March 2021

'Upside/downside capture' – a meaningful measure of manager capability?

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Upside/downside capture is a favoured performance metric for active multi-asset managers. But what does it actually measure and what can it tell us about GARS' performance?

Upside/downside capture – what is it?

When evaluating multi-asset funds the usual performance metrics such as performance versus benchmark, volatility and tracking error remain useful. However, there are also more insightful measures for absolute return funds, such as upside and downside capture. These can evaluate not just the manager's investment research prowess and portfolio construction skill but also their ability to navigate changing market environments.

Upside capture is simply the ratio of a fund's overall return to global equity market returns evaluated over periods when equities have risen. Downside capture is the same ratio when equities have fallen.

The time period for measurement matters. Too short and results can be meaningless and volatile. Too long and they become cumbersome, only identifying change long after it has passed. To be useful, we believe the period chosen should be aligned to the pace at which the portfolio is adjusted by its managers. Although GARS is not a tactical fund, the overall risks taken by its managers can alter materially over a year. Therefore, a one-year (52 weeks/12 months) measurement window is consistent.

What levels of capture are to be expected?

A passive equity-index portfolio would be expected to show upside and downside capture both close to 100%. This would imply faithful tracking of the benchmark.

An active manager striving to beat the same index might hope to add value in up-markets and down-markets. If the manager's choices resulted in 102% upside capture and 98% downside capture, even this apparently small asymmetry would be sufficient to generate around 2% per annum outperformance while tracking close to the benchmark. For an active manager, it is the extent to which upside capture exceeds downside capture that reflects the quality of their insights, and effectiveness in implementing them.

For absolute return portfolios, the goal is to deliver positive returns, irrespective of what's happening in markets. In a perfect world, this would require upside capture to be positive and downside capture to be negative, indicating the fund rose in both up and down markets. In practice, this is a very challenging objective, which is unlikely to be achieved other than over short periods. However, the extent to which upside capture exceeds downside capture remains a key indicator of skill. Additionally, low levels of downside capture can indicate how well risk is being managed - variation in capture levels through time can reflect versatility in portfolio risk positioning.

Absolute return managers have the flexibility to adapt to changing conditions, so their skill is also reflected in how their capture levels have changed through time. Did the manager increase upside capture during rising markets? And reduce downside capture during periods when market sold off?

Capture levels for absolute return portfolios

The risk and return objectives of an absolute return portfolio indicate broadly the levels of upside and downside capture you might expect. For example, if the level of risk is expected to be around one-third that of equities then average downside capture of 33% would be consistent. If the result achieved is lower than this figure, especially in times of market stress, this can be evidence of skilful risk management and portfolio positioning. Equally, we would hope to see upside capture that remains above the downside figure and that is higher in periods when markets are rising.

Our analysis indicates that, where downside capture is 33%, then an upside capture just 6.2% higher is sufficient for a portfolio's long-term overall return to equate to that of global equities.

Aberdeen Standard Investments

Chart 1: Performance comparison: global equities versus absolute return portfolio with 39.2% upside capture and 33% downside capture

Global Equities | 0.39 Upside and 0.33 Downside

Source: Aberdeen Standard Investments, Bloomberg, January 2021.

For illustrative purposes only. No assumptions regarding future performance should be made. Past performance is not a guide to future results.

In Chart 1, the blue line plots the performance of global equities since 1990. The green line indicates what a portfolio with 33% downside and 39.2% upside capture would have delivered over the same period. This portfolio would spend equal time ahead and behind the market, bisecting its path but doing so with volatility of 5.8% versus 16.1%. Note how the green line tracks below the blue line towards the end of bull-market cycles in 1998-2000, 2006-2008 and 2016-2019. Conversely, the green line is materially ahead of the blue line following sharp recessions. These are exactly the characteristics you would expect of an absolute return fund.

If downside capture is even lower than 33%, then less upside capture is needed to achieve the same result. This is because, after each downturn, the portfolio starts from a higher base. Likewise, if capture rates are seen to change through time, then a good manager will be seen to have increased upside capture in periods of rising markets and, conversely, reduced downside capture in falling markets.

How does GARS measure up?

