

# Investment Insights

## Protecting a Client’s Portfolio from Drawdown

(Estimated Read Time: 4 Minutes)

For General Public Use

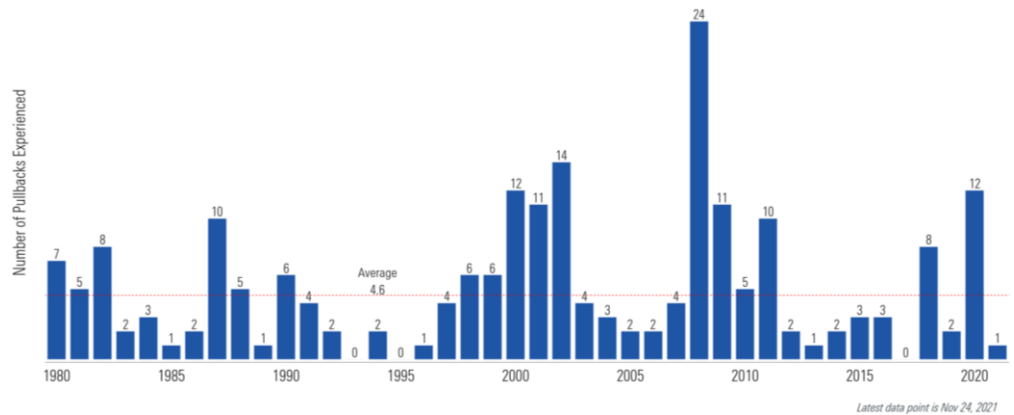
Morningstar Investment Management LLC  
December 2021

Investing is all about taking risk. To achieve our investment objectives and enable investors to meet their goals, we need to assess the investment environment and take what we deem appropriate risks. Sometimes the opportunity set will be rich, and we will be able to build robust portfolios that should comfortably meet an investor’s investment objectives. Other times, that’s not the case. Our analysis hints that the path ahead could be a little rocky at times, but we must accept some risk to achieve goals.



Matt Wachter  
Chief Investment Officer, Asia Pacific

### Exhibit We Must Expect Setbacks, With a Long History of 5%+ Setbacks Experienced Annually



Source: Clearnomics, Morningstar Investment Management, as of October 31, 2021. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

### “Risk is the Price You Pay for Good Returns”

Calling drawdowns good or bad is somewhat flippant. Of course, no drawdown is good for an investor. This is especially the case for investors with shorter time horizons.

In fact, risk aversion can be a rational response, as people often fail to appreciate the danger of negative compounding. The common message is that compounding is a beautiful thing, however it is more powerful on the downside than the upside. Consider various scenarios. If the market were to sell off by 20% tomorrow, you need to make 25% to get back to square. If it falls by 50%, you need to earn 100%. Avoiding losses matters because losing less means you require less to bounce back.

That said, failing to take calculated risks is a risk itself. Or, said simply: we must ensure that we take enough risk to meet our objectives. This side of the coin is just as important, as goal attainment is the key reason most people invest. This is also the main focus of our investment approach — we need to ensure we are being rewarded for the risks we take.

### **Tomorrow versus Yesterday**

In the last decade it has been a relatively simple task to invest in a very risk-focused way and still achieve healthy returns above the inflation rate.<sup>1</sup> Even in the extreme market event in March 2020, we were afforded the opportunity to buy assets at prices that could deliver exceptional long-term returns—enabling us to be confident that we could deliver on our promises to investors.

However, the opportunity set has clearly narrowed. Equity markets have become more expensive on almost every measure, with some parts of the market moving to what we'd consider quite extreme levels. The same can be said for traditionally defensive assets, with bonds trading at levels that could lead to significant capital losses, especially with economic growth remaining a tailwind and inflation at levels not seen for many years.

Faced with these risks, the key is to assess a portfolio relative to the corresponding goals and risk tolerance of the investor, whilst also acknowledging the investing environment we operate in. Regarding the investment environment, we foresee a wide range of potential outcomes, expecting the next year (and decade) to look quite different from the last.

This is both an opportunity and a threat—it presents an opportunity for us to add value for investors by navigating the series of setbacks ahead, but it'll require a different approach from that taken over the last decade. We are heading into a time when broad market exposure (passive investing) could easily fall short of historical averages and may fail to meet absolute return objectives, making it difficult for investors to achieve their goals. In this sense, we don't expect an easy ride for the average investor.

### **Defending in a Low Interest Rate Environment**

Perhaps the biggest dilemma for risk-sensitive investors resides in traditional fixed income. Holdings in “defensive assets” such as bonds offer poor return prospects, in our analysis, creating a true challenge for risk management.

