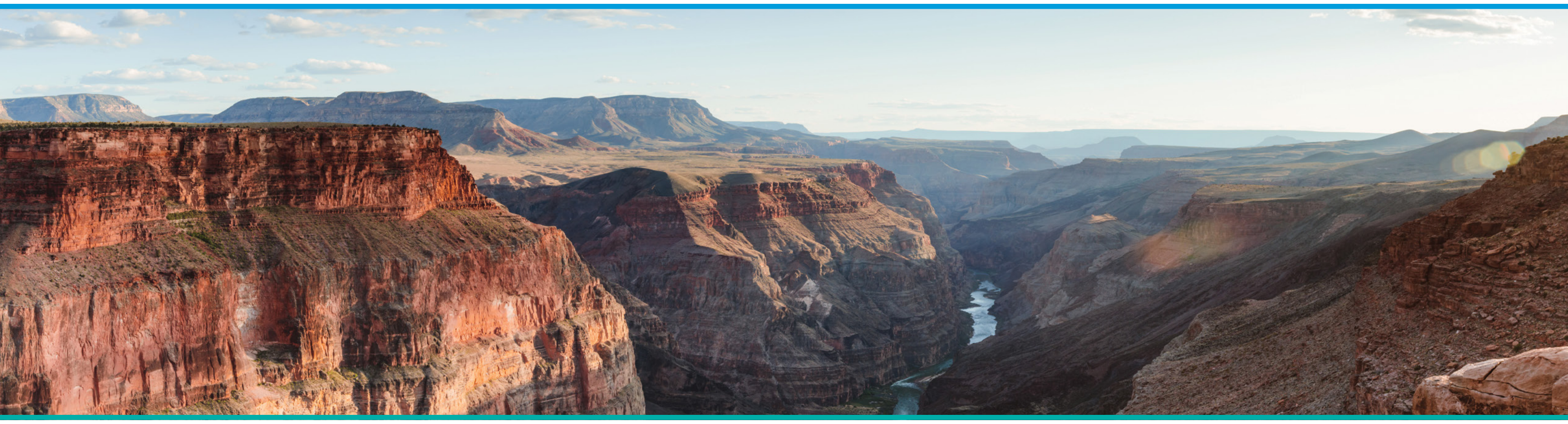
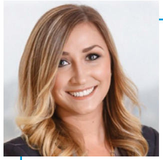
Don’t get caught in the “volatility drag”





Polina Tsybrovska
Multi-Asset
Product Manager

Key takeaways

- In addition to looking at an investment’s results, it is important to consider its volatility and downside risk
- As the magnitude of a loss increases, the subsequent gain required to recoup it grows exponentially, and large losses can impact investor behavior and the potential for long-term growth of wealth
- Metrics that assess an investment’s results relative to its risk, track its performance in both up and down markets, or illustrate its hypothetical growth over time can help investors compare alternatives

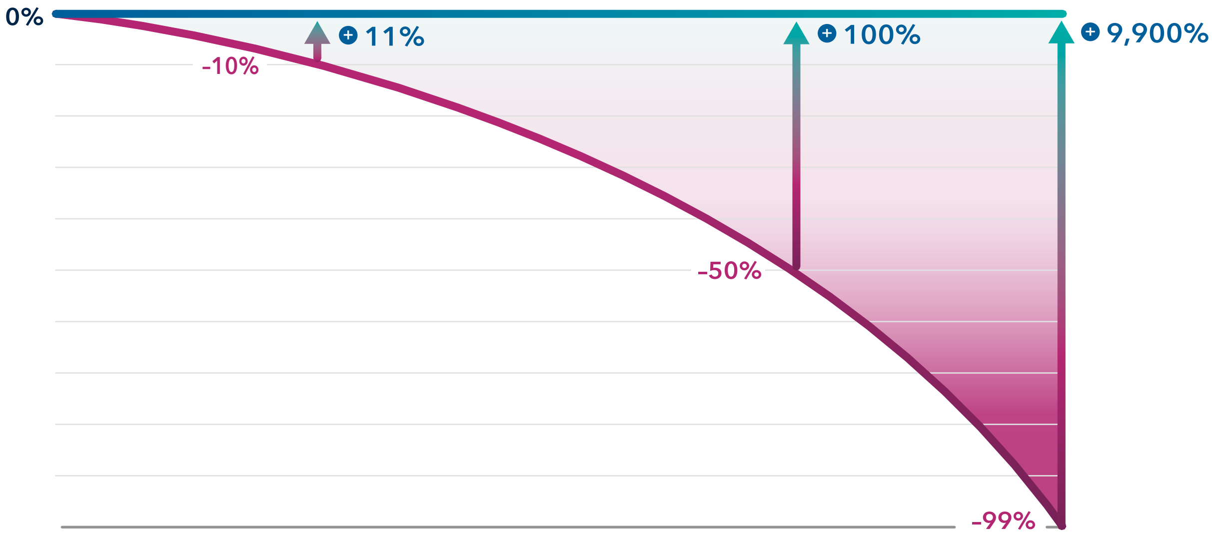
When it comes to markets and investments, it’s easy to focus on the upside. Lists of the top-performing sectors, funds and individual stocks feature prominently in financial media each year. Much less attention is paid to the equally important elements of volatility and downside risk.

Volatile periods can be unnerving for investors. They can result in emotional distress and may lead investors to succumb to decision-reversal risk, potentially abandoning their chosen investment program at precisely the wrong time — that is, at the point of maximum loss. But losses hurt mathematically as well as psychologically: They can have a serious negative effect on an investment’s long-term growth due to an effect known as “volatility drag.”

Consider a hypothetical $100,000 investment that loses 20%. To recoup the loss, the investment must gain 25%. Deepen the loss to 50%, and the gain to recoup the loss grows to 100%. The rebound gain necessary to recoup losses grows exponentially from there, as illustrated below.

Breaking even can be hard to do

As losses grow, the rebound gain required grows exponentially



Source: Capital Group. This example is hypothetical and is for illustrative purposes only.

The outcome of this mathematical relationship is that even if an investment falls by 5% and subsequently rebounds by 5%, it ends with a loss of 0.25%.

Given its impact on the long-term growth of wealth and potential ramifications on behavioral elements, investors should be mindful of portfolio or investment volatility and downside resilience measures, not just returns data. They may find that downside resilience isn't just nice to have – it's practically a must-have for long-term wealth creation.

When comparing investment alternatives, **consider a few important metrics beyond absolute results:**

- **Risk-adjusted returns,** which typically incorporate both the performance achieved and the volatility experienced over a given time period. High Sharpe ratios* relative to comparable peers signify that an investment delivered attractive returns given its level of risk.
- **Up- and downside capture ratios** can be useful tools to help assess how an investment has performed in up and down markets. Specifically, the upside capture ratio is a measure of how well a portfolio performed when its index had positive returns, while the downside capture ratio indicates how it performed in periods of negative market returns. Generally, higher upside capture and lower downside capture is preferable.
- **Wealth generated in dollars** – What's most important for participants is how the metrics above translate to wealth creation in dollar terms. Tracking the growth of a hypothetical $100,000 investment over a long time frame helps illustrate how a given investment approach may deliver spendable wealth.

Downside risk affects the investing experience in ways that aren't always accounted for in absolute returns. A thoughtful approach to risk mitigation such as that taken in the American Funds Target Date Retirement Series® seeks to deliver favorable outcomes for participants.

* Sharpe ratio uses standard deviation (a measure of volatility) and returns to determine the reward per unit of risk. The higher the ratio, the better the portfolio's historical risk-adjusted results.

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