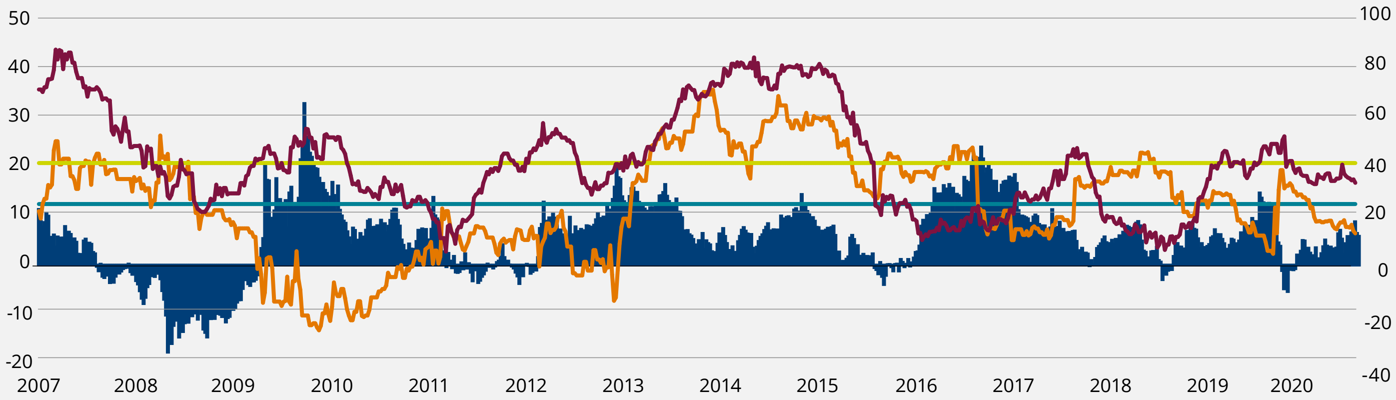
GARS has been praised for providing good downside protection in weak markets but, in the past five years, is perceived as delivering too little upside. However, the question is, have the managers have shown skill? And does the much stronger performance over the last two years indicate improvement?

Analysis of upside and downside capture levels offers useful insight.

Chart 2 shows GARS' rolling 52-week upside and downside capture ratios (left-hand scale) and the averages since inception to December 2020. The corresponding rolling one-year global equity returns (right-hand scale) are shown for comparison.

At first glance, overall levels of capture appear consistent with portfolio risk expectations and, for most periods, upside capture is greater than downside capture.

Chart 2: Rolling 52-week capture ratios for GARS versus global equities



Global Equities | Downside | Average Downside | Upside | Average Upside

Source: Aberdeen Standard Investments, GARS UK Unit Trust, 30 December 2020.

Evaluating GARS' downside capture

We look first at downside capture, where investors perceive we've done a good job. Downside capture has been low but generally positive, meaning GARS experienced a small proportion of the equity market falls. The average since inception (teal green line) is 11.7%. This is materially below the 33% level that would be consistent with GARS' expected risk level of around one-third of equity market risk. This result is therefore consistent with widely-held perceptions. It also means that upside capture, on average 8% higher, is consistent with delivering GARS' return target.

The shape of downside capture through time is also important. In periods of major crashes, low downside capture is particularly useful in preserving capital, whereas at other times it is less relevant. Hence in 2014 and 2015, when downside capture was higher than average, it had minimal impact because markets were generally rising. At such times, we would expect the focus to be on upside capture. There were also periods of negative downside capture between 2009 and 2013 meaning that, even in weeks when equity markets fell, GARS delivered a positive return. While in retrospect this was generally a strong period for equities, it was also a period of high uncertainty stemming from the novelty of quantitative easing and recovery from the global financial crisis.

The trend in downside capture has been improving since 2015. This is consistent with our view that the economic cycle was becoming long in the tooth, with the possibility that rising interest rates would weigh on growth. Encouragingly, since we made changes to GARS' process and management in H2 2018, downside capture has continued to fall. Hence, the portfolio was in a good position in Q1 2020 during the Covid-19 crash. Therefore, perceptions of GARS' good downside protection appear wholly supported.

Has GARS' upside capture been disappointing?

