

DOWNSIDE MATH

JULY 2005

In order to see healthy investment returns it is necessary to take on some risk. However by not managing risk through various tools such as asset allocation, covered calls, and stop-losses you will sooner or later get steam-rolled financially. Whereas compounding interest can sow windfalls over time, there is a brutal side to math that most investors miss.

One of my favorite questions I pose to people is this...

“Suppose you have a \$100,000 portfolio. You make the unfortunate decision to listen to some idiot broker and your portfolio tumbles to \$50,000. To recoup this 50% loss, what percentage return does your portfolio need to grow?”

If you answered 50% stick a dunce cap on and join the other 90% of individuals who also answered this incorrectly. The answer is 100%. Unfortunately most investors who have taken severe losses like this continue to take huge risks in an effort to trade their way back to profitability. This gambler-like mentality takes portfolios to even greater lows.

It is March 2000, and despite all the obvious risks and signs, you chose to ignore the *Markowski Monthly* and you decide to listen to your dim-witted broker and invest your entire nest egg into the NASDAQ Composite Index. What the hey...everyone else was doing it. From March of 2000 to October of 2002 your nest egg went the way of Humpty Dumpty and you lost 78%. Sorry, all the king's horses and all the king's men can't help you now. What you need is a 355% return to just break even. The question is...

“How long will it take to earn back that 355% assuming an 8% annual performance?”

Most mathematically challenged people will divide 355% by 8% which puts the recovery time at a daunting 44 years. Fortunately that formula doesn't work, if you don't believe me ask Matt. He will explain it to you in five words or less or possibly a mathematical formula (whatever is shorter). Anyway, assuming an 8% return it will take a little under 20 years to put Humpty back together again.

To avoid having to utilize these grim formulas we suggest calling us and not taking the losses in the first place.