Augustus King Vanguard

Dealing With Drawdowns

Dear Investors,

It's time to learn about drawdowns. You may have heard me talking about them in previous reports, sometimes I've been told that I hark on about them ad nauseum, and this makes me look negative. So why do I continue being a negative Nelly? Let's explore.

What Is a Drawdown?

A drawdown is when your equity (money) declines from the recent peak of your performance, to your recent low. In other words 'a losing streak'.

Every single fund, trader and portfolio has drawdowns. If it doesn't have any losing periods then stay a mile away, they'll lose everything in one fell swoop very soon.

Why Do Drawdowns Occur?

Not all drawdowns are made equal. The size and formation of your drawdown is dependent on your trading/investing system.

NB: No trading system is perfect! ← *this is so important to bear in mind.*

Drawdowns occur because the predominant trading system is not as compatible with the current market environment, resulting in a higher number of losing trades than winning trades, or in larger losers than winners.

Investment managers try to mitigate this effect by diversifying not only the markets that they trade, but also the systems they deploy.

Let's take a look at 3 forms of investing and how they fare in different market conditions.

Mean Reversion

A 'mean reversion' approach to the markets is predicated on the theory that markets will always return to their average (mean) price. So, if the market has gone up for a while then it won't be long before it turns backwards and falls a bit (reverting to the mean/average price). Then they might continue further downwards, but after a while of dropping they'll head back up to meet that average price again. As such the most profitable market environment for mean reversion traders is a flat market that's undulating up and down repeatedly.

However, if the markets continue to trend either upwards or downwards then the mean reversion portfolio is going to see a drawdown. The drawdowns can be catastrophic to a portfolio, because when a market trends (bad for mean reversion, they tend to last for a long time).

As such, I've heard this strategy behaviour referred to as: "eating like a rabbit, and shitting like an elephant" ← how eloquently put!

In other words, it takes lots of small meagre wins (66% win ratio) and then huge thumping losing streaks that can outweigh the winners.

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Buy & Hold

This is the most common strategy around, because it's easy, and because as long as inflation continues upwards, so too will stock prices as more money flows through the market. It's a passive strategy based solely on the hope that the markets will always go up. The observant among you may have started to detect a hint of disdain in my tone, I genuinely cringe as I write about what 'Buy & Hold' is.

Sadly, most ISAs and pension funds will largely comprise Buy & Hold portfolios. Thankfully, these days, more of these are balanced out by having exposure to bonds, treasuries and sometimes currencies and/or commodities - which is better.

Buy & Hold will do well when the market moves upwards. If there is a crash or a bear market (where stock prices are moving down slowly) then Buy & Hold (and with it decades of pension savings) get decimated. Sometimes by as much as minus 60% - imagine that just before retirement - yikes!

Of course, as I've said before, all systems have their drawdowns, and they might happen any time. But bear in mind that Buy & Hold will not make any money if the market is down, so ask yourself: "am I willing to risk that stocks will always go up?"

In my opinion, a more fitting term would be "Buy and Hope".

Trend Following

Ahh that's better (a smile returns to my face). However, this is yet another imperfect system. But beautifully imperfect due to its robustness.

Trend following systems will make money in up, down and surprise markets (like crashes). But it won't make money in flat/ranging markets (where mean reversion systems will perform well).

So if the market is confused and consequently chops up and down, this will create a drawdown for trend following portfolios.

It's interesting to note, although I'm not sure the validity of this statistic, that apparently markets tend to trend only 30% of the time. However, when a market does trend it creates very large and profitable movements that give much larger winning trades than the many smaller losing trades (40% win rate). This is how trend following makes money.

NB: To make all of these systems more robust one should target larger winners than losers and diversify the number of markets that are traded.

What To Look For

Now you know what a drawdown is, and how it occurs, you can look for the important factor that will tell you if a fund is sticking to their system. For example, with the Augustus King Vanguard Diversified Trend Following Fund, if we experience a sustained drawdown while the markets are predominantly trending, then something is off.

