

# THE MOST IMPORTANT RULE IN INVESTING



CHARLIE BILELLO | COMPOUND CAPITAL ADVISORS

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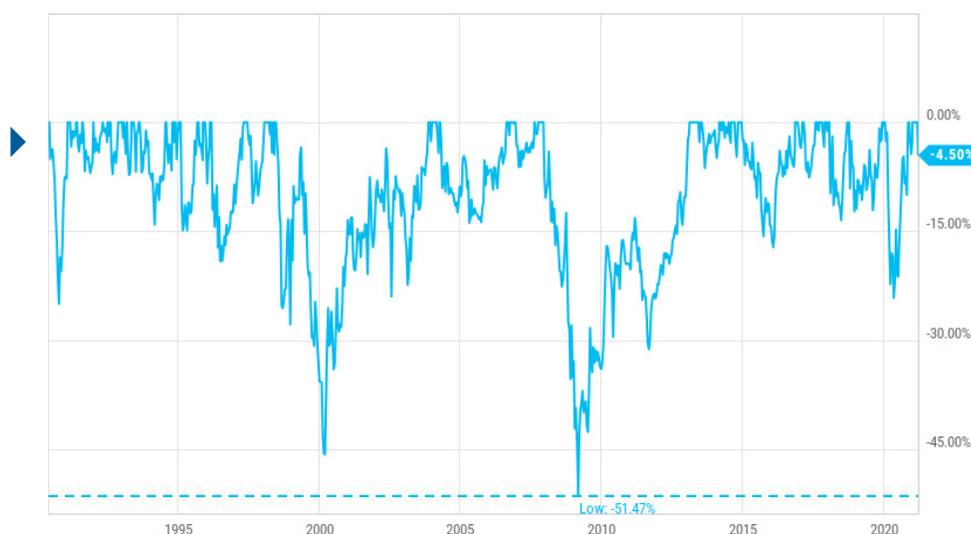
“Rule No. 1: Never lose money. Rule No. 2: Never forget rule No. 1.” – *Warren Buffett*

With all due respect to Warren Buffett, the most important rule in investing is not anything close to “never lose money.” In fact, the entire notion is absurd.

Anyone who has ever invested, in the history of the world, has lost money at one time or another. Buffett himself lost over 50% from late 2007 to early 2009, and over 45% from mid-1998 to early 2000.

Being in a drawdown is the norm, not the exception, and is the price you pay in exchange for a higher long-term return than bonds or cash.

BERKSHIRE HATHAWAY INC. TOTAL RETURN PRICE% OFF HIGH



Past performance is not indicative of future results.

## So What *Is* the Number 1 Rule in Investing?

That’s an impossible question, but if I had to pick just one, it would be the famous line from Peter Lynch: **“know what you own, and why you own it.”** If you don’t get that right, you won’t hold any investment long enough to reap the enormous benefits of compounding.

You can have the best portfolio in the world, but if you don’t understand what’s in it, you will abandon it at the first sign of trouble. And believe me when I tell you that there will be many troubling times.

My goal in this piece is to dig deeper into stock/bond allocations (the most common portfolio holdings among investors), and hopefully give investors a better understanding of what they own and why they own it. Let’s begin...

### 1) Why You Own Stocks

Investors own stocks to participate in the growth and ingenuity of human beings and enterprises over time. In doing so, they hope to outpace inflation and earn a higher return. Makes sense, but what exactly does that last part mean? Higher than what? How much higher? And why are they giving you this higher return?

Over long periods of time, stocks have delivered a higher return than bonds (4.5% higher per/year), and you were able to earn this return because you were being compensated for higher volatility and higher drawdowns (due to economic uncertainty and long-run growth risk).

Since 1976, a 100% stock portfolio (far left side of table) has had the highest return (11.8%) with the highest volatility (15.0%) and max drawdown (-51%) while a 100% bond portfolio (far right side of table) has had the lowest return (7.2%) with the lowest volatility (5.2%) and nearly the lowest drawdown (-13%).