We don't paint with a broad brush here, still selectively investing in pockets of the bond market for their defensive characteristics and/or return potential. However, many fixed income markets are expensive (especially so in corporate high-yield bonds, where we carry an underweight position). This is quite different from the last 30 years, where bonds have played the dual role of return generator and diversifier in portfolios. We are therefore balancing what is left of their defensive characteristics against low absolute yields while also looking for more defensive characteristics from the growth holdings in our portfolios.

### **The Goal Must Still be to Avoid Permanent Loss of Capital**

Importantly not all drawdowns are equal. Volatility provides investment opportunities—the ability to get set in assets with significant upside. As investing great Bill Miller says, “volatility is the price you pay for returns” and accepting volatility will be necessary for most investors. The way we approach risk is to consider the potential for two types of drawdowns: 1) *valuation*-induced drawdowns, and 2) *volatility*-induced drawdowns. We embrace volatility, within reason, but want to avoid valuation-induced sell-offs.

---

<sup>1</sup> In our own research, using Australian data, over the last 10 years a typical 60/40 portfolio (60% in stocks and 40% in bonds) achieved a return of at least CPI +3.5% during 96% of rolling three-year periods since the start of 2010, well above the 62% of rolling three-year returns if we take the analysis back to 1970.

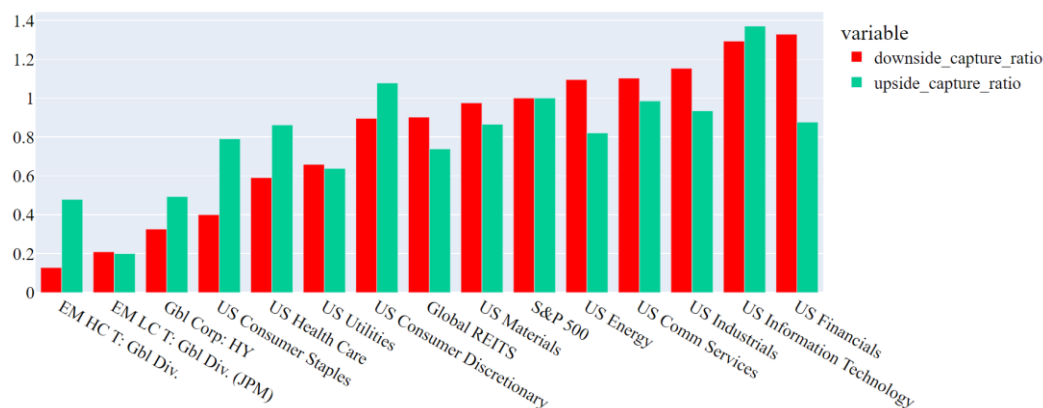
When you look at the exposure in our multi-asset portfolios, this difference between volatility and valuation becomes evident. We have a decent tolerance for holding assets with economically sensitive cashflows, even if these assets tend to have higher core volatility.

Valuation-based drawdowns (paying too much for an asset) can be more enduring and may not be fully recouped—even over the long term. Equities that go bankrupt or bonds that default are extreme examples. These are the drawdowns our process seeks to avoid where capital can be permanently impaired.

So, how can an investor both protect and earn? We believe the best pathway is to identify the assets with the greatest reward-for-risk and size them appropriately to manage total portfolio risk. Today, the most attractive holdings are concentrated in cyclical areas of the market, despite their higher volatility, so we employ portfolio construction techniques to offset or temper the cyclical risk, including defensive sector exposures.

Our analysis has shown some of the most attractive assets include emerging-markets debt, consumer-staples stocks, healthcare, and utilities companies. These are all attractive as replacements for growth assets in an array of different environments we might face, especially where the opportunity set is diminished and the potential for a risk event is elevated. Analysis we have recently carried out shows that each of the asset classes named above have inviting downside- and upside-capture ratios against the S&P 500, presenting particularly attractive asymmetry between the two in the significant market scenarios we have run.<sup>2</sup>

#### Exhibit Upside and Downside Capture Ratios Versus the S&P 500



Source: Morningstar Investment Management calculation, as of October 31, 2021.

Somewhat counterintuitively, it is therefore likely that average “through-the-cycle” portfolio growth exposure ought to be higher than last decade—to the point where it may make sense to gain exposure to more volatility assets to achieve investment objectives. This is a good example of using smart diversification techniques, smoothing the ride via carefully selected growth holdings instead of relying on expensive traditional defensive exposures. Still, there is a potential for more volatility in portfolio returns and temporary drawdowns are there.

<sup>2</sup> Emerging-markets debt presents with not just inversely-related downside capture (positive return when the S&P is negative), but also surprisingly large upside capture. Similarly, US consumer staples stocks and healthcare stocks both show low downside captures (consumer staples nearly as low as the fixed-income asset classes) while ranking among the top upside captures.

