



The Down Part of Downside Volatility

Key Takeaways:

- **Long-Term Market Upsides Are Longer, but Downside Protection Is Still Key:** Although bull markets outlast bear markets, extreme downturns still pose a significant threat to long-term portfolio growth.
- **Traditional Diversification Is Becoming Less Effective:** The historic inverse relationship between stocks and bonds is weakening, meaning a classic 60/40 portfolio may offer less protection during major crises.
- **Put Options Provide a Defined Floor for Your Portfolio:** To directly counter severe downturns, you can use put options to set a specific maximum loss limit, safeguarding your capital while allowing for full participation in market gains.

In the world of investing, there are few things more unsettling than watching the market tumble. The anxiety, the sleepless nights, and the nagging question of "How low will it go?" are all too familiar to anyone who has lived through a significant market decline.

While the media often focuses on the daily swings and record highs, a true understanding of risk involves preparing for the inevitable downturns that can threaten to derail even the most carefully constructed financial plan. The statistical term is "downside volatility. What is it? Why is it important? And what can be done to protect against it?"

WHAT IS DOWNSIDE VOLATILITY?

Downside volatility is a measure of an investment's tendency to decline in value. It focuses specifically on the negative fluctuations of a portfolio, stock, or other asset. While volatility in general refers to both upward and downward price movements, downside volatility is concerned only with the drops, which is what most investors are concerned about.

A common misconception is that market drops are just as common as market gains. The reality, however, is that bull markets tend to be significantly longer than bear markets. According to data from Hartford Funds, analyzing the S&P 500 from 1928 to 2022, the average bull market lasted approximately 2.7 years with an average cumulative return of 114.9%. In contrast, the average bear market lasted about 10 months, with an average cumulative loss of -35%. Since 1945, a bear market hits about every 5.1 years. This data highlights that while market declines can be swift and painful, they are typically much shorter in duration than the periods of growth.

THE THREAT OF LEFT-TAIL RISK

Beyond the typical, shorter-lived market downturns is a more severe issue known as left-tail risk. This refers to the risk of an investment experiencing an extremely large and unlikely loss, such as a market decline of 20% or more. (The term "left-tail" comes from the left side of a bell curve, which represents the most extreme, negative outcomes.)

Such significant drops can have a devastating impact on a portfolio due to the loss of compounding. Compounding is the process of earning returns on both your initial investment and the accumulated returns from previous periods. When a large loss occurs, it not only wipes out a portion of the principal but also eliminates the potential for future returns on that lost amount. For example, a \$100,000 portfolio that drops by 50% needs to gain 100% just to get back to its original value. This required gain is a steep hill to climb and can take years to recover from.

THE LIMITATIONS OF TRADITIONAL DIVERSIFICATION

Many investors rely on a traditional portfolio of stocks and bonds to mitigate risk. The idea is that when stocks fall, bonds will rise or, at the very least, remain stable. This negative or low correlation between stocks and bonds has historically provided a buffer during market downturns. However, the effectiveness of this strategy has been increasingly challenged by a rise in positive correlation between these asset classes.

In a major crisis, like the one we saw in 2008 or during the initial phase of the COVID-19 pandemic, both stocks and bonds can decline simultaneously, offering little to no protection. Because this correlation cannot be controlled, the efficacy of traditional diversification as a sole downside protection strategy has been weakened.

A MODERN STRATEGY: USING PUT OPTIONS TO SET A FLOOR

For investors seeking a more direct way to protect against left-tail risk, using put options on equities can be an effective strategy. A put option gives the owner the right, but not the obligation, to sell an asset at a predetermined price, known as the strike price, on or before a specific date. By purchasing a put option on an index like the S&P 500, an investor can set a defined floor for their portfolio at a specific level, such as a 15% or 20% loss.

For instance, if an investor holds a portfolio that tracks the S&P 500 and is concerned about a major market decline, they could buy a put option with a strike price 15% below the current market price. If the market were to drop by more than 15%, the put option would increase in value, offsetting the portfolio's losses beyond that point. This strategy provides a known maximum loss, allowing the portfolio to participate in all the market's gains while being protected from catastrophic left-tail events.

UNDERSTANDING LEFT-TAIL RISK PROTECTION: THE HOMEOWNERS INSURANCE ANALOGY

To understand downside protection consider an analogy familiar to nearly every client: homeowners insurance.

Just as homeowners accept that property ownership includes regular maintenance, small repairs, and cosmetic upgrades (comparable to “normal” market downside), they also understand that insurance exists to protect against catastrophic, value-destroying events like fires or floods.

Likewise, investors should view left-tail risk protection as cost-effective portfolio insurance—not for day-to-day market volatility, but to shield against large, sudden drawdowns that impair long-term wealth accumulation. Protective puts serve this purpose, capping the severity of loss during market crises—when traditional diversification often fails.

The premium paid for this protection is not a loss; it's a strategic cost for peace of mind and the preservation of capital. By paying this “insurance premium,” investors avoid the far greater cost of rebuilding a portfolio from a deep hole—a process that can require substantial returns just to break even.

CONCLUSION

While the allure of market growth is strong and statistically more common, ignoring the potential for significant declines is a risk no prudent investor should take. As traditional diversification methods face new challenges, it's becoming more critical to explore modern strategies that provide a defined level of protection. By understanding and actively preparing for downside volatility generally and left-tail risk in particular, you can safeguard your portfolio, preserve your capital, and ensure that your long-term financial goals remain on track.

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