Trade-off of Safety: Downside Protection or Long-Term Returns?

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Dot-com bubble, the collapse of Lehman Brothers, the COVID-19 pandemic, and the ongoing war in the Middle East have each produced significant turbulence for the global economy. Many traders (both institutional and retail) have suffered losses (McCabe and Dummett, 2026). In periods of heightened equity-market volatility, capital preservation is essential to staying in the game. Is it that simple? Yes, and no.

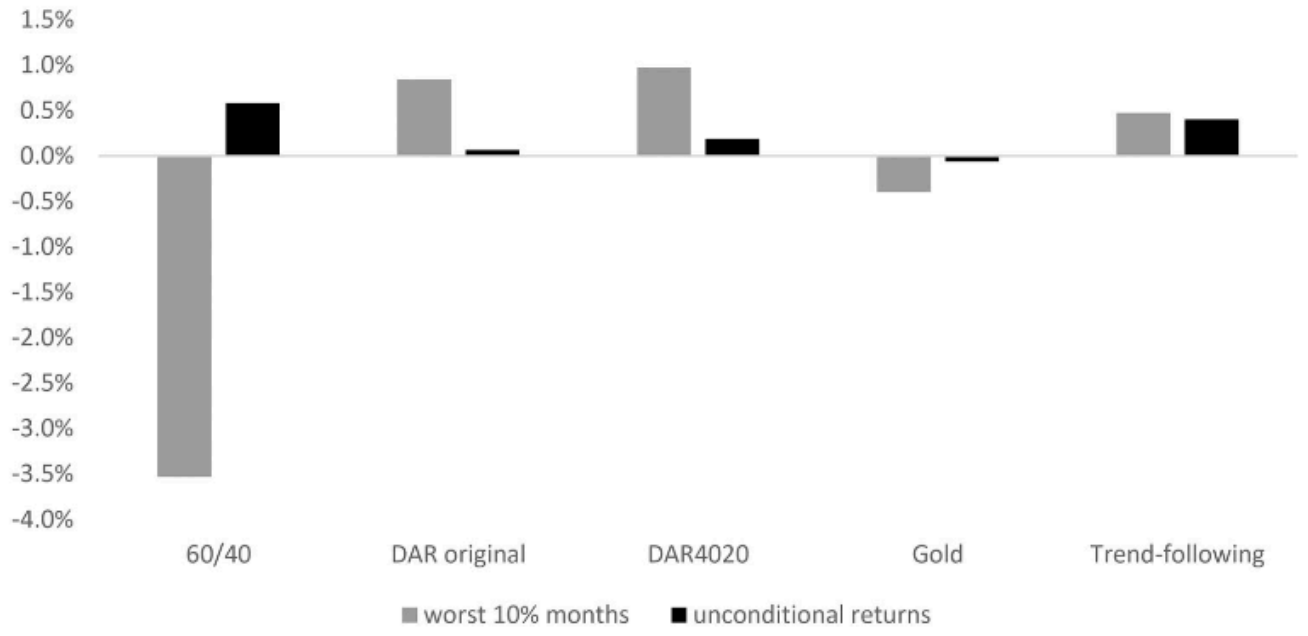
Yes, because many knowledgeable practitioners have "generously" shared downside-protection strategies, often accompanied by polished metrics and attractive equity curves. A widely cited benchmark is the 60/40 portfolio composed of 60% equities and 40% bonds. Baltussen et al. (2023) studied this portfolio extensively over 222 years of data, and reported an average annual return of 7.0%. While 7.0% isn't spectacular, the allocation remains appealing if it can roughly sustain that return through turbulent periods. But can it?

Numerous studies have criticized the 60/40 portfolio for large drawdowns during crises and for a weakening cushioning effect from fixed income (Capital Group, 2025). In particular, the 60/40 portfolio's negative performance during volatile periods is remarkably consistent across 200 years of data.

Cavaglia, Hua Fan, and Wang (2022) proposed the Defensive Absolute Return (DAR) portfolio. Using the 60/40 portfolio as its benchmark, DAR goes long the top 33% of factors most negatively correlated with the benchmark and shorts the top 33% most positively correlated. This reduces drawdowns in the worst 10% of periods but comes at the cost of very low unconditional returns, which has drawn criticism. Baltussen et al.(2026) proposed a variation, that is going long the top 40% most negatively correlated and shorting the top 20% most positively correlated, and showed improved downside protection further, but still failed to boost average returns materially.

This leads to a final, practical question: are you willing to accept lower returns 90% of the time to preserve gains during the worst 10%? If so, the solution is straightforward. If not, as many investors (including institutions) conclude, you must either tolerate greater market risk and potential downturns or search for alternative approaches.

Figure 1: Monthly return of 60/40 portfolio and some downside-protection strategies



Source: Baltussen et al., 2026

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