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Hoe: Downside Capture

By Richard Hoe

The most important element of my investment work can be summed up in those two title words.

When the market goes south, how much of it does a portfolio, fund, or stock capture? If the S&P 500 went down 40% in one year, would an investment you recommend also go down 40%? If so, it is capturing 100% of the downside. If it went down half of the 40%, your investment would capture 50% of the downside.

Unconscious Automaton

I learn new things all the time, but sometimes I connect with concepts unconsciously, almost automatically, over long periods of time. I am not strictly aware of it when it happens. While I may have been aware of downside capture as an investing tool, I never really gave it much deep thought until a few weeks ago. I went to a group lunch with a mutual fund wholesaler, and downside capture was the topic du jour. Good grief, I thought to myself, that's one of the most important things I do, and I didn't even realize it.

In my portfolio design, I spend countless hours analyzing funds and stocks and asking questions like these (relative to a mutual fund — the stock questions are different):

- What is the purpose of the fund?

- When the market goes down, what happens to the fund?
- Is the fund based on value or growth?
- Does fund management work top-down or bottom-up?[1]
- Does the fund capture X% of the upside and Y% of the downside?
- Is management consistent and are the goals consistent over time?
- Do the managers stick to their guns, or do they permit style drift?

So, a fund[2] that captures only 60% of the upside (60% of the S&P 500 or whatever index is used) will go up 60% of the index. If the index rises 25% in a year, the fund will rise only 15%. But the most important question is, what will the fund do when the index goes down, down, down?

Most investors play in what Charles Biderman of TrimTabs Investment Research refers to as the stock market casino. I call it the Big Casino. (The stock market cashbox is lots bigger than the one in Las Vegas, or in all the casinos in the world combined, for that matter.) Players in the Big Casino are happy when they win and sad when they lose. They scatter their money like drunken sailors.[3]

Few investors fully understand that they can make consistent gains through consistent investing. I can say with certainty that fewer than 1% of the non-professional people I meet professionally are competent in the art and science of investing. Unfortunately, many investment representatives aren't much good at it either. The problem is that when the market is humming, as it has over the past 18 months — some burps, but mostly up — people forget about downside risk and every Joe and Jane Investor thinks he or she is a winner. Then the market turns south for a sustained period, and many, perhaps most, lose what they've won.

Here's the way it works for a mutual fund that is trying to minimize downside capture. Assuming the fund captures 9% of the downside numbers and 60% of the upside, it might look like Fund X in the chart below, compared to an index that, while volatile, is actually flat over time.

Because my portfolios include more than just mutual funds, it is likely that my overall yearly average return will be higher than the 4.18% average shown in the chart. I might well buy Fund X for my customer's portfolio, but I would also have corporate bonds, government bonds, inflation-protected bonds, real estate, natural gas, opportunistic real estate, leasing, natural resources, and other sensible non-correlating assets. Readers of The Investment Edge know that I shoot for an overall 8% to 12% average yearly return. It's the combination that makes things work.

By combining non-correlating asset classes, you can develop a methodology for investment success and avoid as much of the gambling aspect as possible. It's not that there's no risk — there is risk in everything — it's that there is less risk in diversification. A fistful of bank CDs can have more risk than a well-diversified portfolio. Virtually by definition, CDs cannot keep up well with inflation.

Chasing Tails

If you think a 10-year roller-coaster ride like the one in my chart couldn't happen, think again. Meanwhile, we math-challenged humans look at the 10-year results and tend not to look past the raw numbers: "Big deal," we say, "Fund X was only a bit over 3% more than the index."

Note that the Fund X 10-year average is more than five times greater than the average of the hypothetical S&P 500 index, producing close to six times as much money. If we were dealing with income, and the amount of the retirement nest egg was $400,000, Fund X would yield an average of $16,720 yearly vs. $2,880 for the index. There's also a better chance of preserving capital with Fund X than with the index fund because of the greater diversification.

