

The Upshot of Downside Capture

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John Buckingham

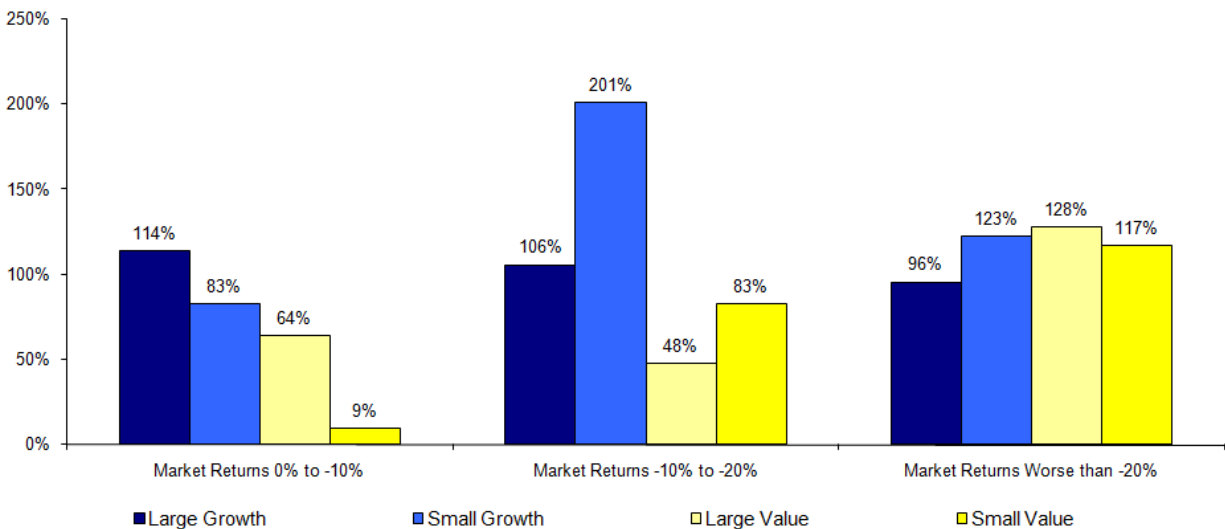
Last year was tough on practically all types of equities, and value stocks were unfortunately no real exception. This would seem to buck conventional wisdom that value stocks hold up better in downturns given the greater perceived “margin of safety” inherent in their less richly valued shares. Fact is, in most down markets value stocks do indeed hold up much better than growth stocks. However, in years when market declines are particularly severe, we see that value has been unable to provide its traditional safe haven.

To demonstrate this we look at the downside capture of value and growth stocks. Typically used to compare the performances of equity managers, downside capture is a measure of a particular return series’ performance in down markets relative to the market itself. A downside capture ratio of 90% suggests a loss of only nine tenths of the market’s loss during the selected time period. The lower the ratio the better. Specifically, we look at downside capture from 1927 through 2007 in years of:

1. Modest market declines (up to a 10% decline)...occurred eight times
2. Larger market declines (a decline of 10% to 20%)...occurred eight times
3. Severe market declines (worse than 20%)...occurred five times

Downside Capture (1927 – 2007)

