Minimizing Drawdown Lay the Foundation to Quick Recovery

By Sarvajeet Bodas

17th Sept 2020

Almost everyone has heard the expression, at one time or another, that *“the best defence is a good offence.”*

Be it football, cricket or investing, offensive play is more evident. It seems the human brain is wired to accentuate offensive gains.

In football, everyone remembers how a striker scored a goal, but not the steal and tackle by a defender or midfielder that created the goal.

The similar is true in the world of cricket. In the T-20 format, scoring 24 runs in an over is more glamorous than bowling a tight over by a bowler by just giving three runs.

The investing world is no different. Here, the bull market is glamorous. Investors focus more on the gains, chasing fancy stocks, hot sectors, and fads. Less attention is given to the portfolio’s ability to protect the downside risk.

Sir Alex Ferguson, the famous football coach of Manchester United once immortally stated, “*Attack wins you games but defence wins you titles.”*

What he meant was, attacking players will score the goals that win games, but defenders are the ones fighting till hell and back to prevent your goals from being equalised. A good defence sees one through difficult matches.

In investing, the investors often forget the underrated but crucial role of the ability to protect the downside risk from market drawdowns in determining long-term outcomes.

After all, what matters is the ability to restrict drawdowns during unavoidable downturns that come in the investing journey, and reasonably able to capture the upside over long periods.

Let's understand this aspect through a case study and examples.

First, the math of a drawdown and the recovery.

Consider a 20% drawdown. To get back to the original level, you need a 25% gain.

Or take a 50% loss. Now, to come back to the original level, you need a 100% gain.

The steeper the drawdown, more daunting it is to get back to the starting point.

Let's say your portfolio value is Rs 5 million. Due to some unavoidable event like Covid-19 or any other black swan event, your portfolio experiences a 30% drawdown and the portfolio value is now Rs 3.5 million.

I know, I know… the markets have recovered very quickly. But the point is if the recovery after a sharp drawdown gets delayed, then what happens?

Now, it gets interesting here.

CAGR returns	15%	12%	10%	8%	5%
No of Years Required to Recover after 30% drawdown	**2.55**	**3.14**	**3.74**	**4.63**	**7.31**

If a portfolio earns 15% annualised returns, it will take 2.55 years to return to the starting point. As your returns get lower, the number of years required to recover your original portfolio value gets further delayed.

For young investors who have just started investing, this is not much of a concern. But consider middle-aged or older investors. They have to carefully consider drawdown risk to avoid large losses as they near retirement.

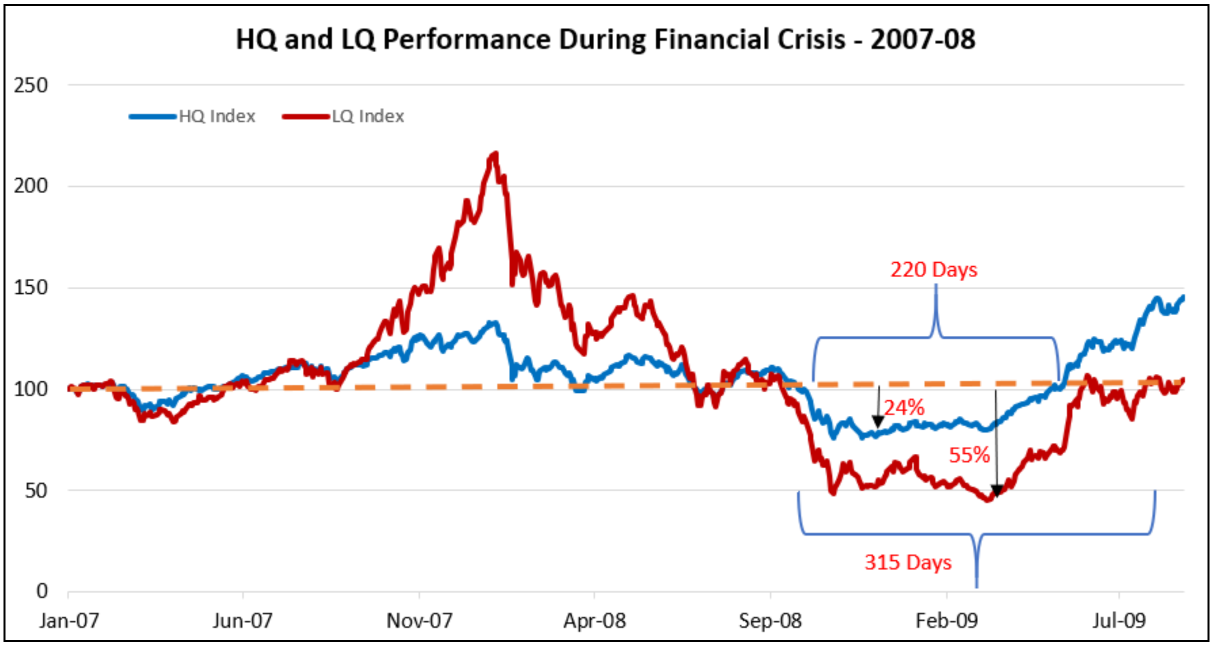
Now let's understand this aspect through a case study.

In the Multi-Act framework, we have classified companies considering multiple **Quantitative parameters** (like ROCE, ROE, Free Cash Flow, Leverage etc) and **Qualitative parameters** (Corporate governance, Competitive advantage etc).