Similarly if you are invested into a fund that predominantly uses mean reversion as its core strategy, you can expect to see more winning trades, more often, but when markets really start to move (either up or down) you should mentally and emotionally prepare yourself for a drawdown.

In fact, before you make any investment whatsoever you should honestly be prepared to stomach a drawdown. Despite my disdain for other trading systems, I've traded them all in various ways and all of them will make money if losses are kept small and the winning trades are allowed to run (something we refer to as 'targeting asymmetrical gains').

All the systems should make money in the long run if managed responsibly, and they all produce losing streaks (drawdowns).

But if you understand how the fund should behave in different environments, then you should be able to keep your investments in safe hands and rationalise any drawdowns.

This will save you from ripping your money out at the bottom of a drawdown, then investing into another fund at the top, only to experience this new fund's upcoming drawdown.

It's imperative to your future wealth that you allow your savings to compound healthily over time, and if you're affected by scary drawdowns (when they're expected to occur naturally, then this will severely hamper your ability to create wealth.

If you do spot a misplaced drawdown then you should question why that is, and if it doesn't add up then remove your funds and think about where else to make them work for you.

What Should You Expect as an Investor in AKV's Trend Following Fund?

In short, over time you should expect to see:

30-40% winning trades, 50-60% winning months, 70-80% winning years.

Winning trades should be larger than the losing trades. Winning months should be larger than losing months. Winning years should be larger than losing years.

Drawdowns will occur when markets are flat or choppy. This normally happens at the end of a long trending period.

Because AKV is diversified across over 40+ markets when one market zigs, others will zag, meaning that we're organically hedged/balanced, keeping your investments more stable.

-4% possible average losing month scenario	+5% possible average winning month scenario
-15% possible terrible month scenario	+40% possible fantastic month scenario
-40% possible bad expected drawdown	+150% possible good runup (opposite of drawdown)

**These are only guidelines to help manage expectations, actual data will vary depending on a variety of factors, and I'm always happy to discuss those with each of you individually should you have any questions.*

Chesapeake Capital

This is one of the world's leading and most well-renowned pure trend following funds. Their risk profile is close to what I aim to emulate with the Augustus King Vanguard fund.

