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INVESTMENT MANAGERS

Risks are Rising: Is Now the Time for Down Market Protection?

Michael Jaje, CFA

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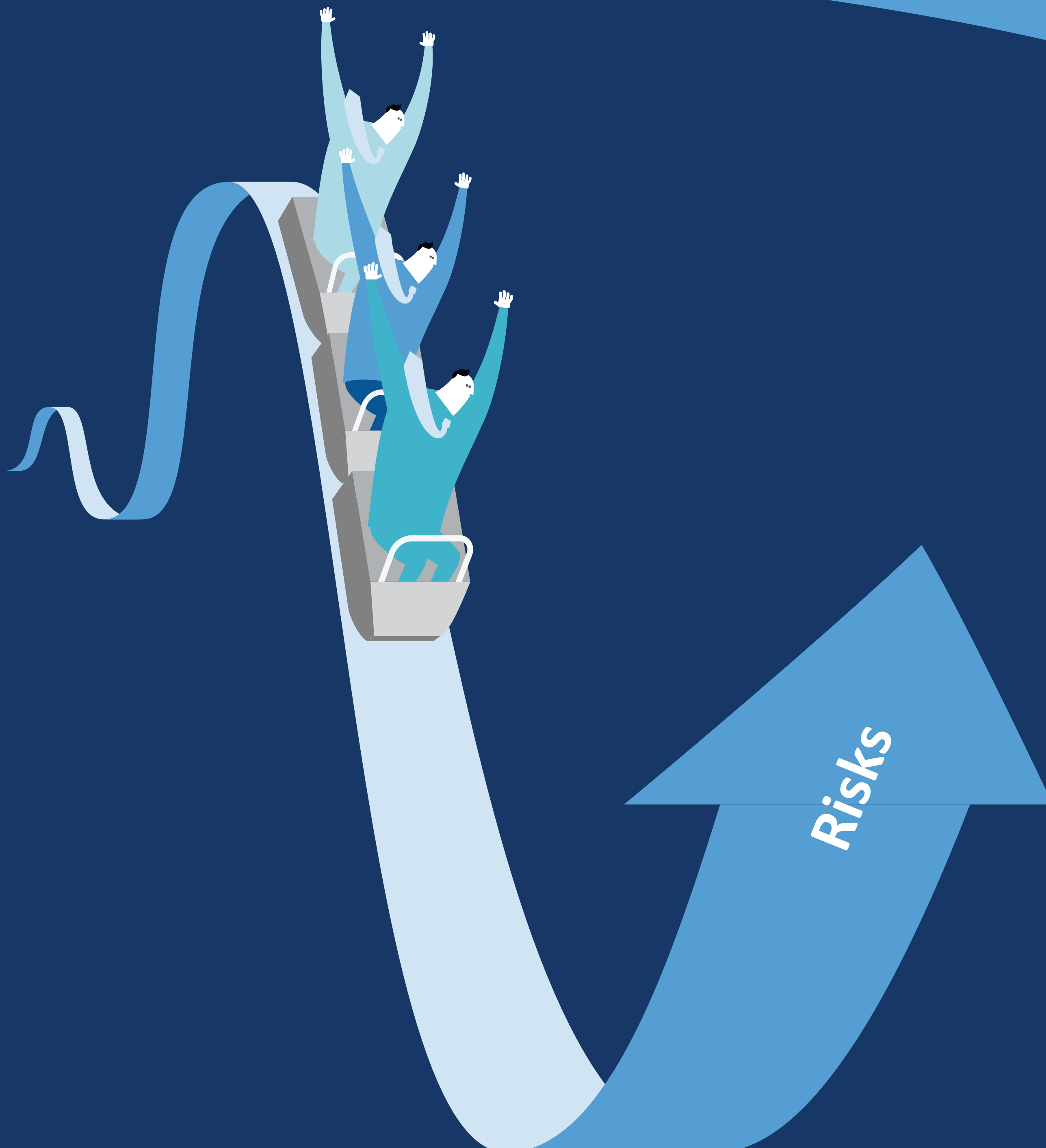


Is Now the Time for Down Market Protection?

There's nothing like a roaring bull market in stocks to make investors forget about the risk of down markets. After all, history shows that U.S. equity markets rise about 72% of the time—so why worry too much about the 28% of the time that they decline?

We believe there are two key reasons investors should worry about declining markets. The first reason is tied to where we are in the current market cycle. Since the March 2009 bottom, broad U.S. equity market indexes like the S&P 500® have gained about 210% in the past 72 months. To put that into context, the average U.S. equity bull market gain over the last 100 years is 188% over 58 months. While the length and gain of this current bull market appear to be "above average," we all know that U.S. equity markets could move higher. This leaves investors with a dilemma—how do you maintain exposure to equities, but also protect your hard-earned gains from future market declines? One solution is to increase your exposure to equity strategies that provide a meaningful level of down market protection.