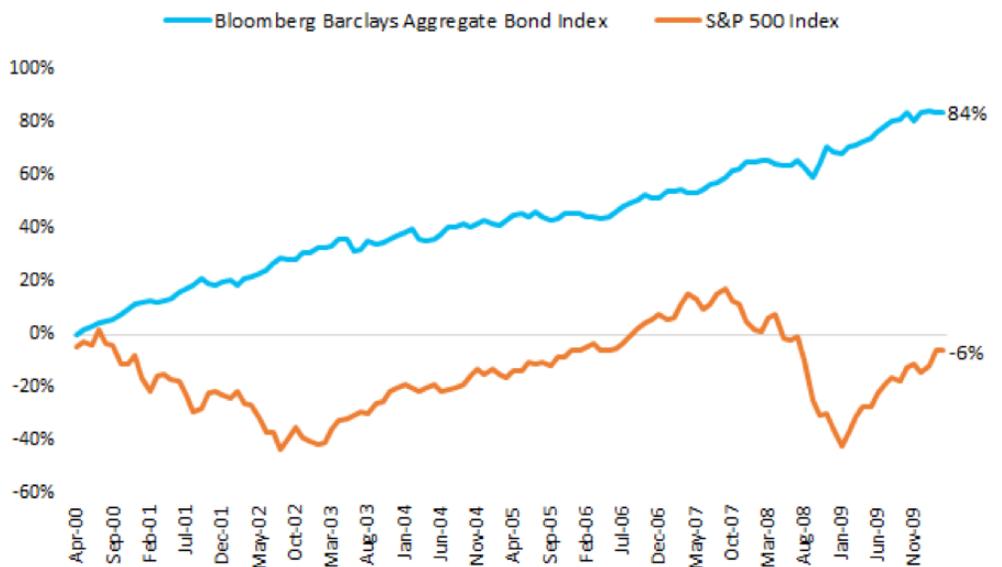
Jan 1976 - Feb 2021 (Monthly)	Stock/Bond Allocation (S&P 500/Bloomberg Barclays Aggregate)										
	100/0	90/10	80/20	70/30	60/40	50/50	40/60	30/70	20/80	10/90	0/100
Annualized Return	11.8%	11.2%	10.9%	10.5%	10.1%	9.7%	9.3%	8.8%	8.3%	7.9%	7.2%
Annualized Volatility	15.0%	13.3%	12.0%	10.7%	9.5%	8.3%	7.2%	6.3%	5.7%	5.3%	5.2%
Max Drawdown	-51%	-47%	-42%	-38%	-32%	-27%	-21%	-15%	-11%	-11%	-13%

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Showing that stocks have earned a higher return with higher volatility over long periods of time is the easy part. The hard part is explaining to investors that they are by no means *guaranteed* this higher return, particularly over shorter periods of time.

And, by shorter periods of time, I mean even as long as 10 years. 10 years, you say, but that's an eternity. Indeed. But, from April 2000 through March 2010, stocks declined 6% while bonds gained 84%. And they did so with 16% volatility versus 4% for bonds.

S&P 500® VS. BARCLAYS AGGREGATE—MONTHLY TOTAL RETURNS: APRIL 2000—MARCH 2010



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**The lesson:** the so-called “risk premium” from stocks is far from constant, and there can be long periods of time where it is negative (stocks lose money with higher volatility than bonds). Understanding that—and I mean really understanding that—is critical to setting realistic expectations. If an investor is not equipped to handle a large drawdown (mentally, emotionally, or financially), they cannot put all of their money in stocks. Which brings us to the next topic.

## 2) Why You Own Bonds

If stocks never went down, there would be little need to own anything else. But, as we know, they do go down from time to time. Since 1976, there have been eight calendar years in which stocks have finished lower: 1977, 1981, 1990, 2000, 2001, 2002, 2008, and 2018. In each of these years, bonds finished higher, cushioning the blow.

Year	S&P 500 (Stocks)	Barclays Agg (Bonds)
1977	-7.2%	3.0%
1981	-4.9%	6.2%
1990	-3.2%	9.0%
2000	-9.1%	11.6%
2001	-11.9%	8.4%
2002	-22.1%	10.3%
2008	-37.0%	5.2%
2018	-4.4%	0.0%

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And the higher allocation to bonds, the higher the cushion...