Currency exposure is another available tool that may be highly underrated by many investors. For example, the U.S. dollar and the Japanese yen tend to behave as so-called “safe-haven” currencies in periods of broad market stress. By allocating smartly across the currency universe, we can lean on the protective characteristics of the dollar and the yen where it makes sense to do so and have recently boosted this exposure.

### **Key Takeaways for Risk Management**

The hardest, yet most effective, approach when protecting against loss is to distinguish between volatility-induced setbacks and valuation-induced losses. Periods of volatility will come and go, which are scary at the time, but they rarely impact goal attainment.

As advocates of great investing, we must collectively resist impulsive actions and understand that the road won't be straight. Accepting some volatility is a pre-requisite for good returns in any market, but today's market arguably requires greater care than usual. In our view, this necessitates us to target the best assets to protect and earn, with careful sizing and smart diversification.

A final thought on downside protection: we should be happy to forego some of the gains in strong upwards markets, acknowledging that we won't participate in losses to the same extent as others if we maintain a risk-focused approach. Ideally, if we can limit losses by investing in a risk-focused way, we are less likely to trigger an irrational response from investors, meaning we are more likely to help them stay invested, giving them a better chance of achieving their goals over time.

### Highlight of Our Convictions

Steering investors to our asset class convictions, our investment team monitors over 300+ markets across equities, fixed income, and currency. We highlight our conviction level across some core assets, including a micro-thesis on the key drivers.

	Asset Class	Overall Conviction*	Key Long-Term Drivers
<b>EQUITIES</b>	United States	Low to Medium	Valuations are not as compelling as international markets. Investor optimism was bordering on excessive, which remains a concern to us.
	Europe ex-U.K.	Medium	We find the opportunity set in Europe to be diverse. The recovery continues to take shape, with sector selection important.
	U.K.	Medium to High	Investor sentiment has improved, following a long period of negativity. The reward for risk continues to appeal.
	Japan	Medium	We still cite structural reform, providing upside to earnings drivers. The relative appeal is moderate.
	Emerging Markets	Medium	Recent weakness has improved the opportunity set in emerging markets, although the overall appeal is still moderate. Risks need to be managed.
	Germany	Medium to High	German stocks offer solid balance sheets and upside to earnings —without the eyewatering valuations in some other markets.
	South Africa	Medium	While sensitive to cyclical earnings and concentration risk, valuations reflect these concerns. Our view has moderated though.
<b>FIXED INCOME</b>	Government Bonds – U.S.	Low to Medium	Yields are still incredibly low and no longer cover inflation risks. The defensive attributes are appealing, but unlikely to contribute to returns.
	Government Bonds – U.K. & Europe	Low	Gilts, Bunds and other EU Treasuries have terribly low yields. Longer-dated bonds are particularly sensitive to inflation risk with poor return prospects.
	Investment-Grade Corporate Bonds	Low to Medium	Yields are unattractive in an absolute sense, with a narrow spread to government bonds. We are wary of valuation risks if the recovery stutters.
	High Yield Credit	Low to Medium	Yields no longer compensate for the risk taken. Defaults remain low, but credit risk should not be ignored.
	Emerging-Markets Debt (Local)	Medium to High	Emerging market debt in local currency (which we prefer over hard currency) continues to offer healthy relative yields, even accounting for risk.
<b>LISTED PROPERTY</b>	U.S. REITs	Low to Medium	U.S. listed property remains broadly unattractive on an absolute basis, carrying high debt and concentrated exposure.
	Non-U.S. REITs	Low to Medium	Continues to rank behind other opportunities on both an absolute and relative basis, although South African REITs continue to stand out.

Source: Morningstar Investment Management, conviction levels confirmed at November 12<sup>th</sup>, 2021.

\*Overall conviction is a long-term judgement built on a five-point scale from “Low” to “High”. Typically judged on a 10-year horizon, a “Low” means that reward-for-risk is likely to be subdued, whereas a “High” means reward-for-risk is appealing. This incorporates our four pillars of conviction including 1) absolute valuations, 2) relative valuations, 3) fundamental risk and 4) a contrarian scorecard.

**Disclosures**

\*The Overall Conviction level and Key Long-Term Drivers reflect the opinion of Morningstar Investment Management. These opinions are as of the date written, are subject to change without notice, do not constitute investment advice, and are provided solely for informational purposes. Morningstar Investment Management shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses, or opinions, or their use. This document contains certain forward-looking statements. We use words such as expects, anticipates, believes, estimates, forecasts, and similar expressions to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause the actual results to differ materially and/or substantially from any future results, performance, or achievements expressed or implied by those projected in the forward-looking statements for any reason.