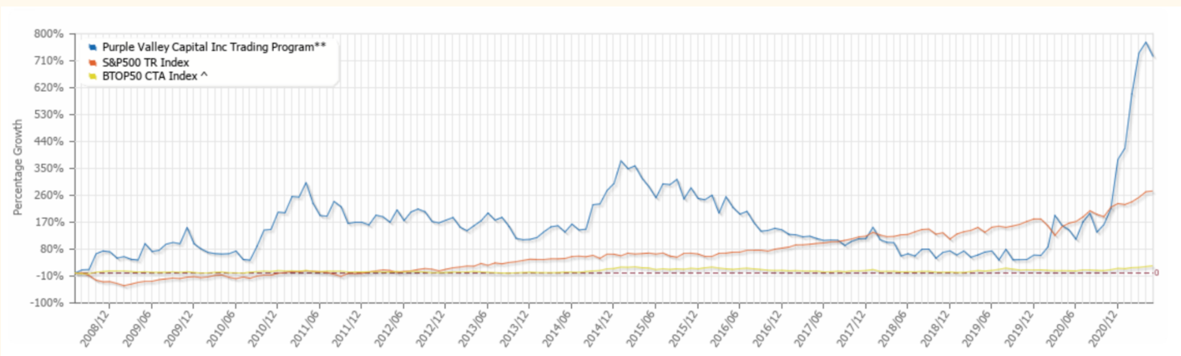
CHESAPEAKE CAPITAL CORPORATION - DIVERSIFIED PROGRAM Monthly Performance (%) Net of Fees	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year		
2021	0.51%	6.32%	0.15%	6.15%									13.13%		
2020	2.14%	-6.40%	-2.96%	0.49%	-1.20%	-0.92%	2.33%	2.47%	-3.94%	-0.78%	7.44%	8.04%	5.87%	Monthly Win Rate	55.10%
2019	-6.18%	4.55%	1.12%	2.88%	-6.49%	3.18%	3.71%	1.71%	-2.18%	-3.27%	-0.65%	-1.70%	-4.02%	Avg Monthly Win	4.46%
2018	8.03%	-6.40%	-1.87%	-0.57%	-2.55%	-0.96%	0.24%	5.18%	-0.46%	-3.54%	-0.81%	-3.45%	-7.69%	Avg Monthly Loss	-3.47%
2017	1.30%	1.79%	-2.51%	-0.14%	-0.82%	-0.97%	-0.56%	1.73%	-1.53%	1.62%	1.69%	2.98%	4.51%	Best Winning Month	32.40%
2016	0.30%	0.69%	-4.22%	-1.76%	0.85%	4.98%	0.23%	-1.34%	0.73%	-1.76%	-1.45%	-0.96%	-3.92%	Worst Losing Month	-18.29%
2015	3.21%	-0.18%	1.65%	-3.83%	1.30%	-2.21%	4.00%	-2.94%	0.75%	-0.56%	1.62%	-0.53%	1.97%		
2014	-3.27%	1.16%	-0.82%	0.65%	0.88%	2.13%	-0.86%	3.23%	1.72%	1.19%	3.91%	3.28%	13.77%	Annual Win Rate	78.79%
2013	6.29%	-1.86%	2.08%	1.31%	-0.94%	-0.36%	3.60%	-5.32%	1.02%	4.60%	7.96%	5.23%	25.38%	Avg Annual Rtn	10.91%
2012	-2.30%	-2.23%	1.08%	2.24%	-3.14%	-3.59%	5.75%	-0.85%	-5.10%	-5.03%	-0.07%	-3.29%	-15.82%	Best Annual Rtn	61.82%
2011	1.45%	6.34%	1.16%	5.63%	-8.27%	-5.91%	2.77%	-0.30%	-12.63%	-0.86%	5.23%	0.83%	-6.32%	Worst Annual Rtn	-15.82%
2010	-5.90%	2.47%	6.40%	3.71%	-18.29%	-3.05%	-1.54%	3.50%	8.80%	10.93%	-6.11%	13.89%	10.85%		
2009	0.50%	-0.89%	-1.04%	-3.13%	-3.12%	-1.38%	-0.32%	4.80%	3.20%	-4.68%	4.15%	2.81%	0.40%		
2008	2.35%	17.15%	-7.49%	0.63%	2.07%	9.48%	-9.39%	-7.50%	-7.20%	7.29%	6.44%	4.14%	15.39%		
2007	2.63%	-2.33%	-1.27%	4.53%	5.48%	0.80%	-8.30%	-16.42%	11.42%	10.64%	-6.73%	5.52%	2.26%		
