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The Cruel Math of Big Losses

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

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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.

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

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.

"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-value peer.

Having a smaller hole to dig out of has paid off this year: As of Oct. 28, Royce Special Equity's 20.9% return so far in 2009 was right in line with its average peer and the fund was just shy of breaking even for the period since year

-end 2007, with a slight 2.8% loss. Meanwhile, the average small-value fund was still down 19% from year-end 2007, according to Morningstar.

Happily, some less-volatile funds also have strong long-term performance records. For instance, Royce Special Equity ranks in the top 15% of its Morningstar category for the past five years, and the top 10% for 10 years.

Mr. Phillips says there's another advantage to picking less volatile funds over those that take investors for a wilder ride: "Investors are so much more likely to be buy-and-hold investors with low-volatility funds."

In contrast, "more-volatile funds bring out the worst behavior on the part of investors," he says. Investors tend to go into those funds "after they've had a great run, and sell them at the trough," Mr. Phillips says. They're driven first by performance-chasing and then by shock at the magnitude of their losses.

Leg Up

A look at the 100 largest diversified U.S.-stock funds shows that a few of the best performers since year-end 2007 are funds that have exhibited less volatility than peers over time, while also delivering strong long-term results. Some look good for the combined 2008-09 period, despite middle-of-the-pack performance so far this year, because they had smaller 2008 losses to recover from.

From year-end 2007 through Oct. 28, the smallest cumulative loss among these 100 funds—11%—was posted by Perkins Mid Cap Value, which held its 2008 loss to 27.3%, and then gained 22.5% through Oct. 28. The fund, which is part of the Janus family, emphasizes "financially strong companies that have the ability to survive tough times," and it attempts to buy shares at low prices to minimize the downside risk, says co-manager Tom Perkins.

Indeed, before they buy a stock, the managers estimate how low the price might fall (assuming the overall market is roughly unchanged) and also how high it might go. The idea is to identify stocks that are unlikely to tumble more than 20%—again, in a flat market—but that have a reasonable chance of rising 30%.

"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

Perkins Mid Cap Value ranks in the top 10% of Morningstar's Mid-Cap Value category for the past five and 10 years. Compared with peers, it has exhibited low risk but high returns, Morningstar says.

Another strong performer over the 2008-09 period, down a cumulative 12.8%, is AIM Charter, which fell 28.5% last year and then gained 22% through Oct. 28. Lead manager Ron Sloan says he tries to "lose less when times are tough" and get "reasonable returns on the upside" by seeking out companies with long-term promise but short-term challenges that have depressed their share prices.

He lets his cash position rise when he can't find attractive stocks to buy. It was close to 20% coming into this year, down to 10% as of April after he found some bargains, and then rose to around 15% after he harvested some gains.

Less Pressure

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 in the top 5% of Morningstar's Large Blend category for the past five years and the top half for 10 years.

Among the 100 largest funds, a few of this year's biggest gainers rank in the bottom fifth for the combined 2008-09 period. As of Oct. 28, Longleaf Partners and Calamos Growth were among the group's top five gainers so far this year, both up 40.3%. But after losing half their value last year, the funds were still down a cumulative 30.7% and 30.2%, respectively, over the combined 2008-09 period. Both are very strong performers over the past decade.

To be sure, some investors have the fortitude to hold volatile funds in hopes of higher returns over time. Mr. Wiener says he's happy to buy funds "where the upside volatility makes up for...the downside volatility." One such fund he likes is Vanguard Capital Opportunity, which fell 39% last year and rose 30.6% this year through Oct. 28. Its cumulative loss for the 2008-09 period is 20.4%, and it ranks in the top 10% of Morningstar's Large Growth category for the past five years and the top 1% for 10 years.

Fund buyers can check a fund's 2008 results and various measures of risk to try to get a handle on how badly it might suffer relative to its peers in future downturns. Morningstar, Lipper and Standard & Poor's all evaluate risk as part of their ratings of funds.

Past riskiness is usually a far better predictor of a fund's future riskiness than past performance is of future performance, Mr. Phillips of Morningstar notes. Still, it's also possible for a fund manager who successfully limits losses in one downturn to be caught flat-footed in the next one.

Helping Hands

For investors who research funds on Morningstar.com, one easy, graphic indicator of a fund's risk (and return) comes from a chart that compares the growth of $10,000 invested in the fund to the performance of its Morningstar category and a relevant index. The more volatile funds swung higher than the benchmarks in the bull market and sank lower in the bear; investors can see if that hypothetical investment is anywhere near back to the level of late 2007.

By clicking on the Ratings and Risk tab for a fund, you can find Morningstar's risk rating, which the site says is "an assessment of the variations in a fund's monthly returns, with an emphasis on downward variation." (Both return and risk are factored into Morningstar's widely used star ratings of fund performance.) The same page also lists the fund's standard deviation, a mathematical measure of volatility, which you could compare with that of an index fund in the same investment category.

You can use the Morningstar risk rating as one factor in searching for funds using the fund-screening tool on Morningstar.com.

Lipper has a couple of risk-related measures as part of its rating system, in which the top 20% of funds by each measure earn a score of 5 and are deemed Lipper Leaders. A fund that gets that top score for Preservation "has demonstrated a superior ability to preserve capital in a variety of markets when compared with other funds in its asset class," according to LipperLeaders.com. Lipper Leaders for Consistent Return have provided "relatively superior consistency and risk-adjusted returns" versus peers, the site says.

Tom Roseen, a research manager at Lipper, which is a unit of Thomson Reuters Corp., says he likes to screen for funds that over time get top ratings on both of those measures as well as on Total Return. The screening tool on LipperLeaders.com includes funds and variable-annuity accounts. For a more detailed tool that includes only funds, Mr. Roseen suggests going to Reuters.com: Use the navigation tools on the left side to click on "Stocks," then "Funds," and then "Funds Screener."

Standard & Poor's adds another wrinkle in gauging a fund's risk. Besides looking at a fund's past performance, the firm uses its analysts' evaluations of the fund's most recently reported holdings. The firm, a unit of McGraw-Hill Cos., sells its rankings to securities firms and other professionals; some firms will provide S&P fund reports to individual-investor clients.

In looking at an S&P fund report, an investor can get a sense of the role of the fund's record and its holdings in the overall risk score. In looking at some large-stock funds, S&P analyst Todd Rosenbluth points to Dreyfus Appreciation as one fund that gets a positive risk rating partly because of the analysts' views on the underlying stocks.

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