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Surviving Corrections

The coronavirus correction in March 2020 took the stock prices of the S&P 500 companies down by 35%. Ouch! How did your portfolio do? Did you bail out and take the losses? Did you hide under the bed and refuse to open your brokerage statements?

The perennial trading argument is Buy and Hold vs. Timing the Market. The Buy and Hold camp tells us that it is impossible to sell at the highs and buy back at the lows. I grant that perfect market timing is impossible but open a price chart of the S&P 500 index. It was obvious to everyone by the last week in February 2020 that the market was in serious trouble. Depending on when you started closing positions that week, you would have limited your losses to something on the order of 10-12%. You don’t have to hit the perfect highs and lows of the market to save yourself a lot of anxiety (and a lot of money).

Earlier this year, the Buy and Hold crowd rode the market down to the 35% low on March 23rd. Those portfolios took around five months to recover those losses. The Buy and Hold crowd became the Hiding Under the Bed crowd.

Some will argue this is a matter of unavoidable risk. Conservative investors have been told that actively trading their stock portfolio is a high-risk game. The results for 2020 in two of my trading services, each of which mirror my portfolios at Charles Schwab and E*Trade, serve as excellent real-life examples.

The Conservative Income trading service mirrors the covered calls and cash secured naked puts in my E*Trade account. When used with solid blue-chip stocks, these are widely regarded as the most conservative stock and option trading strategies available to the retail investor. When the market lost 35% in March, this service lost 10%. One month later, this portfolio had returned to break-even for the year. The Conservative Income service completed the year with returns for investors of 26%. The S&P 500 recovered to a year end finish of 16%, lagging well behind our Conservative Income portfolio. This subscription service takes low risk positions and survived the correction very well. Taking more risk isn't necessary to protect your portfolio from corrections in the market.

Dr. Duke's Trading Group uses a variety of option spreads that incur moderate to high levels of risk. Our low point during the March correction was -36%, approximately the same as the overall market. But that is where the similarity ended. This portfolio returned to break-even after six weeks. Our trading group finished the year with a gain of 370%. Members of this group are certainly taking more risk, but they survived the correction very well.

Whether an investor uses conservative, low risk trading strategies or chooses to incur higher levels of risk doesn't affect the trader's ability to survive a correction.

The difference is risk management:

- Choose trading strategies consistent with your risk profile.
- Trade small and scale up slowly. Trading small gives you the time to build experience without incurring too much damage from the inevitable early mistakes in the learning curve.
- Develop and follow a trading system, i.e., a system of rules for entering, managing, and exiting each trade.
- Both greed and fear are dangerous emotions. Your trading system is the cure.

Conservative trading strategies lead to a tighter spread of wins and losses, i.e., the standard deviation of the results is smaller. Large investment banks and hedge funds track the standard deviations of their portfolios very closely. The standard deviation of the returns is the best measure of the risk incurred by that portfolio's investments. The average gains over time will be positive if trades are managed well. But conservative trading strategies take less risk and therefore result in smaller net gains over time.

Trading strategies that incur higher risk lead to a wider spread of wins and losses, i.e., the standard deviation of the results is larger. But, again, the average gains over time will be positive if the trades are managed well. One of the fundamental laws of finance reminds us that the potential of higher gains is always accompanied by higher levels of risk. The higher returns and the wider range of the returns for the trading group are an excellent illustration of that principle.

If we apply those principles to the results of the Conservative Income trading service and Dr. Duke's Trading Group, we see precisely the correlations we would predict.

The monthly returns of Conservative Income from its inception in April 2016 through December 2020, or 57 months, averaged 1.07% per month with a range of -10.1% to +8.5% and a standard deviation of 0.03. Contrast that with the Trading Group's 138 trades in 2020 that averaged 27.1% per trade with a range of -100% to +1667% and a standard deviation of 1.66.

Two standard deviations correspond with a 95% probability of including all of the data. Hence it is common to report an average result plus or minus two standard deviations as the expected return over a large number of events:

> Conservative Income resulted in an average monthly return of
> 1.07% $\pm$ 0.06 for an expected range of 1.01% to 1.13%
>
> Trading Group resulted in an average return per trade of
> 27.1% $\pm$ 3.32 for an expected range of 23.8% to 30.4%

Members of the Conservative Income trading service achieved a relatively low monthly return with a low level of risk, resulting in a narrow range of returns over time.

By contrast, members of the Trading Group achieved a relatively high return per trade, but incurred a higher level of risk, resulting in a wider range of returns over time.

The level of risk you take in your trading does not affect the ability of your portfolio to survive a correction. The ability to survive the correction is rooted in risk management. The level of risk affects the average return and the expected range of the trading results – higher risk leads to a higher average return and also a wider range of results. Higher risk traders must be comfortable with wide swings in the results of the individual trades.

If you want to learn more about real world trading absent the marketing hype, check out the private coaching, group classes, and trading services offered by Parkwood Capital.

You have entered The No Hype Zone!

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