The second and perhaps most important reason why investors should pay significant attention to declining markets is they have an outsized impact on total return over a complete market cycle. It seems counterintuitive that investment success is largely influenced by the 28% of the time when markets decline —but simple mathematics proves the point. If your portfolio declines by 50%, you have to have a subsequent return of 100% just to get back to even. By minimizing exposure to market declines, you may dramatically improve your chances of performing well over a complete market cycle. Because of the power of compound returns, investing is one of the rare activities where you can win by not losing.

To see if investors are well served by focusing on investment products that protect in down markets, we analyzed the past performance results of U.S. large-cap core equity managers versus the Russell 1000® index. We elected to study large-cap core managers as they represent a large portion of the investable U.S. market cap range without any overt bias to style (growth or value). What our analysis shows is that an investment manager's ability to perform well in down markets is a good indicator of his or her ability to outperform the index over an entire market cycle.

We began by screening the eVestment Alliance database for all U.S. large-cap core products with a minimum of 10 years of gross performance history as of December 31, 2014. We then calculated the trailing 10-year Down Market Capture ratios for each strategy. Down Market Capture (DMC) measures how well or how poorly a manager has performed when the market declines. If the market is down 10%, a DMC of 150% implies that the manager would have a -15% return—i.e. "capturing" 150% of the down market. Conversely, a manager with a DMC of 50% would only "capture" half of the down market, and have a -5% return.

Our screens identified 275 large-cap core separate account products, with Down Market Capture ratios ranging from a high of 182% to a low of 16%. In order to reduce the impact of outliers, we chose to exclude the top and bottom 5th percentiles of the distribution. We also excluded 17 products that only provided performance results on a net-of-fee basis. This resulted in a universe of 233 separate account products with DMC ranging from a high of 111% to a low of 64%, and a median of 94% (i.e., if the market was down 10%, the median manager's return would be -9.4%).

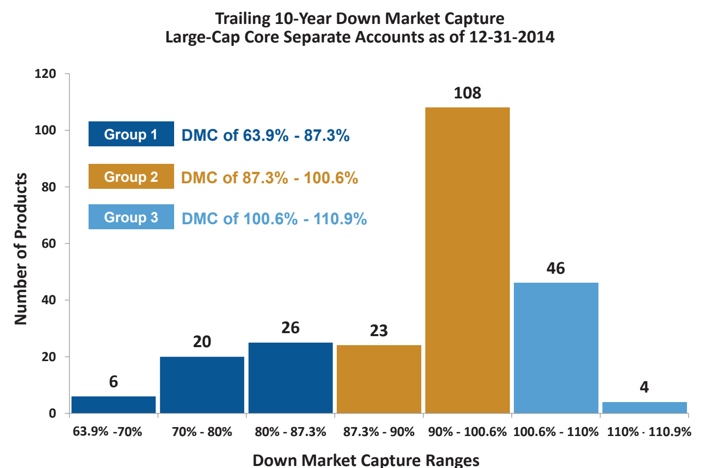
We then divided the 233 large-cap products into three groups based on the trailing 10-year DMC quartile break points. (Figure 1)

Group 1: Managers with Down Market Capture between 63.9% and 87.3% (Quartile 4).

Group 2: Managers with Down Market Capture between 87.3% and 100.6% (Quartile 2 and 3).

Group 3: Managers with Down Market Capture between 100.6% and 110.9% (Quartile 1).

Figure 1: U.S. Large-Cap Core Products divided by Down Market Capture vs. Russell 1000® Index



Sources: eVestment Alliance, Atlanta Capital

The Impact of Down Market Capture on Returns

We first calculated the trailing 10-year annualized excess return of the three groups versus the Russell 1000® to see if Down Market Capture had any impact on long-term performance.

As can be seen in Figure 2, the average and median products within Group 1 produced the highest excess annualized returns. Group 2 average and median products also experienced positive excess returns, but at a level that would likely not be very compelling on an after-fee basis. The average and median Group 3 products produced little-to-no excess return before fees.

We also looked at the impact of Down Market Capture over time to see if there was any meaningful connection to returns.