While I believe that the S&P 500 will perform well and generate a good average return over time, I consider it a 20-year game of chance. And that assumes we are around for 20 years. I can't make a 20-year warranty, however, on you or me or any of my customers. I also cannot predict what a customer will do when we have a calamitous 10-year run like the one in the first chart. But I can say that a customer invested in Fund X is likely to continue to do business with me.

Consider, too, that if a customer began with $400,000 in an index fund and lost 41.5% in the first year, that's $162,000 out the window, plus whatever income he or she might have taken. Making up that deficit is a killer of a task.

Running Out of Gas

The chart above shows what I consider a fairly reasonable scenario, an investment in an index, the annual result, and an annual payout (income taken by the owner) that begins at 5% of the amount invested. The amount drops to $139,334 over 10 years, and will surely vanish completely — assuming a constant annual withdrawal of $20,000 — over 15 or so years.

This chart illustrates that while index investing may be OK when a customer is 30, there is a good chance it won't work when the person is retired. And the chart doesn't take into account another very real factor — panic. How do customers feel as their hard-won money is evaporating? How do they act? One problem I see often from panic is that customers who quickly lose big money in the Big Casino seek out riskier schemes and gunslinging financial advisers to make up the losses. This almost always has the opposite effect, and even more money is lost.

These numbers are not the same as the ones in the first chart, but I did lift the 41.5% downturn from before and put it in the first year this time.

The main thing to take away from this column is this: to come out ahead in the stock market casino, to make it work for you, you need to diversify and manage. An index, such as the S&P 500 or the Dow, usually will perform well over 20 years, but few investors can wait 20 years to see real gains.

In a volatile market, panic will rule the day, and customers will scatter on the wind. For those who are at or near retirement, the overwhelming priority is income. So it's a whole new ballgame when your customer retires, and your mission is to make the money last as long as it needs to last.

(By the way, if you are thinking of using indexed annuity or indexed life insurance products for this job, please remember that none of them account for dividends, which make up 35% to 40% of the S&P 500's result, and consequently you may find yourself squarely behind the investment eight-ball.)

Investing for others is always the province of intensely thoughtful people. Ours is a very serious and very rewarding profession. The standard is taking care of your customers, and taking care of them well.

Broker's Bookcase

The Flip Side — Break Free of the Behaviors That Hold You Back, by Flip Flippen (Springboard/Warner, 2007). Why do some people who seem, right from the beginning, to have no chance in life, overcome everything and become successful while others go negative in virtually every possible way, and fail?

This book is all about overcoming constraints — the things imbedded in our psyches that keep us from success, however we define it. You don't have to be born in a ghetto to have constraints. We all have them, and they affect the way we live, love, and work.

Flippen, a psychotherapist and businessman, offers his own definition of success: "Being successful is being able to see past your private agenda, and learning to manage innate tendencies toward selfishness and greed to become more sensitive to others who share your journey," he writes. "Real success is being known as someone who improves the lives of those (you) touch — which also means that we strive to touch more because internally we know that we can make a difference."

The book is most helpful in its prescriptions for dealing with constraints, which "… set the limits for where you ultimately go; no matter how gifted or talented you are. Your personal constraints — your conscious and unconscious limiting behaviors — hold you back and determine your ultimate level of success."

Flatliners, bulldozers, and volcanoes are some of the people you'll meet in this book; you'll recognize them, of course, but more importantly, you'll find yourself in these pages. There's plenty of good storytelling, too, and nothing holds my interest better than that.

With Flip Side, you'll get an enjoyable read, and learn about overcoming your own constraints and how to deal with the ones other people have. It's no wonder that Flippen works with a lot of sports figures: he's good. Head on down to the bookstore and pick up a copy.

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Footnotes

1. Top-down looks first at global and macro economic conditions, sectors, and other data and works down from these and other factors to the company; bottom-up investing looks at the company (stock) first and then works up.
2."Fund" in this sense includes sub-accounts in variable products.
3. Paraphrasing Senator John McCain, this may be an insult to drunken sailors.