Investments in securities (e.g., mutual funds, exchange-traded funds, common stocks) are subject to investment risk, including possible loss of principal, and will not always be profitable. Prices of securities may fluctuate from time to time and may even become valueless. Securities in this report are not FDIC-insured, may lose value, and are not guaranteed by a bank or other financial institution. There can be no assurance any financial strategy will be successful.

Diversification and asset allocation are methods used to help manage risk; they do not ensure a profit or protect against a loss.

Morningstar® Managed Portfolios<sup>SM</sup> are offered by the entities within Morningstar's Investment Management group, which includes subsidiaries of Morningstar, Inc. that are authorized in the appropriate jurisdiction to provide consulting or advisory services in North America, Europe, Asia, Australia, and Africa. In the United States, Morningstar Managed Portfolios are offered by Morningstar Investment Services LLC or Morningstar Investment Management LLC, both registered investment advisers, as part of various advisory services offered on a discretionary or nondiscretionary basis.

Portfolio construction and ongoing monitoring and maintenance of the portfolios within the program is provided on Morningstar Investment Services' behalf by Morningstar Investment Management LLC. Morningstar Managed Portfolios offered by Morningstar Investment Services LLC or Morningstar Investment Management LLC are intended for citizens or legal residents of the United States or its territories and can only be offered by a registered investment adviser or investment adviser representative.

Investing in international securities involve additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may carry these risks. Emerging markets are countries with relatively young stock and bond markets. Typically, emerging-markets investments have the potential for losses and gains larger than those of developed-market investments. A debt security refers to money borrowed that must be repaid that has a fixed amount, a maturity date(s), and usually a specific rate of interest. Some debt securities are discounted in the original purchase price. Examples of debt securities are treasury bills, bonds and commercial paper. The borrower pays interest for the use of the money and pays the principal amount on a specified date.

Investment research is produced and issued by Morningstar, Inc. or subsidiaries of Morningstar, Inc. including, but not limited to, Morningstar Research Services LLC, registered with and governed by the U.S. Securities and Exchange Commission.

The terms "we," "us," and "our" throughout this document refer to Morningstar Investment Management LLC. The term "Morningstar" refers to Morningstar's Equity Research Group.

The information, data, analyses, and opinions presented herein do not constitute investment advice; are provided solely for informational purposes and therefore are not an offer to buy or sell a security; and are not warranted to be correct, complete, or accurate. The information contained herein is the proprietary property of Morningstar Investment Management and Morningstar Investment Services and may not be reproduced, in whole or in part, or used in any manner, without the prior written consent of Morningstar Investment Management or Morningstar Investment Services.

The opinions expressed herein are those of Morningstar Investment Management and Morningstar Investment Services, are as of the date written and are subject to change without notice, do not constitute investment advice, and are provided solely for informational purposes. Morningstar Investment Management and Morningstar Investment Services shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses, or opinions, or their use.

Morningstar Investment Management and Morningstar Investment Services do not guarantee that the results of their advice, recommendations, or the objectives of your portfolio will be achieved. There is no guarantee that negative returns can or will be avoided in any of the portfolios. An investment made in a security may differ substantially from its historical performance and as a result, you may incur a loss. Past performance is not a guarantee of future results.

### **About Indexes**

The indexes noted are unmanaged and cannot be directly invested in. Individual index performance is provided as a reference only. Since indexes and/or composition levels may change over time, actual return and risk characteristics may be higher or lower than those presented. Although index performance data is gathered from reliable sources, Morningstar Investment Management and Morningstar Investment Services cannot guarantee its accuracy, completeness, or reliability.

### **About Morningstar's Investment Management Group**

Drawing on our core capabilities in asset allocation, investment selection, and portfolio construction, Morningstar's Investment Management group provides a global point of view and local market experience. Our investment professionals, located around the world, are guided by core principles focused on long-term investment results and helping end investors reach their financial goals. Built around world-class investment strategies and harnessing the global resources of Morningstar, Inc., our investment offerings support financial advisors, institutions, and the investors they serve.

### **For More Information**

Phone: + 1 877 626-3227

Email: [ManagedPortfolios.US@morningstar.com](mailto:ManagedPortfolios.US@morningstar.com)

Online: [www.mp.morningstar.com](http://www.mp.morningstar.com)



22 West Washington Street  
Chicago, IL 60602 USA

©2021 Morningstar Investment Management LLC. All rights reserved. The Morningstar name and logo are registered marks of Morningstar, Inc. Morningstar Investment Services LLC is a registered investment adviser and subsidiary of Morningstar Investment Management LLC. Portfolio construction and ongoing monitoring and maintenance of the model portfolios discussed herein is provided on Morningstar Investment Services' behalf by Morningstar Investment Management LLC.