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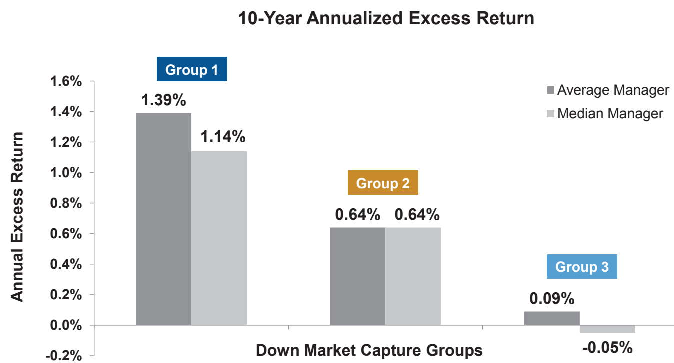
Figure 2: Trailing 10-year Annualized Excess Return vs. Russell 1000® Index

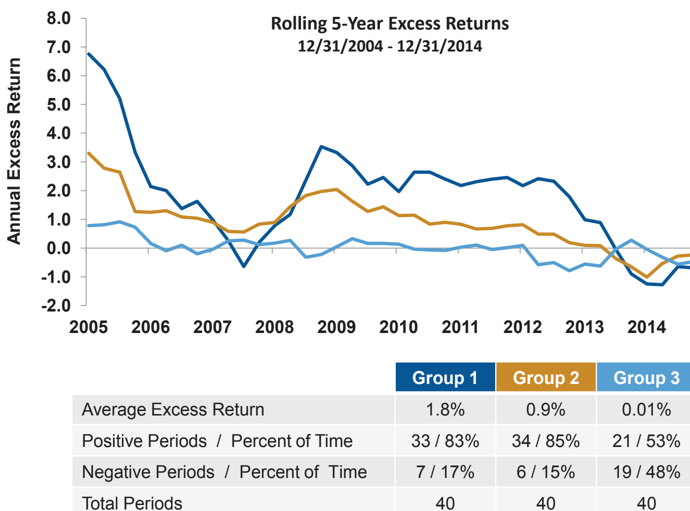


Sources: eVestment Alliance, Atlanta Capital. Data as of 12/31/14.

We calculated the annualized excess return versus the Russell 1000® index of the products in Groups 1, 2, and 3 over 15 years of quarterly rolling 5-year periods.

The rolling return data shown in Figure 3 provided us with some interesting findings. The median product within Group 1 produced an average annualized excess return of 1.8% and was able to beat the index 83% of the time (33 of 40 rolling 5-year periods). The median manager within Group 2 produced a lower average excess return of 0.9% and was able to beat the index in 85% of the rolling 5-year periods. The median manager within Group 3 produced little-to-no average excess return, and was only able to outperform the index 53% of the time (21 of 40 rolling 5-year periods). Just as we saw in the trailing 10-year return data (Figure 2), it appears that managers with higher levels of down market protection were more likely to outperform the index over rolling 5-year periods.

Figure 3: Rolling 5-Year Average Annualized Excess Returns: Median Manager vs. Russell 1000® Index



	Group 1	Group 2	Group 3
Average Excess Return	1.8%	0.9%	0.01%
Positive Periods / Percent of Time	33 / 83%	34 / 85%	21 / 53%
Negative Periods / Percent of Time	7 / 17%	6 / 15%	19 / 48%
Total Periods	40	40	40

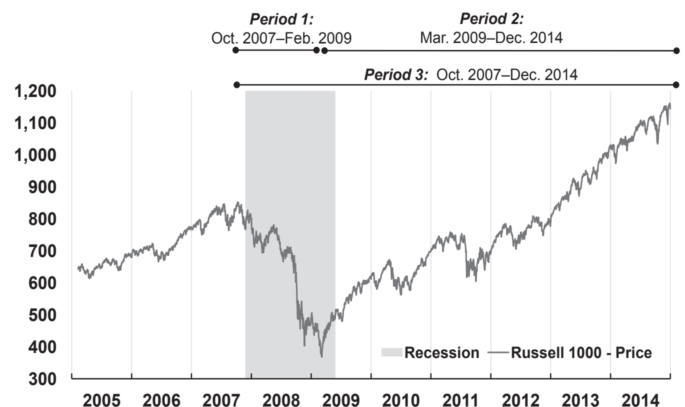
Sources: eVestment Alliance, Atlanta Capital

The Impact of Down Market Capture Across the Market Cycle

Another interesting finding from the graph in Figure 3 is that there appears to be some cyclicality/variability in the magnitude of excess performance over time. When you look at Group 1, it appears that excess 5-year returns are weakest during periods of sustained market strength (2007, 2014). This cyclical performance trend makes intuitive sense, i.e. products with good DMC would not be expected to outperform in the later stages of a bull market. We decided to test the relative performance of managers with differing Down Market Capture characteristics during different periods of the market cycle.

Over the last 10 years (Figure 4), there has been one distinct down market (October 2007 – February 2009), followed by the current bull market recovery (March 2009 – December 2014). We wanted to see how managers from the three Down Market Capture groups performed versus the Russell 1000® index during the market decline, the current bull market, and across the full market cycle (from October 2007 market peak to the current December 2014 market peak).