2006	5.54%	-0.70%	5.37%	3.19%	-1.50%	-0.74%	-2.13%	-4.66%	-1.53%	1.38%	3.38%	3.35%	10.88%		
2005	-3.82%	0.46%	-0.92%	-3.62%	-1.25%	3.40%	0.45%	4.70%	-1.10%	-4.75%	4.33%	1.97%	-0.69%		
2004	1.63%	5.05%	-2.70%	-6.05%	-0.50%	-2.90%	-1.86%	-3.23%	3.50%	2.32%	8.89%	1.53%	4.84%		
2003	6.52%	3.61%	-8.76%	0.29%	5.35%	-5.65%	-1.85%	2.42%	-2.78%	15.48%	1.91%	6.61%	23.07%		
2002	-2.11%	-1.79%	2.43%	-3.27%	2.26%	4.19%	2.84%	2.55%	3.81%	-2.63%	-1.58%	4.31%	11.08%		
2001	-0.43%	3.75%	4.98%	-7.50%	-1.43%	0.16%	-3.06%	-3.40%	7.15%	5.01%	-10.09%	-1.92%	-7.99%		
2000	-0.87%	0.92%	1.88%	-3.80%	0.63%	-0.99%	-3.71%	3.90%	-7.30%	-0.62%	7.42%	8.80%	5.24%		
1999	-2.76%	1.90%	-2.65%	8.42%	-8.71%	3.57%	-4.80%	3.37%	1.98%	-7.88%	4.16%	8.49%	3.30%		
1998	-1.29%	6.06%	3.65%	-2.16%	3.62%	-0.67%	3.03%	7.27%	-0.59%	-3.21%	-1.68%	1.80%	16.31%		
1997	1.86%	5.48%	-1.24%	-2.41%	-2.28%	1.44%	6.24%	-7.88%	5.06%	-2.34%	1.70%	4.88%	9.94%		
1996	1.69%	-4.26%	0.28%	10.16%	-3.04%	3.27%	-7.64%	0.57%	6.47%	5.92%	6.57%	-4.30%	15.05%		
1995	-3.23%	-4.39%	8.60%	1.45%	6.84%	0.88%	-3.09%	-2.66%	0.20%	-1.11%	1.76%	9.18%	14.08%		
1994	-3.33%	-4.88%	0.09%	-0.60%	9.06%	7.02%	-1.70%	-2.98%	3.49%	1.97%	4.83%	2.86%	15.87%		
1993	0.42%	15.99%	5.86%	7.38%	0.40%	0.98%	9.49%	5.88%	-2.63%	-0.06%	1.03%	5.77%	61.82%		
1992	-10.98%	-2.86%	0.53%	-0.44%	-3.66%	6.52%	12.96%	3.16%	-6.78%	5.21%	2.27%	-1.93%	1.81%		
1991	-1.29%	4.84%	2.32%	-2.80%	0.27%	-1.25%	-1.75%	-3.32%	4.39%	4.21%	-4.68%	12.08%	12.51%		
1990	0.49%	3.37%	8.62%	4.37%	-4.61%	1.77%	6.25%	15.15%	0.60%	1.86%	-0.25%	0.11%	43.12%		
1989	4.93%	-5.42%	6.64%	-8.82%	22.38%	-8.28%	11.66%	-11.75%	-2.82%	-7.40%	3.90%	28.56%	28.30%		
1988		-2.63%	-6.89%	-10.71%	6.93%	32.42%	-9.41%	6.85%	2.03%	10.65%	11.06%	7.04%	48.91%		