Based on the above, we have categorised companies into different grades and further categorised these companies into High Quality (HQ) and Low Quality (LQ) buckets.

Let's look at what happened during the financial crisis of 2007-08.

Although the LQ index was outperforming the HQ index in the beginning, during the severe downturn, LQ index collapsed by 55%, whereas, HQ index was down by about 24%.



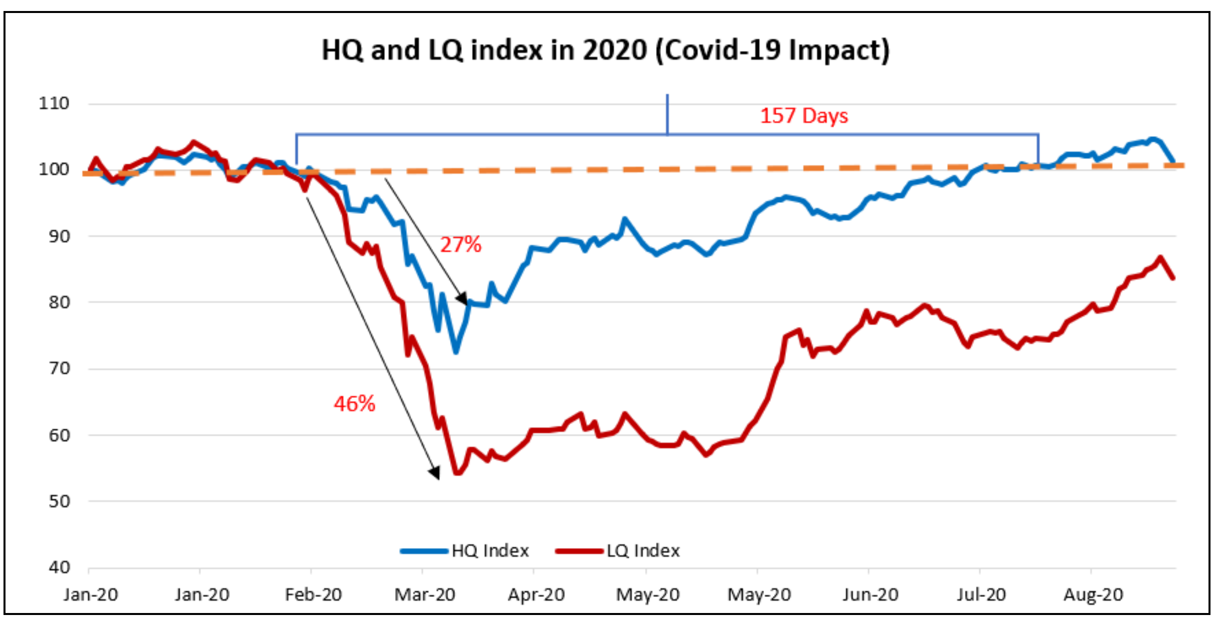
Source: Multi-Act

Similarly, in terms of recovery, the HQ index was quick to rebound to its earlier starting point and that took about 220 days. Whereas, the LQ index took a whopping 315 days to recover.

Let's look at this year.

The outbreak of the Covid-19 pandemic is an unprecedented shock to the Indian economy.

How did the HQ and LQ index perform?



Source: Multi Act

The above chart shows the impact on the HQ and LQ index. The HQ index saw a drawdown 27%, it took 157 days to come back to the earlier starting point. The LQ index, on the other hand, witnessed a steep drawdown of 46% and has yet to recover.

Remember, the steeper the drawdown, more daunting it is to get back…

How did Multi-Act's portfolio schemes perform during this time-frame?

Click here to know more about the performance, drawdown and recovery.

Many investors mistakenly base the success of their portfolios on returns alone. However, it is equally important to consider the risk involved in achieving those returns.

In the bear market, investors often sell and wait on the sidelines, and miss an equity market rebound. Minimizing drawdowns discourage such behavioural mistakes.

By restricting drawdowns and reasonably capturing the upside, over the long period, a portfolio is in a better position to compound returns when things bounce back.

Disclaimer

The views expressed in this article are for educational and reading purpose only. Multi-Act Equity Consultancy Private Limited (MAECL) does not solicit any course of action based on these views and the reader is advised to exercise independent judgment and act upon the same based on its/his/her sole discretion, their own investigations and risk-reward preferences.

The article is prepared on the basis of publicly available information, internally developed data and from sources believed to be reliable. Due care has been taken to ensure that the facts are accurate and the views are fair.

MAECL, its associates or any of their respective directors, employees, affiliates or representatives do not assume any responsibility for, or warrant the accuracy, completeness, adequacy and reliability of such views and consequently are not liable for any direct, indirect, special, incidental, consequential, punitive or exemplary damages, including lost profits arising in any way for decisions taken based on the said article.

Risk factors
General risk factors

a. Securities investments are subject to market risks and there is no assurance or guarantee that the objective of the investments will be achieved.
b. As with any investment in securities, value of the Client's Portfolio can go up or down depending on the factors and forces affecting the capital market.
c. The investments made are subject to external risks such as war, natural calamities, and policy changes of local / international markets which affect stock markets.
d. The Portfolio Manager has renewed SEBI PMS registration effective November 24, 2017 and has commenced its portfolio management activities with effect from January 2011. However, the Portfolio Manager has more than 10 years of experience in managing its own funds invested in the domestic market.