Figure 4: Russell 1000®, Market Cycle Periods



Period 1: Bear Market	Group 1	Group 2	Group 3
Average Excess Return	8.02%	3.40%	-0.12%
Median Excess Return	7.58%	3.46%	-0.31%
Total Strategies in Group	52	127	50
Positive Strategies / % of Time	52 / 100%	118 / 93%	20 / 40%
Negative Strategies / % of Time	0 / 0%	9 / 7%	30 / 60%

Period 2: Bull Market	Group 1	Group 2	Group 3
Average Excess Return	-1.49%	-1.04%	-0.18%
Median Excess Return	-1.56%	-0.94%	-0.19%
Total Strategies in Group	52	128	50
Positive Strategies / % of Time	8 / 15%	32 / 25%	23 / 46%
Negative Strategies / % of Time	44 / 85%	96 / 75%	27 / 54%

Period 3: Full Cycle	Group 1	Group 2	Group 3
Average Excess Return	1.50%	0.39%	-0.19%
Median Excess Return	1.20%	0.41%	-0.33%
Total Strategies in Group	52	127	50
Positive Strategies / % of Time	46 / 88%	88 / 69%	22 / 44%
Negative Strategies / % of Time	6 / 12%	39 / 31%	28 / 56%

Sources: FactSet, eVestment Alliance, Atlanta Capital

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Period 1: Bear Market (October 2007 to February 2009)

As one might expect, managers in Group 1 meaningfully outperformed the index in the market decline from October 2007 to February 2009. The median manager had 758 basis points of annualized excess return, and 100% of the products in the group outperformed the index. Managers in Group 2 also performed well, while managers in Group 3 had the poorest relative performance.

Period 2: Bull Market (March 2009 to December 2014)

During the market rally from March 2009 through December 2014, the average and median manager in Groups 1 and 2 underperformed the index. This might be expected as both groups had products that performed well during the previous market decline. Most surprising, however, was the performance from Group 3. One would think that products that were not equipped to deal with market declines would perform better in a rising market. The average and median manager within Group 3 failed to outperform in the bull market.

Period 3: Full Market Cycle (October 2007 to December 2014)

So how did the three groups perform over the full market cycle? Group 1 products provided the best annualized excess return with 88% of the products within the group outperforming the index. The average and median manager in Group 2 also outperformed the index, but by a smaller margin. The average and median manager within Group 3 underperformed the index, with only 44% of the products outperforming.

Down Market Protection – A Good Solution Now and for the Full Market Cycle

Successful investing is not about what you **make**, it is about what you get to **keep**. While equity markets tend to go up 72% of the time, minimizing exposure to market declines during the 28% of the time that they go down can have a meaningful impact on total return.

From our analysis, it appears that U.S. large-cap core strategies with strong down market protection have a higher likelihood of outperforming both the index and managers with lower levels of down market protection. We also found that the degree of outperformance seems to be directly linked to the level of down market protection. Over the last decade, the average and median manager with the best down market capture (Group 1) saw relative performance that was nearly double that of strategies with more modest down market capture (Group 2).

While down market protection appears to provide a performance benefit over the course of a full market cycle, a substantial amount of that benefit occurs during market declines. Of course, no one can know when the next market decline will come. However, as the current bull market celebrates its 6-year anniversary, now might be a good time to increase down market protection.

Index Descriptions: *The Russell 1000® Index includes the largest 1000 companies in the Russell 3000® and measures the performance of the large cap U.S. equity universe. The S&P 500® includes 500 leading companies in leading industries of the U.S. economy and is a measure of large cap U.S. stock market performance. Indexes are unmanaged and do not incur management fees, transaction costs or other expenses associated with separately managed accounts. It is not possible to directly invest in an index.*

Down Market Capture *measures a portfolio's compound return when the benchmark was down divided by the benchmark's compound return when the benchmark was down; the smaller the value the better. The ratio is determined by the benchmark, which has a down-capture ratio of 100% when the benchmark is performing negatively; if a manager captures less than 100% of the declining market it is said to be "defensive." The Russell 1000® Index is used as the benchmark in all down market capture calculations in this material. Individual portfolios included in the DMC calculations may be managed to a different market benchmark.*

eVestment Alliance *is a third-party database provider. The company collects self-reported portfolio data from institutional investment managers globally. eVestment Alliance provides no assurances regarding the reliability of such information. eVestment Alliance utilizes this data to identify a manager's style and then assigns them to a particular peer universe, such as U.S. large cap core, based on its own predetermined criteria. In addition to data collection, eVestment Alliance also provides a suite of analytical tools which a user can utilize to screen, sort and compute portfolio level measures such as down market capture and relative excess return. Atlanta Capital has prepared this report. eVestment Alliance does not endorse it or guarantee, review or endorse Atlanta Capital's products.*

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Michael Jaje, CFA
Investment Specialist, Core Equity
Vice President and Principal

Atlanta Capital Management Co., LLC
1075 Peachtree Street NE, Suite 2100
Atlanta, GA 30309
404.876.9411

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