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Why losing less means gaining more over the long term

In our last edition of this publication on October 31, as global stocks were headed for their worst monthly performance in years, we had discussed the virtues of staying invested for the long haul. One of the points we had highlighted was that most investment returns can be attributed to a handful of periods of exceptionally strong market performance. Staying out of the market during these periods could have an adverse effect on portfolio performance, while trying to "time the markets" can be an exercise in futility.

Widespread hopes that November – historically the time of year when markets begin to pick up – would provide some respite from the market selloff have been dashed so far. In fact, the S&P 500's 3.8% tumble last week was its third-worst performance in a Thanksgiving week in almost 80 years.

In 2017, global markets were unusually becalmed and almost every asset class posted solid returns. In stark contrast, 2018 so far has been a year when most markets and asset classes are down – "no place to hide" in market parlance. With North American indexes having already endured two corrections (a decline of at least 10%) this year, market turbulence seems likely to continue in 2019. Against this backdrop of rising market volatility, the concept of upside / downside capture assumes even greater importance.

Upside /downside capture ratios indicates by how much a portfolio or fund has outperformed its benchmark during periods of market strength and weakness respectively. An upside capture ratio of over 100 indicates that the fund generally outperformed the benchmark during positive market periods, while a downside capture ratio of less than 100 indicates that the fund lost less than its benchmark during negative market periods. For example, consider a Canadian large-cap equity fund that is benchmarked to the TSX Composite and has an upside / downside capture ratio of 75 / 80. If the TSX Composite had gained 10% over a specific time-period, the fund would be up 7.5% over that same period, while if the TSX Composite was down 10%, the fund would have lost 8%.

It is nearly impossible to avoid losses in one's portfolio during times like these, when the TSX is -7.4% YTD, crude oil has plunged by one-third in less than two months, and numerous stocks in the S&P 500 are down more than 20% for the year. In such an environment, mitigating downside risk and protecting capital is of utmost importance, since limiting losses can enable a portfolio to gain substantially more than an aggressive portfolio over the long term, as the following example demonstrates.

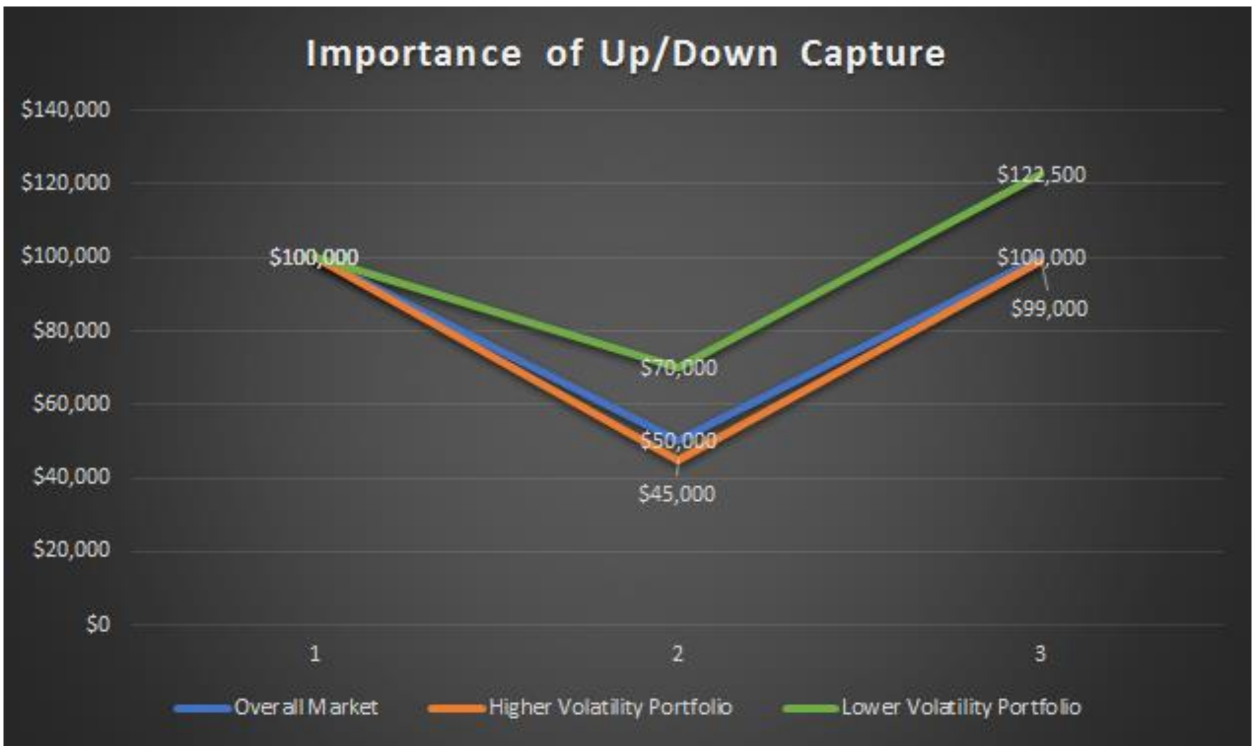
Consider two portfolios with very differing characteristics. The higher-volatility portfolio – which swings for the fences, to borrow a baseball analogy – has an upside / downside capture ratio of 120 / 110, while the lower-volatility portfolio has an up/down capture ratio of 75 / 60. Here's how the performance of these two hypothetical portfolios stacks up over a typical cycle period when the broad market plunges by 50% (the drawdown period), and subsequently rebounds 100% (the recovery period).

Table 1: Performance of two portfolios with differing characteristics during drawdown and recovery

	Drawdown(%)	Recovery(%)	Starting Value	Drawdown($)	Trough Port.Value	Recovery ($)	Final Value
Overall Market	-50%	100%	$100,000	-$50,000	$50,000	$50,000	$100,000
Higher Volatility Portfolio	-55%	120%	$100,000	-$55,000	$45,000	$54,000	$99,000
Lower Volatility Portfolio	-30%	75%	$100,000	-$30,000	$70,000	$52,500	$122,500

As can be seen in Table 1, the lower-volatility "Steady Eddie" portfolio outperformed the aggressive, higher-volatility portfolio by more than 23 percentage points over this full cycle. Despite lagging it by a huge margin in up markets (75 vs. 120), the lower-volatility portfolio's better downside capture (60 vs.110) resulted in lower losses and therefore a higher capital base at the beginning of the recovery period.

Figure 1: Losing less means gaining more over the long term (Source: Luft Financial)



In our client portfolios, we have been actively rebalancing during this period of enhanced volatility at key periods, such as on the eve of the U.S. mid-term elections. Since the first week of October, we have also added selectively to positions in stocks with excellent long-term prospects and compelling valuations, such as Manulife, Magna, SNC-Lavalin, and Qualcomm. We have also added to our US exposure in US dollars to increase currency diversification. In addition, we are well diversified through exposure to asset classes with an inverse or low correlation to stocks, such as government bonds, mortgages, and hedge funds. These tactical moves should limit losses in our client portfolios if the market downdraft continues, while positioning them to participate in most of the upside as and when markets recover.