MICHAEL MASSEY, Adviser & Partner at Koda Capital

Following on from my recent note "The Upside of Diversification" (available on the Koda Capital Insights page **here**), I want to now turn to a related theme that is also at the core of Koda's investment philosophy: the concept of upside/downside capture.

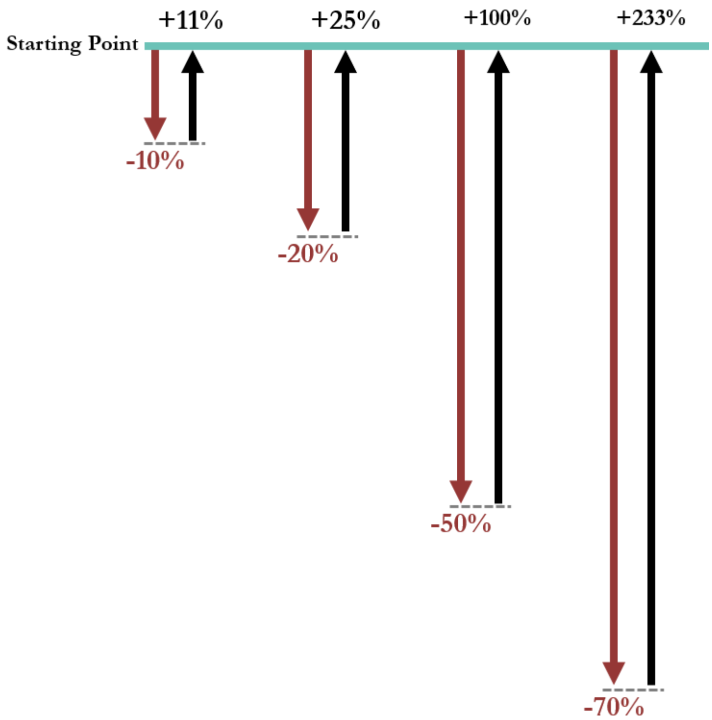
The reality is that minimising the losses in falling markets is far more important to long term investment success than maximising gains in rising markets.

Most people will be familiar with Aesop's fable **"The Tortoise and the Hare,"** in which the slow but consistent tortoise eventually outpaces the much faster hare to ultimately win the challenge race. For us as investors, the challenge race is our long-term investing goal, and the tortoise's approach of 'slow and steady' is the winning strategy. At the risk of overplaying the analogy, whereas at times the hare was indeed out in front of the tortoise, the consistent advances the tortoise was able to achieve (and even more importantly, the tortoise's persistence in not stopping or going backwards) allowed him to finish first, all the while embracing the theory that sits behind upside/downside capture.

The chart below will help explain why upside/downside capture, along with the topic of diversification that I touched on in my paper last week, are at the core of Koda's investment philosophy.

When a portfolio experiences a drawdown it inevitably stings for an investor – though even worse than the negative returns are the larger percentage gains that are required to simply recover from the loss.

Drawdown	-10%	-20%	-50%	-70%
% Return Required to Fully Recover	11%	25%	100%	233%
% of original portfolio value if the recovery return % = initial drawdown %	99%	96%	75%	51%



The greater the initial drawdown, the more extreme the percentage return is to get an investor back to their starting point. Given just how hard significant drawdowns are to recover from, having an investment strategy that in part emphasises avoiding them is a wise decision over the long run.

For most investors, the best way to avoid meaningful drawdowns is to assemble a diverse portfolio that combines different sources of risk and return, preferably with low degrees of correlation and from multiple parts of the capital structure.

At a point in time, within a diverse portfolio some assets will perform extremely well whilst others will not, and some might even perform badly. In aggregate the portfolio will perform quite well – though in all likelihood not as well (at a single point in time) as a separate portfolio invested only in the best performing asset class at that same point in time. This can be frustrating for an investor. However, a deeper understanding of the upside / downside ratio provides a clear understanding of the long-term benefit of diversification.

"I would emphasise avoid losing money over missing opportunities." - Howard Marks

Being highly diversified means that over the long run your portfolio returns will capture most – but not all – of the upside in strong markets. Conversely, in the long run your portfolio will capture some – but not all – of the downside in bad markets. The upside/downside ratio, in other words the amount of upside your portfolio captures relative to the downside, is a key determinant of long-term investment returns.

Importantly, if you minimise the downside during market dislocations, when the market recovery inevitably comes, your portfolio has much less ground to make up before it begins to grow again.

Over short time frames, correlations of risky assets will often converge towards 1. In such circumstances the benefits of diversification can be less obvious. However, as timeframes extend you will start to see the benefits of compounding smaller drawdowns and capturing large parts of the good times.

All Koda portfolios are built with the goal of optimising the upside/downside capture ratio. Unfortunately, there is no single magic formula for achieving this – it is a combination of experience, hard work and quite a bit of research travel that all play a role. **Across most portfolios we aim to capture 80% or more of rising markets and no more than 50% of down markets**. By maintaining the upside/downside capture ratio at our target level or better, our portfolios have achieved significant out-performance versus the median manager.

"Rule No. 1: Never lose money. Rule No. 2: Never forget rule No. 1." - Warren Buffett

In the long term, the key to not losing is being diversified and optimising a portfolio's upside/downside capture. From time to time – like the tortoise watching the flashy hare running out in front – you will likely feel like you are missing out on the latest and greatest asset class to outperform. **Investors, however, must not lose sight of the fact that investing is a long race**, and the finish line (if there ever even is one!) is not around the next corner. The value of staying diversified while focusing on consistent gains (and minimising losses!) cannot be overlooked.

Next week I will take a closer look at the impact of time in the market.

About the Author

Michael Massey has worked in the financial markets and investing since the late 1990s.

Prior to joining Koda in 2015, Michael was an Executive Director at JBWere, where he was responsible for the JBWere Markets Desk and was the primary adviser to family offices, high net worth individuals, and institutional clients. Michael started his career in finance as an adviser at CBA Private.

Michael received a Bachelor of Business from UTS, a Graduate Diploma in Applied Finance from The Securities Institute (FINSIA) and has completed courses in Applied Valuation and Corporate Finance at NYU Stern.
