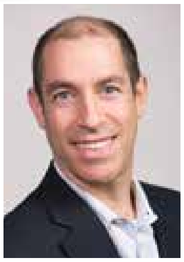

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A Critical Portfolio Construction Concept: Dollar Downside Risk

By Ian A. Post, CFA, CFP®

When thinking about how much equity to hold in a portfolio, we typically think in terms of percentages, i.e. I want to hold a portfolio with 60% in equities and 40% and bonds. This makes sense from a design perspective; we simply divide the pie up based on the target percentages. However, if we stop the portfolio construction process at this stage, we miss a critical component of the decision-making process. The real impact on our lives and emotions are dollar changes. We can't spend a 10% gain on a new car and we don't cancel vacations because of a 20% loss. Dollar changes are what matter.

Suppose an investor begins an investment plan by choosing a diversified balanced 60/40 (60% equity/40% bonds) portfolio. We can estimate the percentage downside of this portfolio by using the experience from the 2008 financial crisis which led to a roughly 50% loss in broad market equities.[1] Assuming a flat return on the bond portion of the portfolio, a diversified 60/40 portfolio should have a downside percentage of 30%.[2]

By maintaining the 60/40 portfolio over time, investors might assume they are also maintaining the riskiness of the portfolio. This is true in regard to potential downside **percentage losses**. However, if the portfolio grows over time (either due to appreciation or additional investments, or some combination of the two), **the dollars at risk increases**. It's important to understand that this happens ***even without*** increasing the percentage of stock exposure in the portfolio.

The key then is to always translate percentage allocation targets into dollars at risk.

The table below illustrates how different dollar risk can be for the same allocation target.

Equity Allocation	Portfolio Value					
	100,000	250,000	500,000	1,000,000	2,000,000	5,000,000
80%	-40,000	-100,000	-200,000	-400,000	-800,000	-2,000,000
60%	**-30,000**	**-75,000**	**-150,000**	**-300,000**	**-600,000**	**-1,500,000**
40%	-20,000	-50,000	-100,000	-200,000	-400,000	-1,000,000

A traditional 60/40 balanced portfolio has a downside dollar risk of $30,000 assuming a total portfolio balance of $100,000. At a $500,000 balance, the downside dollar risk increases to $150,000. At a $2 million balance, the dollars at risk reaches $600,000 and at $5 million, the dollar downside risk of a 60/40 portfolio is $1.5 million.

The same 60/40 portfolio becomes much riskier on larger portfolio balances when measured by dollar downside risk.

The dollar downside risk concept reminds us that investors should continuously monitor the amount and types of risks in their portfolios to ensure they are consistent with their willingness and ability to take risk. It's also important to remember that this type of planning happen ***before*** significant market volatility. Once a bear market takes hold, dollar downside risk becomes actual dollar downside so make sure you know beforehand how many dollars you have at risk.

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[1] Based on a diversified equity portfolio experiencing a 2008-like loss of approximately 50%.
[2] (60% x -50%) + (40% x 0%) = -30%