Fundana
ASSET MANAGER

Drawdown Analysis – Show me your drawdown, I'll tell you who you are.

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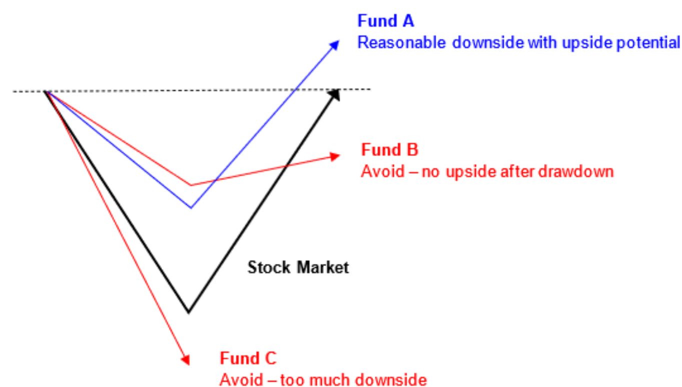
For many investors, experiencing drawdowns can be an emotional roller coaster. At first, a 5% correction can be exciting as it can be seen as a buying opportunity. At -10%, however, anxiety kicks in quickly and now the question becomes: is it still a buying opportunity or rather time to reduce risk? At -15%, all the plans for a good year are now gone and after a few percent more, capitulation typically leads to a massive risk reduction as stress is at a maximum. Unfortunately, this is typically when the market makes a bottom and starts to rise again. Indeed, for our generation, markets have always rebounded. And those rallies are the most hated by investors as they watch markets rise without being fully invested, leaving them lagging the market at the end of the year. With investors going through so many emotions, it is easy to make serious mistakes and to ruin a track record.

However, as painful as these drawdowns might be, they also represent excellent opportunities to analyse your managers and refine your manager selection. At Fundana, we like to say that monitoring our managers is at least as important as the initial manager assessment. The COVID-19 crisis is certainly providing another opportunity to separate the good managers from the bad and more importantly from the ugly.

After decades of manager selection and monitoring, we have developed a simple yet robust tool that enables us to assess the quality of managers during a drawdown. We call it the V-Shape analysis and a stylized version is shown in the graph below.

V-Shape Analysis



The idea is to compare a manager's drawdown versus the market. Here we will use fundamental Long/Short Equity managers to explain the concept. While these managers are primarily stock pickers, we want to make sure that they are also good risk managers.

Over the long run, and with enough market corrections, it becomes as important to be a good risk manager as it is to be a good stock picker.

Scenario 1 – Too much downside

The first check is to see if a manager does worse than the market on the way down. From the chart above, we can see that Fund C loses more than the market. This is already a bad sign as Long/Short Equity managers are supposed to protect the downside and hence reduce an investor's portfolio volatility. In addition, the fund will now need to take more risk if he wants to recover the high watermark. That situation is quite dangerous because if the market has another leg down, the fund will now lose a lot more than the market, putting itself in a position where recovering those loses will be next to impossible. Not surprisingly, Fund C types are to be avoided, even if they have recovered during previous crises. It may work a few times until it doesn't, and you end up with an accident in your portfolio.

Scenario 2 – Too little upside

Another common outcome is a fund that protects the downside but that does not participate during the market rebound, like Fund B. This is usually because managers cut risk massively at the worst time or because the Short book is not constructed properly. While the initial protection is welcome, these funds end up the year behind the markets and make for poor investments. Being able to participate in rebounds is as important as protecting the downside!

Scenario 3 – Getting it just right

What we should always be looking for are funds like Fund A. The manager limits the downside with a sound portfolio construction and good risk management and yet manages to capture the upside. Because he lost less than the market on the way down, all he needs to do is to capture the rebound to finish *ahead* of the market at the end of the drawdown. Over the years, we have observed that the very best managers tend to reduce Net and Gross exposures as the market corrects while increasing certain position sizes on a stock-by-stock basis. In doing so, the manager reduces the directionality risk and the balance sheet risk in case the market gets even worse, but keeps sufficient upside potential thanks to a higher concentration level in certain stocks. Basically, they are transferring the market risk to a stock specific risk which is the risk these managers know best. Indeed, a good risk manager is not only someone who can reduce risk but also someone who knows when to put the risk back on.

In addition, a fund like Fund A is in a fantastic position. He is up on the year, while markets might still be down, and that puts the manager in a position of strength as this provides him plenty of investment choices going forward. The manager has buying power to profit from current market opportunities and can chose how and when he wants to take risk. If the market continues to stabilize, we can expect strong results from the fund. If the market goes through another correction, this manager will also have an advantage as his YTD cushion would provide him additional buying power later on.

One quickly understands that correctly analyzing a manager's drawdown cannot be done simply by looking at his returns. One needs to understand in detail how their portfolio

changes during such a period. Simply looking at returns, one could conclude erroneously that the manager did the right thing while in reality they may have increased risk unduly in one stock or sector. Hence having resources dedicated to these analyses is paramount.

The track record does still matter

Whilst the V-Shape analysis looks just at a crisis period, the size of the drawdown also has to be put in perspective with the manager's prior performance. Indeed, it might be acceptable to keep a manager who loses 8% during a drawdown if they generated a 30% return over the previous cycle. However, you may want to reduce a manager who only lost 5% but had only returned 10% prior to the drawdown. It is also important to put in context these loses versus the manager's expected future performance given the new environment and portfolio.

Conclusions

Drawdowns are always nerve wracking for investors. However, they do provide unique opportunities to better understand your managers and how good they are at risk management. Ultimately, these periods should be used to refine your manager selection and make your portfolios more resilient for the future.

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