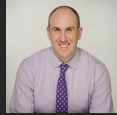


How Loss Aversion and the Sequence of Returns Impact Investors

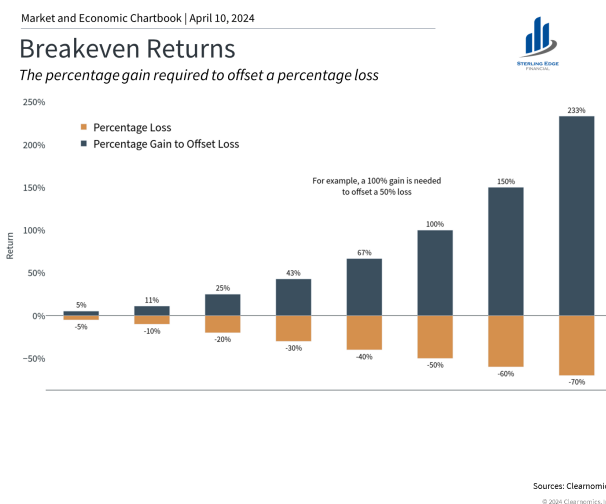


Kit Lancaster, CFP®, AWMA | President

August 16, 2024

The S&P 500 index recently closed above 5,000 and set a new all-time high, less than three years after it first crossed the 4,000 mark. While some are understandably nervous any time the market is near record levels, investors also tend to grow more bullish as the momentum continues. Across market cycles, fear often turns to caution, giving way to optimism and eventually irrational exuberance. With the market's rapid climb over the past year, what should investors keep in mind to stay disciplined and focused on their financial plans?

Much larger percentage gains are needed to offset losses



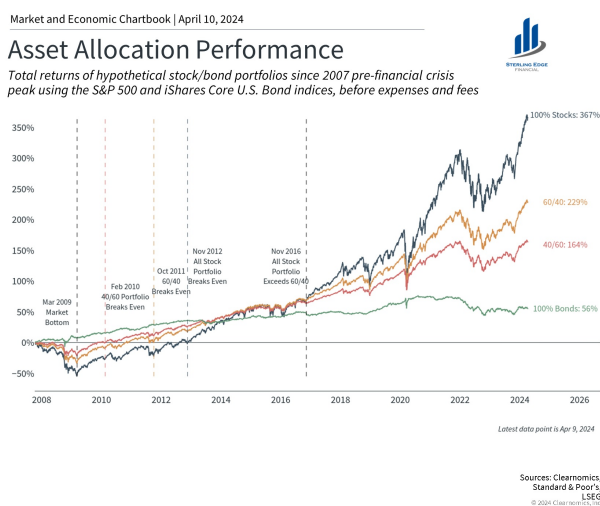
For some investors, it may increasingly feel as if the market can only go up despite ongoing financial and economic uncertainty. The bear market of 2022 may even seem like a distant memory now that the Fed is expected to cut rates and inflation has fallen to more manageable levels. While structuring portfolios to benefit from market gains is important, it's also critical to manage risk. How investors behave when markets are down - even if only for a few days, weeks or months - can be as important as how they position over years and decades. In this context, there are a few key principles to keep in mind.

First, the way investment returns are calculated can create a daunting situation for investors. This is because positive and negative compound returns are not symmetric - in general, a larger gain is needed to offset a loss. For

instance, a 10% decline requires an 11.1% gain to recoup those losses. These differences grow with larger percentages, as shown in the accompanying chart. It's easy to see that a 50% decline, which cuts the value of a portfolio in half, would require a 100% increase to return to the original value. The effect of losses on compounded returns is sometimes referred to as a "volatility tax" or "volatility drag."

Thus, in the midst of an inevitable market pullback, it can be easy for investors to become discouraged by the magnitude of the gain needed to return to par. However, history shows that markets do rebound over time, even when the S&P 500 declines nearly 50% as it did in 2008 or 34% as it did in 2020, making up for these losses on their way to new all-time highs. Of course, the timing of these rebounds is difficult if not impossible to predict. Thus, it's important to stay invested and not focus on the magnitude of gains and losses.

Having a smoother ride can help investors stick to their long-term plans



Second, one of the most important ideas in behavioral finance is known as "loss aversion," the idea that losses tend to feel worse to investors than similar gains. A simple example is that finding twenty dollars on the ground will certainly make you happy but accidentally losing a twenty-dollar bill - or having it stolen from you - will likely make you more upset. This asymmetry in how we experience gains and losses grows as the amount increases. In the extreme, large portfolio gains may make investors quite happy for a short time but large losses may lead investors to give up on their financial plans altogether.

