Market Volatility

The Upside of Downside Protection

WHY DOWNSIDE PROTECTION?

Market declines are an inevitable part of investing and the primary reason many investors seek downside protection strategies for their portfolios. Such losses represent a threat to a portfolio's long-term returns since:

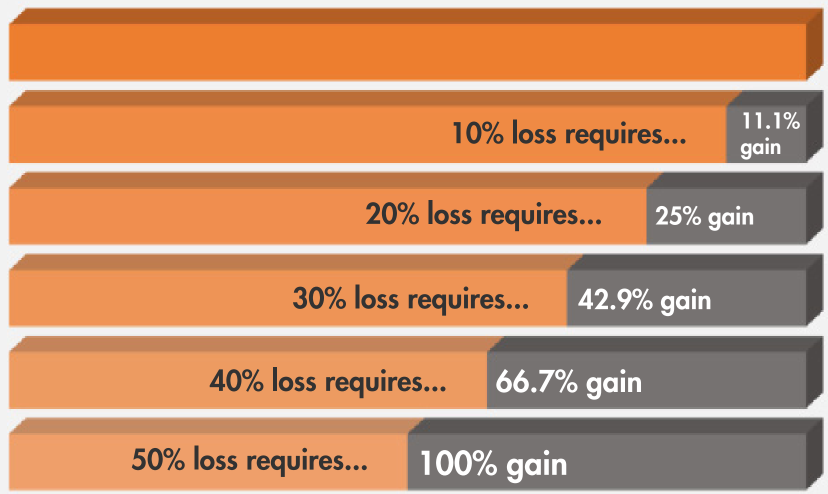
- Greater positive returns are needed to overcome the decline
- Market declines erode the power of compounding
- Recovery may be more difficult during a withdrawal phase (such as retirement) because the new investment base is lower.

Illustration1 shows the returns you would need to recover from various levels of market declines. For example, if a portfolio started with an initial investment of $1,000 and subsequently lost $100 (a 10% decline) the portfolio would need an 11.1% gain to return to its original value. Likewise, if a portfolio suffered a $200 loss (20% decline), it would need a 25% return on the new $800 value to recover the loss. A 50% loss requires a whopping 100% performance return to recover.

As you can see, the absolute percentage return needed to recover a loss is more than the absolute percentage loss. The greater the loss, the percentage return needed to recover increases significantly. When one considers that market pullbacks and corrections are a necessary, normal part of market cycles, the need to balance upside capture with downside loss minimization becomes clear.

Illustration 1: Returns necessary to recover from market downturn.

Portfolios that lose less during periods of market declines generally have a greater ability to recover the losses. Compounding power is less impacted leaving the portfolio in a potentially better position when markets rebound.



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ADVISORS ASSET MANAGEMENT

LOSS MINIMIZATION

Downside protection strategies seek to limit the impact and magnitude of losses during market declines. By not incorporating downside protection strategies, a portfolio is potentially left vulnerable to significant market declines which, in turn, require greater future returns to get back to the initial portfolio value.

