M&G Investments

M&G Insights

Mind the drawdown

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The key to the back-to-back Springbok Rugby World Cup triumphs was their exceptional defence, demonstrated during their narrow 1-point victories in the 2023 knockout stages. In rugby, as in many other sports, defence plays a pivotal role in securing success. In cricket, the saying "catches win matches" applies, while in rugby, one might say that "tackles win matches."

This idea extends to the world of finance, particularly in investment management. Hedge fund manager Mark Sellers reinforced this notion by stating, "Focus on the downside and the upside will take care of itself." In investments, minimising losses reduces the need for significant gains to break even, making risk management crucial for long-term success.

The M&G Enhanced Income Fund exemplifies this approach. Its strategy focuses on minimising drawdowns - periods of significant loss - which are central to protecting investor capital. By emphasising drawdown protection, the fund ensures that it requires less upside performance to recover from losses, offering a more resilient approach in volatile markets. The strategy is based on three pillars: being drawdown-focused, cyclically aware, and tactically alert.

Drawdown-focused: duration and credit risk

Managing drawdowns effectively requires attention to both duration and credit risk. Duration risk arises from a fund's sensitivity to interest rate changes. When interest rates rise, bond prices typically fall, leading to potential losses. With the FTSE/JSE All Bond Index, for example, we have seen how global and local factors have played a part in driving the five largest monthly losses which included Covid (-9.75%), Nenegate (-6.67%), Rand crisis (-5.02%), Lady R (-4.79%) and Taper tantrum (-4.64%).

Credit risk, on the other hand, occurs when a bond issuer defaults or experiences a significant deterioration in credit quality. This was evidenced last year with securitisation assets issued in the taxi industry.

Risk and reward of income funds

Income funds, by nature, offer the lowest reward and exhibit the least risk of the ASISA Multi-Asset categories. Investors in these funds show the least appetite for drawdowns and generally seek a less volatile return profile. A drawdown-focused strategy helps make the overall return profile more predictable, even in turbulent markets.

However, funds in the category vary in their exposure to risk, with some high duration funds and other high yielding funds available along the spectrum. The opaque nature of some structured products makes it a minefield for investors to assess their risks.

Fixed income managers are tasked with navigating the delicate balance of risk and return. Richard Woolnough, a portfolio manager at M&G UK, once described bond managers as "walking along a pavement avoiding the cracks," while equity managers are "lying in the gutter looking at the stars." The bond market serves as a critical judge of government economic policies, as evidenced by the 2022 UK Gilt crisis, where the government experienced what boxer Mike Tyson once described as: “Everybody has a plan until they get punched in the face”.

The concept of loss aversion, researched by psychologists Amos Tversky and Daniel Kahneman, refers to the psychological bias where the pain of losing money is felt more acutely than the joy of an equivalent gain.

This aligns well with the importance of managing drawdowns in the investor journey. A disciplined approach to drawdown management is crucial for success, and the M&G Enhanced Income Fund’s focus on this aspect has proven its mettle. For the three years ending 31 December 2024, the fund achieved a top-quartile ranking, placing 20th out of 109 peer funds. Its emphasis on risk management through careful control of duration and credit exposure has enabled strong performance, even in volatile market conditions. By prioritising downside protection, the fund helps investors navigate market fluctuations with greater confidence, demonstrating that, in both sport and finance, defence can be the key to long-term success.