Year	Stock/Bond Allocation & Total Returns (S&P 500/Bloomberg Barclays Aggregate)										
	100/0	90/10	80/20	70/30	60/40	50/50	40/60	30/70	20/80	10/90	0/100
1977	-7%	-6%	-5%	-4%	-3%	-2%	-1%	0%	1%	2%	3%
1981	-5%	-4%	-3%	-2%	0%	1%	2%	3%	4%	5%	6%
1990	-3%	-2%	-1%	1%	2%	3%	4%	5%	7%	8%	9%
2000	-9%	-7%	-5%	-3%	-1%	1%	3%	5%	7%	9%	12%
2001	-12%	-10%	-8%	-6%	-4%	-2%	0%	2%	4%	6%	8%
2002	-22%	-19%	-16%	-13%	-10%	-7%	-3%	0%	3%	7%	10%
2008	-37%	-33%	-30%	-26%	-22%	-18%	-14%	-9%	-5%	0%	5%
2018	-4%	-4%	-3%	-3%	-2%	-2%	-1%	-1%	-1%	0%	0%

Past performance is not indicative of future results.

A position in bonds has allowed investors to better withstand stock market declines and to hopefully rebalance back into equities at lower prices/valuations. For investors close to retirement or in the early withdrawal stages, bonds may play a more critical role as their tolerance for a near-term drawdown and higher volatility tends to be much lower.

### Why Do High-Quality Bonds Provide Downside Protection?

Because they are not driven by the same fundamental factors as equities. Bonds are driven by interest rates (both absolute levels and changes) as opposed to earnings growth and multiples. As such, the overall correlation between bonds and stocks is low at 0.20. During down months for stocks—and this is key—that correlation drops to 0.00.

This effectively means that there is no reason to expect a down month in stocks will spill over into bonds. The performance data supports this. Since 1976, during down months for stocks, bonds have been up 60% of the time. The higher the percentage of bonds, the higher the odds have been of having a positive return when the stock market was down.

Jan 1976 - Feb 2021 (Monthly)	Stock/Bond Allocation (S&P 500/Bloomberg Barclays Aggregate)										
	100/0	90/10	80/20	70/30	60/40	50/50	40/60	30/70	20/80	10/90	0/100
% of Time Up When Stocks Down	0%	2%	4%	8%	11%	15%	21%	29%	42%	53%	60%
% of Time Up When Stocks Up	100%	99%	99%	98%	97%	96%	94%	90%	86%	81%	72%
Downside Capture	100%	91%	81%	71%	61%	50%	39%	27%	15%	3%	-10%
Upside Capture	100%	91%	82%	73%	65%	57%	49%	41%	33%	26%	19%

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You'll also note in the table above something of great importance: exposure to bonds does not mean one should expect a negative return when stocks are up.

In fact, a portfolio comprised of 70% bonds and 30% stocks has been up 90% of the time when stocks were up. There are two reasons for this: 1) bonds are slightly positively correlated (0.23) to stocks during up periods for stocks (up 72% of the time), and 2) equity exposure is by far the dominant exposure.

To illustrate this second point, let's have a look at a table of correlations. A portfolio evenly split between stocks and bonds exhibited a 0.95 correlation to

	Stock/Bond Allocation (S&P 500/Bloomberg Barclays Aggregate)										
Jan 1976 - Feb 2021 (Monthly)	100/0	90/10	80/20	70/30	60/40	50/50	40/60	30/70	20/80	10/90	0/100
Correlation to S&P 500	1.00	1.00	1.00	0.99	0.98	0.95	0.91	0.82	0.68	0.47	0.20
Correlation to Barclays Agg	0.20	0.23	0.28	0.33	0.40	0.49	0.59	0.72	0.85	0.96	1.00

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stocks and only a 0.49 correlation to bonds. It is going to behave much more like the stock market than the bond market. This is often a surprise to many, but it should be somewhat intuitive as stocks (on average) have 2.9 times the volatility of bonds. Stock volatility simply overwhelms the movement of bonds. Which is why if you want/need your portfolio to move more directionally with bonds than stocks, you need to have something closer to a 20/80 split.