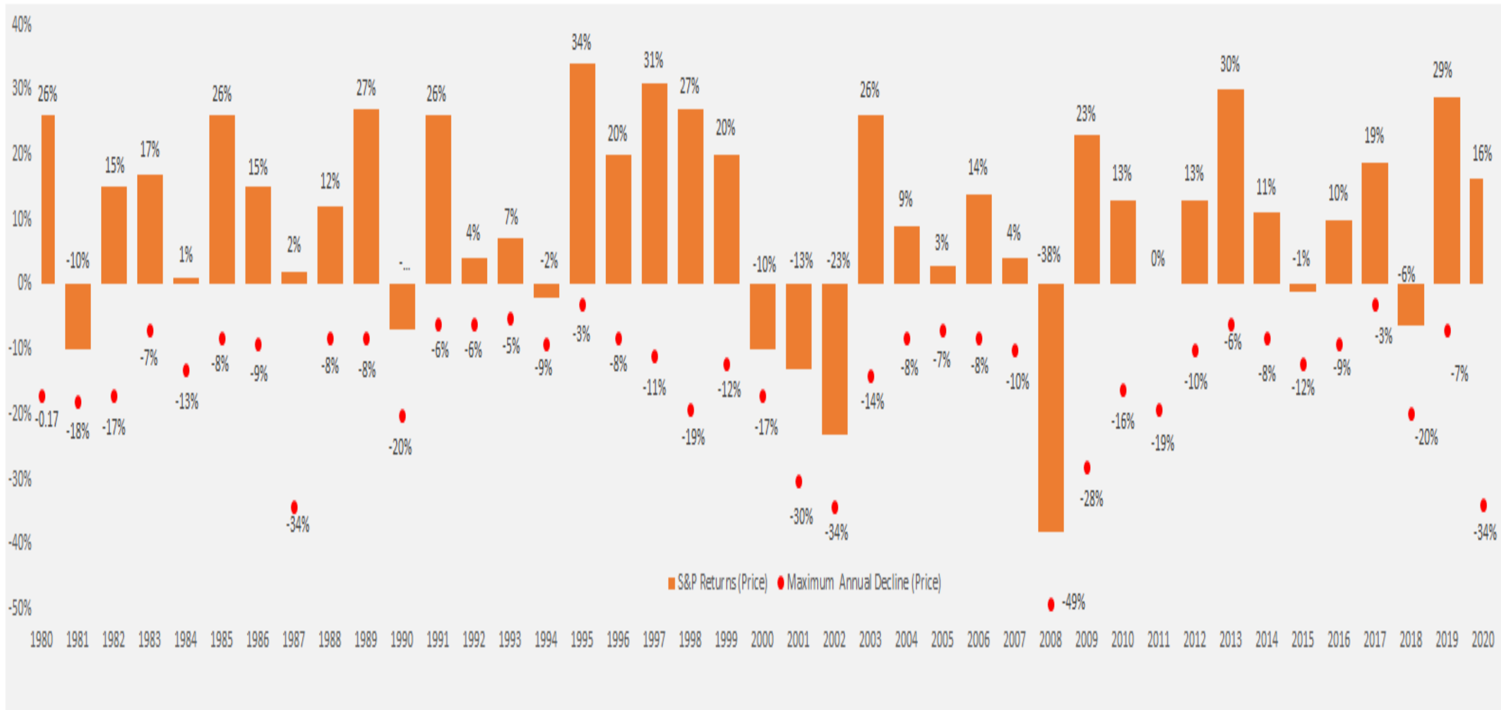
Chart 1 depicts annual returns of the S&P 500 along with the maximum decline in each year. It is clear that even in years with a positive return, the market experienced periods of decline, some considerable. For example, 1987, 2002 and 2008 saw some of the largest market setbacks during this period. A portfolio that was positioned with investments offering downside protection could have potentially offset some of the losses during these difficult periods.

WHO AND WHEN?

We believe downside protection should be considered by investors who:

- Want to preserve capital
- Want to accumulate capital
- Are in a withdrawal phase

Chart 1: Annual S&P 500 Return and Corresponding Annual Maximum Market Decline (1980 - 2020)



Source: Bloomberg 2021. Past performance are not indicative of future results and the actual performance of the numbers may be lower or higher than the future performance. Returns are not indicative of the performance of any AAM product. It is not possible to invest directly in an index. The return of the price index is referred to as capital appreciation. Total Return = Capital appreciation plus reinvested dividends during the time period. The S&P 500 Index is an unmanaged market capitalization-weighted index used to measure 500 companies chosen for market size, liquidity and industry grouping, among other factors.

A prudent time to incorporate a downside protection strategy is *before* a market crisis. Waiting can be costly as, oftentimes, it is too late to reap the maximum benefits.

Visit www.aamlive.com or contact your financial professional to learn more.