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Losses and Compounding

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At Tacit, we firmly believe that equities are a good thing in the long run. Over time, rising equity markets can support confidence, help individuals build wealth and, ultimately, benefit the wider economy as people feel more secure in their financial position.

It is important, however, to remember that equity market downturns cannot be foreseen. Whilst they are often relatively short-lived, they can create real psychological barriers for investors.

Having been positive on equity markets for more than three years, we have noticed a distinct change in investor appetite for riskier assets this year. We would remind readers that being invested before a market rise is vital. Chasing a market after it has already risen is not a long-term investment strategy that tends to end well.

Microsoft provides a useful example. It was, and remains, a well-managed and profitable company, but it took more than 13 years for its share price to recover to its 2000 dot-com peak. Good businesses can still prove poor investments when bought at the wrong price or after excessive optimism has built into the market.

Capturing rising markets is clearly important for long-term returns. However, a common investor mistake is to chase returns during periods of strong performance, only to be caught out by an unforeseen event and then reduce equity exposure when markets are at their lowest.

The successful IPO of SpaceX last month is, in our view, another reminder that herd behaviour remains alive and well. This is not necessarily unhealthy, but it does create risks that investors need to understand.

To illustrate the point, we can consider two hypothetical portfolios. Both have the same starting value, broadly similar asset allocation and comparable risk characteristics at first sight. Their performance is identical during periods when markets are rising. The difference is that Portfolio A suffers larger losses when markets experience short-term falls.

Year	Portfolio A	Portfolio B
2011	£100,000.00	£100,000.00
2012	£85,000.00	£95,000.00
2013	£85,000.00	£95,000.00
2014	£93,500.00	£104,500.00
2015	£102,850.00	£114,950.00
2016	£113,135.00	£126,445.00
2017	£124,448.50	£139,089.50
2018	£149,338.20	£166,907.40
2019	£119,470.56	£150,216.66
2020	£131,417.62	£165,239.33
2021	£144,559.38	£181,762.16
2022	£137,331.41	£181,762.16

Year	Portfolio A	Portfolio B
2023	£151,064.55	£199,938.37

The only difference between the two portfolios is that Portfolio A experiences larger losses in 2012, 2019 and 2022 than Portfolio B.

The power of compounding means that these periods of weakness have a much greater impact on longer-term returns than many investors initially expect. By the end of the period, the difference between the two portfolios is close to 50%.

This is important because losses require a disproportionately greater return to recover. A portfolio that falls by 10% needs to rise by more than 11% simply to return to its starting point. A portfolio that falls by 20% needs a gain of 25%. The larger the loss, the harder the recovery becomes.

Avoiding losses altogether is not realistic, nor should it be the objective for investors seeking long-term growth. Equity market volatility is part of investing. The key distinction is between accepting sensible short-term volatility and taking unnecessary risks that can lead to permanent damage to capital or poor behavioural decisions at the wrong time.

At Tacit, we remain focused on helping clients participate in long-term market growth while managing downside risk sensibly. This means remaining mindful of valuations, ensuring portfolios are diversified and balancing growth assets with appropriate stabilisers. Ultimately, strong long-term returns are not simply about capturing every market rise. They are also about limiting the damage when markets fall, allowing capital to recover and compounding to continue over time.

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