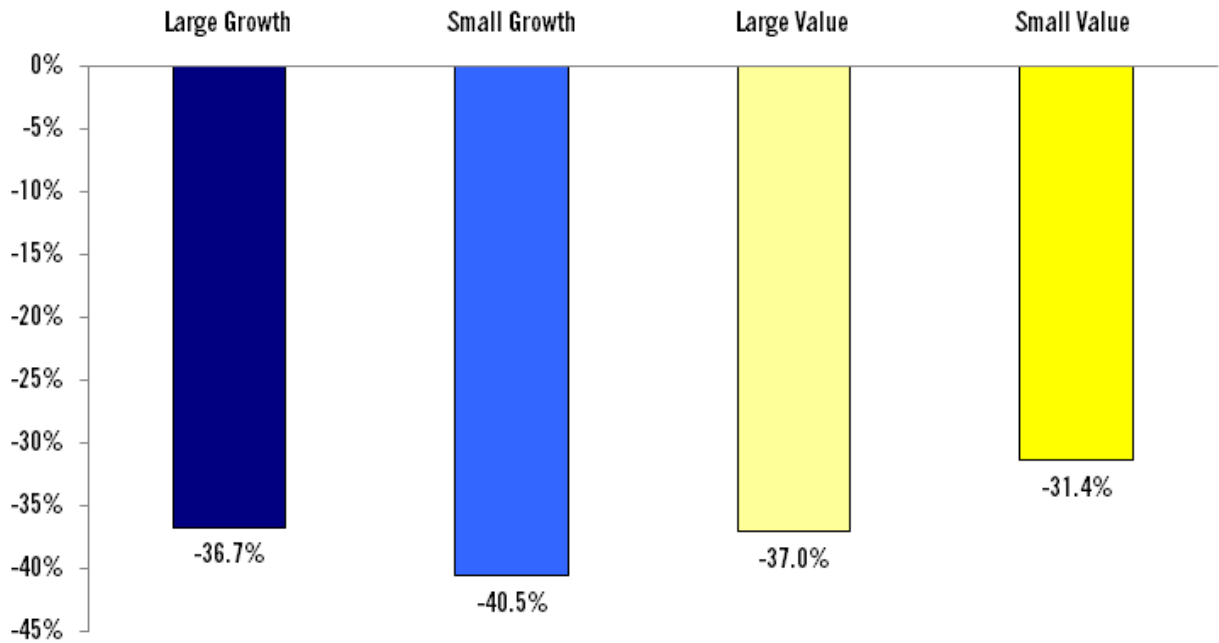
Value traditionally outperforms – Except in the big down years



Source: AFAM using annual data from Morningstar

We can see below that 2008’s results provided a confirmation of this trend as value failed to provide a meaningful buffer from the overall market’s severe decline.

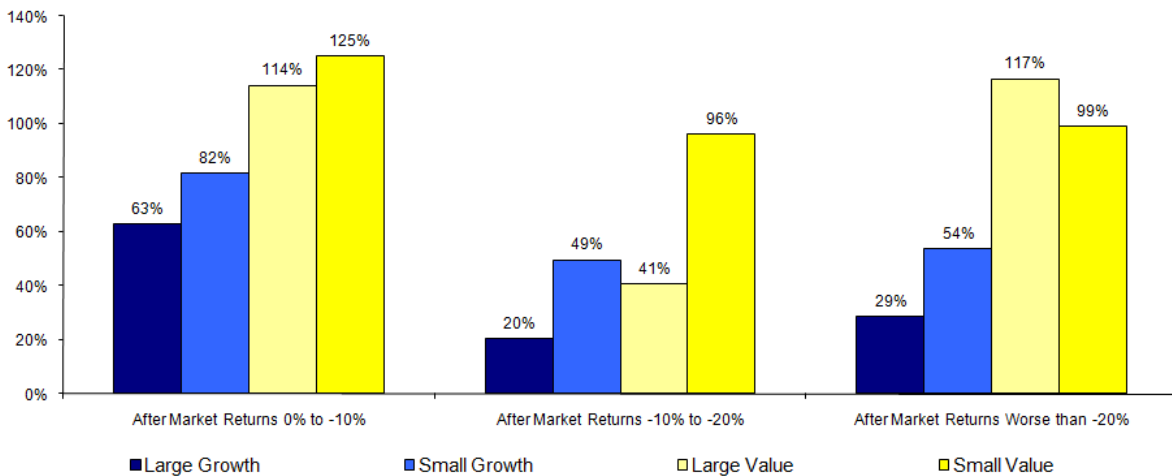
Performance in 2008
Value was no safe haven



Source: AFAM and FactSet Research

Fortunately, history provides a reason to be somewhat optimistic. Following severe annual market declines, total returns for value stocks look pretty attractive, on average, for the subsequent three year period, particularly relative to their growth-oriented peers. Interestingly, we also see below that the large-cap value group, on average, performed very well, even though conventional wisdom might suggest small caps lead recoveries.

Average 3-Year Cumulative Return Subsequent to Years the Market Declined (1927 – 2007)



Source: AFAM using annual data from Morningstar

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