this year when the S&P 500 declined by approximately 33%. However, “just hanging in there” is much easier said than done. It is quite difficult to remain fully invested in equities when markets may be in a steep decline or when equities seem significantly overvalued.

At 3EDGE, we believe that it is possible and essential to investment success to play both offense and defense over time when managing investment portfolios. Our our stated investment objective is to seek to generate attractive, risk-adjusted investment returns over full market cycles (through both up and down markets) and we are less sanguine about a best-case scenario being the most likely outcome in the near future. Therefore, as a tactical, multi-asset investment management firm we are more comfortable with our current positioning across our strategies, maintaining broadly diversified portfolios which hold an appropriate amount of both U.S. and ex-U.S. equities, as well as gold and short to intermediate term U.S. Treasuries in order to hedge equity exposure.

Why being able to play defense when appropriate matters when investing for long-term success.

As I stated earlier, in spite of widespread investor anxiety during equity market downturns, financial professionals often advise their clients to just “hang in there,” even during periods of steep market declines in order to not miss out on periods of major market upswings. However, as we know, that is easier said than done when investors see their liquid net worth in decline, and it may feel as though the market is going to zero. This is consistent with Loss Aversion Theory[1] that teaches us that for most investors the pain of losing money in the market is far greater than the positive emotion from investment gains.

[1] Kahneman, D., & Tversky, A. (1984). Choices, values, and frames. American Psychologist, 39(4), 341-350.

To bolster their "hang in there" argument for clients, financial professionals often illustrate what would happen to the investment performance of a portfolio if an investor were to miss the best months of market performance over an extended period of time. Not surprisingly, their performance would not be as good as it would if they hadn't missed out on the best periods of performance. The chart below shows the difference in investment performance between the average annual return of the S&P 500 Total Return Index from December 31, 1971 through October 31, 2020 as well as what would be the return if an investor missed out on the best 12 months of performance over the same time period. It certainly makes sense that if an investor didn't participate in the 12 best months of performance, he or she would expect that their investment returns would be lower. See Figure 1 below below.

Figure 1: Impact of Missing Best/ Worst Months

Annualized Return for the S&P 500 Index Total Return: Dec 31,1971 - Oct 31, 2020

Average Annual Return for the S&P 500 Total Return Index*	**+10.49%**
Average Annual Return for the S&P 500 Total Return Index **Missed the 12 Best Months of Performance**	**+ 7.43%**

Source: Bloomberg. * Monthly average annual return for the S&P 500 Total Return index from Dec 31, 1971 through Oct 31, 2020.

The other side of the same coin.

Let us examine what would happen if we came at this from a different angle? What if an investor were able to avoid the worst months of market performance over that same period of time? How would this impact overall investment performance over the long-term? Figure 2 below illustrates that by avoiding the worst 12 months of investment returns for the S&P 500 index, an investor would have actually outperformed the index by over 350 basis points per year, and also outperformed the investor who was able to hang in there and capture the best 12 months of market performance. Interestingly, the bottom row of the chart shows that if an investor missed out on the 12 best months but also avoided the 12 worst months of performance, they still would have outperformed the S&P 500 Total Return Index.

Figure 2: Impact of Missing Best/ Worst Months

Annualized Return for the S&P 500 Index Total Return: Dec 31,1971 - Oct 31, 2020

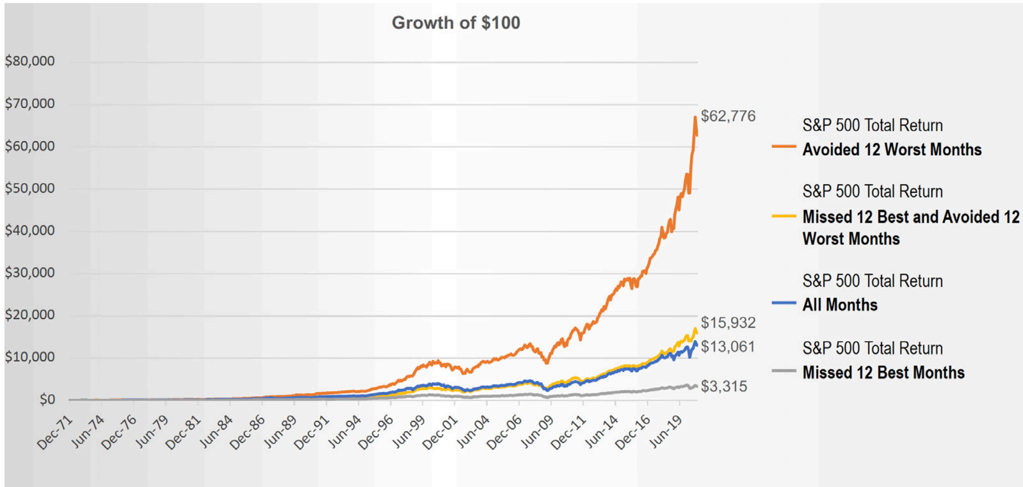
Average Annual Return for the S&P 500 Total Return Index*	**+10.49%**
Average Annual Return for the S&P 500 Total Return Index **Missed the 12 Best Months of Performance**	**+ 7.43%**
Average Annual Return for the S&P 500 Total Return Index **Avoided the 12 Worst Months of Performance**	**+14.10%**
Average Annual Return for the S&P 500 Total Return Index **Missed the 12 Best Months of Performance And avoided the 12 Worst Months of Performance**	**+ 10.94%**

Source: Bloomberg. * Monthly average annual return for the S&P 500 Total Return index from Dec 31, 1971 through Oct 31, 2020.

Figure 3 below provides a different, and perhaps even more compelling, way to look at the same information that is provided in Figure 2 by looking at the growth of a $100 investment in the S&P 500 Total Return Index based upon the different scenarios from Figure 2.

Figure 3:
The Importance of Minimizing Drawdown

Growth for the S&P 500 Index Total Return Under Different Scenarios: Dec 31,1971 - Oct 31, 2020



Source: Bloomberg. From Dec 31, 1971 through Oct 31, 2020.

So, while it is certainly true that an investor who didn't participate in the best periods of investment performance over an extended period of time would not have kept up with the performance of the S&P 500 index, it is also true that by avoiding the worst 12 months of investment performance of that same index an investor would have actually outperformed the S&P 500 index fairly dramatically.

As a tactical, multi-asset investment firm, we have the capacity to increase or decrease the amount of exposure to a variety of asset classes that make up our investment universe, including equities. Our tactical approach also provides us with discretion over the amount and types of hedges that we may utilize as part of our overall broad portfolio diversification, since different asset classes may be better hedges than others depending on where we are in the market and economic cycle. We seek to actively play defense when appropriate to minimize the impact of steep equity market declines on our clients' portfolios. However, it is also true that our approach to portfolio construction means that we will always hold some amount of equity exposure at all times and therefore would not expect to eliminate all equity market risk from our strategies. In addition, we are not always able to time portfolio adjustments perfectly when seeking to minimize equity exposure, particularly when equity markets may be declining.

In the end, our risk-managed approach is consistent with our stated investment objective of seeking to generate attractive, risk-adjusted returns over full market cycles on behalf of our clients (through both up and down markets), and we believe that in the long-term in investing, defense does win championships!