That brings us to upside capture, where perceptions are that we've disappointed. The average since inception of over 21.8% is materially above the level of downside capture. However, Chart 2 shows that, prior to 2015, upside capture was stronger than during 2016-2018. Indeed, the average from inception to 2015 was 24%. Importantly, Chart 2 also shows peaks in GARS' upside capture that correspond to periods when market returns were more positive.

However from 2016 to 2018, the average upside capture was just 11%, suggesting more recent perceptions have been valid. Yet this reflected fund positioning. Our view was that prospects for equity returns were modest, and so we wanted to be less reliant on equity markets. Our focus was more on protecting capital – as evidenced by the trend in downside capture.

As a result of this overall positioning, the strong market rally in 2017 was of limited help to the Fund. However by the final quarter of 2018, we had formalised the changes to people and processes, becoming more versatile in risk positioning. Consequently, GARS delivered good relative performance, and this is reflected in the upside and downside capture data.

Reflecting a more positive outlook and favourable market pricing, we stepped up GARS' risk level in early 2019. Upside capture rose rapidly, reaching 20% by mid-2019. It has remained above the long-term average since then.

In 2020, the positive gap between upside and downside capture rose before the Covid-19 crash. This reflected the high level of diversification in the portfolio, which usefully cushioned the shock.

It takes time for improvements to become visible and to then be deemed consistent. In the case of GARS, the improvement in upside capture is now visible over two years. Moreover, it has exceeded downside capture for a sustained period, and therefore consistency is also increasingly evident. It is also pleasing to see the gap between upside and downside capture widening once again.

In conclusion

Perceptions of GARS' outstanding defensive qualities are well-founded, with a track record of low downside capture. However, perceptions of disappointing upside capture are understandable after several years of weakness.

Following the changes we made to GARS's process and people in late 2018, performance has shown a solid turnaround with recent capture rates around the historic average. Forward-looking investors can benefit from a continuation of this trend. However, convincing others may take a little longer. To change perceptions, we need to build on the recent improvements - reaching upside capture closer to GARS' historic highs would undeniably strengthen the argument. The Fund's performance since 2018 suggests that is eminently achievable.

Year on year performance to 31 January 2021 (%)

	Year to 31/01/2021	Year to 31/01/2020	Year to 31/01/2019	Year to 31/01/2018	Year to 31/01/2017
Fund (gross)	4.65	9.08	-4.96	4.41	-0.14
Fund (net, retail)	3.95	8.37	-5.59	3.72	-0.82
Performance Target (gross)	5.30	5.87	5.87	5.50	5.63
Performance Target (net)	4.55	5.12	5.12	4.75	4.88

Source: Aberdeen Standard Investments; GBP; as at 31 January 2021.

Investment involves risk. The value of investments, and the income from them, can go down as well as up and an investor may get back less than the amount invested. Past performance is not a guide to future results.

For full details of the fund's objective, policy, investment and borrowing powers and details of the risks investors need to be aware of, please refer to the prospectus. For a full description of those eligible to invest in each share class please refer to the relevant prospectus.

Important Information

The value of an investment is not guaranteed and can go down as well as up. An investor may get back less than they invested.

Please consider the below risk factors:

- The fund invests in securities which are subject to the risk that the issuer may default on interest or capital payments.
- The fund price can go up or down daily for a variety of reasons including changes in interest rates, inflation expectations or the perceived credit quality of individual countries or securities.
- The fund invests in equities and equity related securities. These are sensitive to variations in the stock markets which can be volatile and change substantially in short periods of time.
- The fund may invest in emerging market equities and / or bonds. Investing in emerging markets involves a greater risk of loss than investing in more developed markets due to, among other factors, greater political, tax, economic, foreign exchange, liquidity and regulatory risks.
- The use of derivatives carries the risk of reduced liquidity, substantial loss and increased volatility in adverse market conditions, such as a failure amongst market participants. The use of derivatives will result in the fund being leveraged (where market exposure and thus the potential for loss by the fund exceeds the amount it has invested) and in these market conditions the effect of leverage will be to magnify losses. The fund makes extensive use of derivatives.
- The fund invests in high yielding bonds which carry a greater risk of default than those with lower yields.

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