While most investors would like to generate significant portfolio gains year in and year out, the reality is that markets are inherently volatile. This is why, from a long-term perspective, it is far more important for investors to build a portfolio and financial plan that they can stick with through good and bad times, rather than a portfolio with the best theoretical returns.

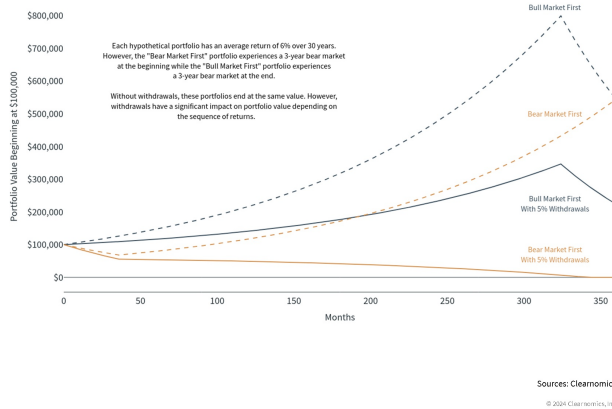
The accompanying chart shows four different asset allocation portfolios and highlights how different their paths have been since the 2008 financial crisis. Clearly, an all-stock portfolio would have performed best over the past 15 years. However, there are few investors who can stomach losses on the order of 50% over the course of years. Thus, most investors would have been better served holding a diversified portfolio instead. Not only would their returns have been quite strong over this period, but they would have been more likely to stick to their financial goals despite the many challenges along the way.

How investors react to bull and bear markets can have long-term consequences

Market and Economic Chartbook | April 10, 2024

Sequence of Returns Risk

The effect of withdrawals on hypothetical portfolios depending on the sequence of returns. For illustrative purposes only.



Finally, the idea that the timing of positive and negative returns matters is known as "sequence of returns risk." In a perfect world, whether an investor experiences a bear market or bull market first would not affect the final outcome, as shown in the dotted lines in the accompanying chart. In reality, however, investors will likely behave differently in bull and bear markets, and they may be withdrawing from their portfolios along the way, creating a drag that is compounded over time. This is yet another reason investors should be careful of making sharp portfolio adjustments during periods of market volatility, and should consult with a trusted advisor on portfolio positioning and

withdrawals.

The bottom line? While markets have reached new all-time highs, investors should not lose sight of risk management. Properly diversifying allows investors to manage through good times and bad, increasing the odds that they will achieve their long-term financial goals.

This content is being provided for informational purposes only and should not be construed as specific recommendations or investment advice. Always consult with your investment professional before making important investment decisions. Diversification and asset allocation strategies do not assure profit or protect against loss. Indices mentioned are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results. Investing involves risk. Depending on the types of investments, there may be varying degrees of risk. Investors should be prepared to bear loss, including total loss of principal.

Securities offered through Registered Representatives of Cambridge Investment Research, Inc., a broker-dealer member FINRA/SIPC. Advisory services through Cambridge Investment Research Advisors, Inc., a Registered Investment Advisor. Cambridge and Sterling Edge Financial LLC. are not affiliated.

Copyright (c) 2024 Clearnomics, Inc. All rights reserved. The information contained herein has been obtained from sources believed to be reliable, but is not necessarily complete and its accuracy cannot be guaranteed. No representation or warranty, express or implied, is made as to the fairness, accuracy, completeness, or correctness of the information and opinions contained herein. The views and the other information provided are subject to change without notice. All reports posted on or via www.clearnomics.com or any affiliated websites, applications, or services are issued without regard to the specific investment objectives, financial situation, or particular needs of any specific recipient and are not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not necessarily a guide to future results. Company fundamentals and earnings may be mentioned occasionally, but should not be construed as a recommendation to buy, sell, or hold the company's stock. Predictions, forecasts, and estimates for any and all markets should not be construed as recommendations to buy, sell, or hold any security--including mutual funds, futures contracts, and exchange traded funds, or any similar instruments. The text, images, and other materials contained or displayed in this report are proprietary to Clearnomics, Inc. and constitute valuable intellectual property. All unauthorized reproduction or other use of material from Clearnomics, Inc. shall be deemed willful infringement(s) of this copyright and other proprietary and intellectual property rights, including but not limited to, rights of privacy. Clearnomics, Inc. expressly reserves all rights in connection with its intellectual property, including without limitation the right to block the transfer of its products and services and/or to track usage thereof, through electronic tracking technology, and all other lawful means, now known or hereafter devised. Clearnomics, Inc. reserves the right, without further notice, to pursue to the fullest extent allowed by the law any and all criminal and civil remedies for the violation of its rights.