A final point on the value of bonds in a portfolio comes in observing the steepest stock market declines. In the top 25 largest monthly S&P 500® Index declines (declines > -6.8%), bonds had a -0.12 correlation with stocks and an average return of +0.5%. Why do bonds hold up particularly well during such periods? There tend to be deflationary concerns during large stock market declines, when growth expectations are lowered, and interest rates tend to fall. Falling interest rates boost short-term bond prices, providing a positive hedge to stocks (on average) during the worst months.

### Rule Number 1 Is Not Enough

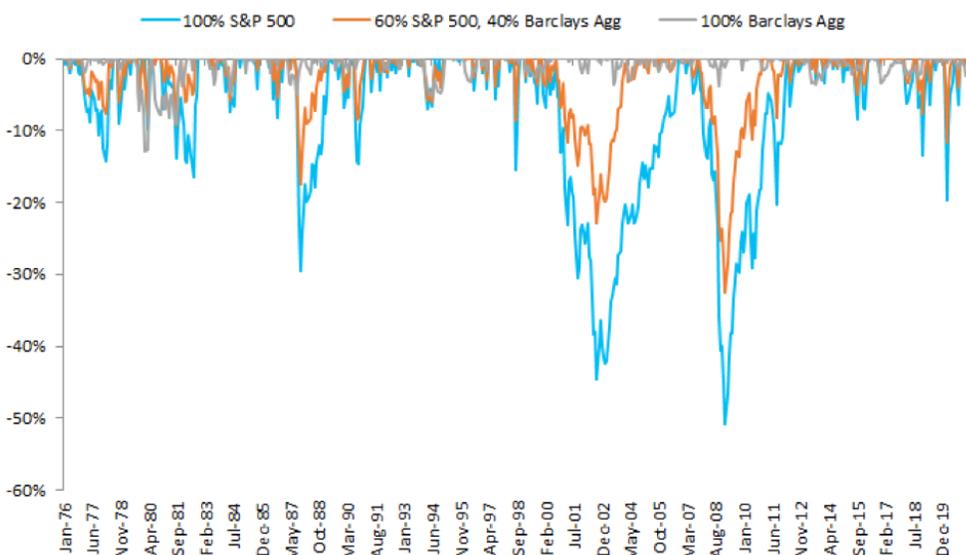
Knowing what you own and why you own it may be the most important rule, but it's just the beginning of the investing journey, not the end.

Once you understand the "what" and "why," the hard work begins. You must have *faith* that your chosen investing plan will work *over time* and the *fortitude* to stick with that plan through the many periods in which it is "not working."

This is no small task as we humans are emotional beings and have little tolerance for things that aren't always working.

But, that is the challenge for which there is great reward at the end; the alternative (a risk-free savings account) always works, but will leave you with far less in the long run.

HISTORICAL DRAWDOWNS: 1976-2021



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So take a good look at your portfolio today and make sure you know what you own and why you own it. Then ask yourself if you have the faith and fortitude to stick with it over time.

And finally, remember that every investor loses money, even the great Warren Buffett. That's the price of admission.



To learn more, please contact us at 800-243-4361 or visit [virtus.com](http://virtus.com).

Throughout this post when I refer to stocks I am using the S&P 500 Total Return Index and when I refer to bonds I am using the Bloomberg Barclays U.S. Aggregate Bond Total Return Index. The data used is monthly returns from January 1976 through February 2021. I started in January 1976 as that is the start of the Bloomberg Barclays Index. Data Sources: Bloomberg/YCharts.

**Correlation Coefficient**—A measure that determines the degree to which two variables' movements are associated. The correlation coefficient will vary from -1 to +1. A -1 indicates perfect negative correlation and +1 indicates perfect positive correlation. **Maximum Drawdown**—The peak-to-trough decline during a specific record period of an investment, fund, or commodity. A drawdown is usually quoted as the percentage between the peak and the trough. **Volatility** is defined as **Standard Deviation**, which measures variability of returns around the average return for an investment portfolio. Higher standard deviation suggests greater risk.

The **Bloomberg Barclays U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment. All investments carry a certain degree of risk, including possible loss of principal.

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