Purple Valley Capital

This is an example of a pure trend following fund who are at the highest level of risk exposure, this fund really swings for the fences and as such if you're able to stomach 5 years of drawdown, then you'll also outperform Buy & Hold (S&P 500) by over 500%. This is too much volatility for my liking, but it's up to each individual.

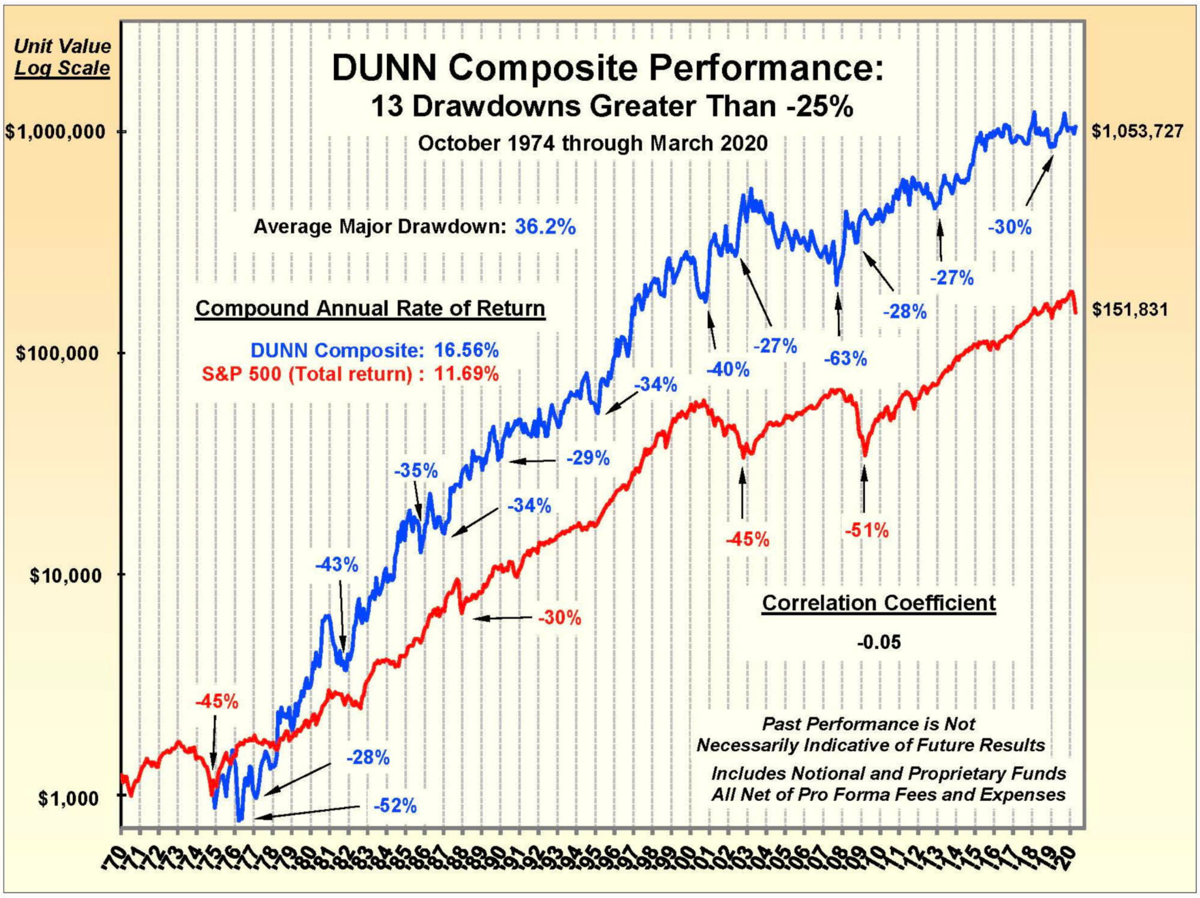
PURPLE VALLEY CAPITAL Monthly Performance (%) Net of Fees	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year		
2021	7.86%	35.24%	19.40%	4.35%	-5.42%								71.89%		
2020	-0.69%	17.65%	56.50%	-11.45%	-5.61%	-12.99%	27.16%	10.83%	-21.09%	10.62%	20.66%	51.81%	199.65%	Monthly Win Rate	52.60%
2019	-7.79%	8.24%	-12.08%	5.09%	5.92%	2.19%	-17.34%	24.86%	-19.57%	0.37%	0.45%	10.08%	-8.07%	Avg Monthly Win	11.43%
2018	17.56%	-16.35%	-4.16%	-0.62%	-22.21%	4.82%	-4.46%	14.22%	0.20%	-16.78%	12.92%	3.06%	-19.11%	Avg Monthly Loss	-7.87%
2017	-6.14%	-0.70%	-2.93%	0.86%	-3.56%	-2.78%	0.68%	-0.41%	-8.35%	7.44%	3.96%	0.25%	-11.95%	Best Winning Month	56.50%
2016	-1.21%	4.33%	-16.59%	18.18%	-10.12%	-6.89%	3.01%	-12.34%	-10.60%	1.06%	2.97%	-2.02%	-30.01%	Worst Losing Month	-22.21%
2015	19.00%	-5.65%	2.15%	-9.01%	-6.87%	-9.48%	13.30%	-0.67%	4.45%	-15.83%	10.72%	-9.26%	-12.56%		
2014	2.93%	8.82%	6.88%	1.42%	-8.09%	11.12%	-7.44%	1.14%	33.18%	0.70%	13.47%	6.37%	87.94%	Annual Win Rate	53.85%
2013	3.15%	-11.19%	-4.75%	6.92%	6.30%	9.50%	-7.92%	3.34%	-10.59%	-15.49%	-2.23%	0.58%	-23.21%	Avg Annual Rtn	27.59%
2012	-3.14%	12.48%	-1.84%	-6.34%	15.27%	-11.55%	10.54%	3.26%	-2.92%	-10.66%	-1.74%	3.42%	2.73%	Best Annual Rtn	199.65%
2011	-0.61%	18.00%	-0.52%	13.64%	-17.28%	-12.14%	-0.79%	17.05%	-5.17%	-17.47%	1.48%	-0.06%	-11.17%	Worst Annual Rtn	-30.01%
2010	-8.48%	-6.65%	-2.46%	-0.77%	0.67%	5.33%	-16.07%	-1.70%	32.59%	28.39%	0.99%	23.32%	53.36%		
2009	-12.07%	3.14%	-5.74%	-1.68%	38.24%	-13.27%	2.31%	11.66%	2.94%	-2.10%	27.26%	-21.51%	15.89%		
2008								10.83%	0.86%	47.09%	5.79%	-1.79%	70.81%		

And here is said performance overlaid on a graph vs. the S&P 500, demonstrating how trend following would have performed in this portfolio vs. Buy & Hold.



DUNN Capital

Another world famous pure trend following fund here, compared to the performance of the S&P 500 (representing a Buy & Hold portfolio).



Showing how if you can handle your drawdowns, you'll be banking massive multiples more than most passive investors. Their average major drawdown has been -36% over the past 50 years, but they've produced 6x more return over the same period.

Human Psychology and Coming to Terms With Losing

The vast majority of people are not able to stomach drawdowns and it makes them do illogical things. The worst of all is taking their money out of a fund at the bottom of a drawdown (when the investment style is expected to be losing at that time) and then investing into another fund whose recent performance is on fire, only to experience another painful drawdown in the new fund. The worst thing about this is that if they were to check back on their original fund's performance, it's highly likely that they've just missed out on a huge recovery rally.

The inability to embrace, even *love*, your losses, as an investor is one of the principal factors behind why 90% of retail traders lose money. **As a trend follower, generally the more small losses you incur, the closer you're getting to a big winner, it's like winding up a Jack-in-the-box. For this reason, I love my losing trades, they're just re-framed in my mind as an exciting build-up to something bigger and better.**

If you don't think you can stomach the drawdowns, then that's fine, be honest with yourself, but be aware that no investment is without risk, the lower the risk, the lower the return. You just have to be honest with yourself as to how much risk you can tolerate where you'll be able to survive multiple drawdowns and not lose sleep.

Final Thoughts

Creating multi-generational wealth that will span decades and make a tangible difference to you and your family's life is all about survival and compounding returns. The temptation is to focus strongly on winning trades and making money, but the reality of focusing on risk and keeping losing trades small is where the real money gets made. If you are investing in a profitable system then you cannot lose money (in the long run) by keeping losing trades small and letting winning trades run to the moon.

Then all that remains is to allow your wealth to compound. That is achieved by understanding, accepting, embracing and then riding-out drawdowns when they occur.

So to return to what I said at the beginning of this document, this is why I focus on how much you can lose as an investor. Yes, I may sound like a negative Nelly, but it's only because I want you to truly come to terms with the psychological hurdles that you'll 100% encounter on your investment journey.

Happy investing!

Matthew Spurr

Founder

Augustus King Vanguard