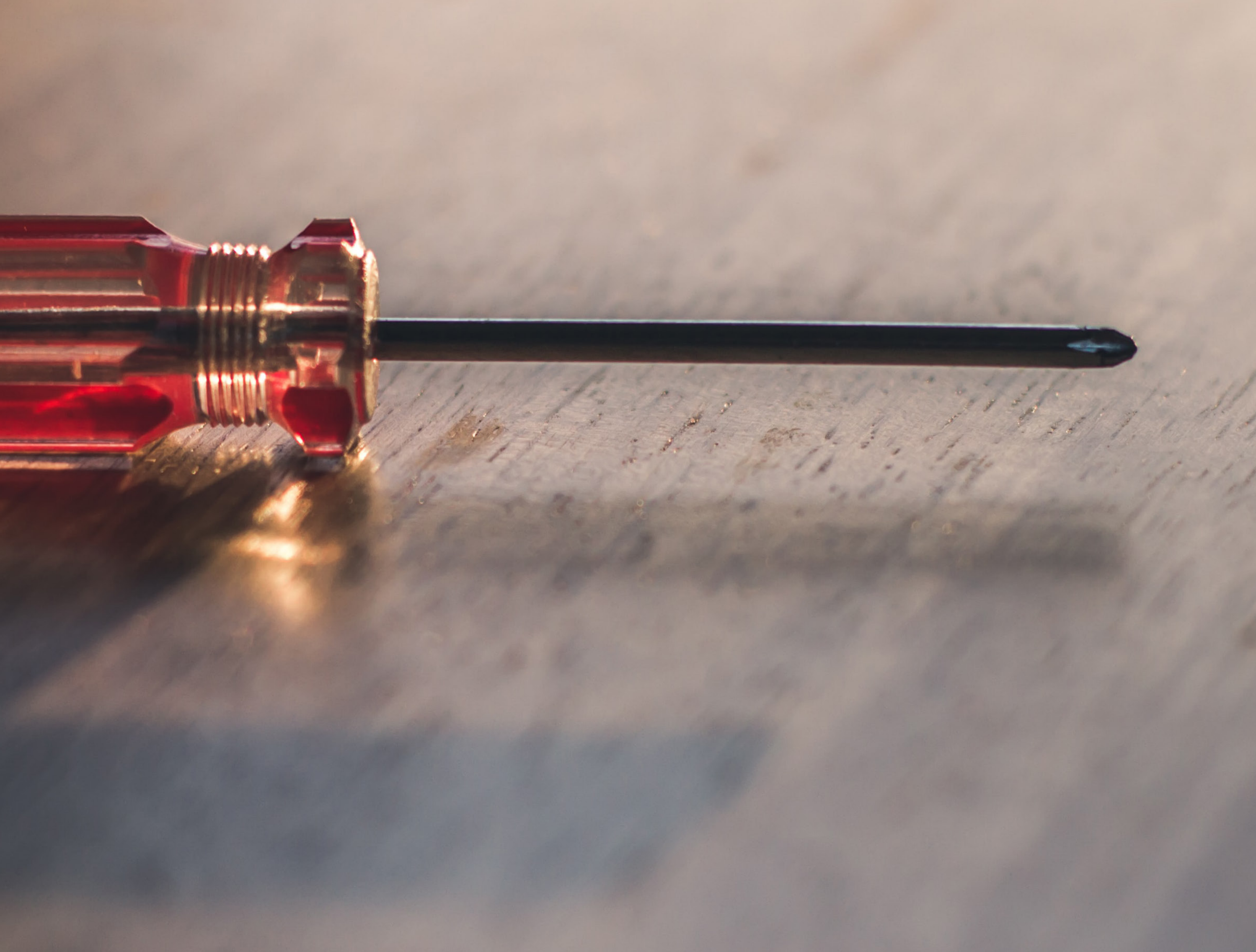
PROGRESSIVE CAPITAL PARTNERS LTD



DIVERSIFY YOUR PROTECTION

HOW TO EFFECTIVELY COMBINE DOWNSIDE RISK MANAGEMENT AND ROBUST ABSOLUTE RETURNS

Imagine a plumber showed up to repair your broken sink with nothing but a screwdriver. Would they not be better equipped for the job with a complete toolkit at hand?

Similarly, a portfolio of complementary convex hedge fund strategies, i.e., the financial equivalent of a toolkit, is well suited to handle ex-ante unknown characteristics of drawdowns of financial markets. The abrupt and massive sell-off caused by the spreading of Covid-19 during the first quarter of 2020 confirmed the benefit of such portfolios. They delivered meaningful positive returns in the first quarter of 2020 – after having also generated gains during the preceding bull market in 2019.

After 10+ years of bull markets, implications of the Covid-19 pandemic abruptly injected fears and uncertainties into the global financial system, resulting in one of the largest drawdowns in history. Although investors experienced several rapid and strong market corrections in the last few years, the speed and vehemence of the sell-off took most investors by surprise.

Instinctively, investors seek for analogue past events and compare them with the most recent one. What we know for sure, is that, even though any of two single drawdowns may exhibit commonalities, they are inherently different. This simplistic notion underlines why it is important to consider multiple types of drawdowns while trying to protect capital, and not to rely too strongly on analogies from the past.

In this short paper we discuss the benefits of diversification across convex hedge fund strategies. We introduce a classification of drawdowns and map the different drawdown scenarios with appropriate and efficient tools (Trading strategies). In addition, this paper touches upon the benefits of concave strategies (Market Neutral strategies) as an absolute return enhancement tool while controlling their primary risks.

HISTORY IS NOT REPEATING ITSELF

History shows that every financial market sell-off had its own specific form and shape, respectively better and worse suited strategies to effectively hedge. While Trend-following CTA strategies were a good hedge during the burst of the technology bubble and in the Global Financial Crisis (GFC), they failed to deliver protection in the European sovereign debt crisis in 2011 and 2012. In contrast to this, Discretionary Global Macro strategies struggled in the GFC, yet delivered protection in the 2011/2012 period. Gold, as another example, offered decent shelter during the Chinese stock market crash in 2015/2016, but lost during the peaks of the GFC. Interestingly, it did not help much during the first phase of the technology crisis, but turned into a good hedge as the technology crisis evolved in 2002.

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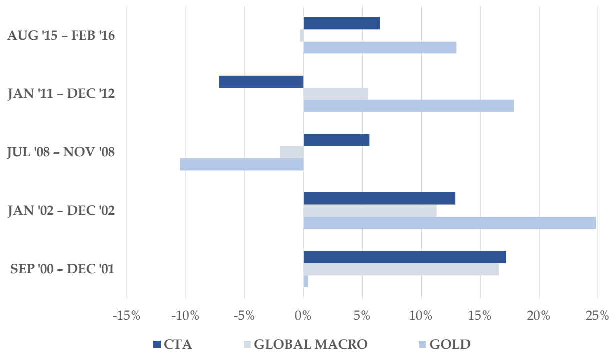
Chart 1 below exhibits the perfomance of different protective strategies during selected past market sell-offs.

CHART 1: RETURNS OF CTAS[1], GLOBAL MACRO[2] AND GOLD[3] AS PROTECTIVE STRATEGIES DURING SELECTED PAST MARKET SELL-OFFS



SOURCE: BLOOMBERG, PROGRESSIVE CAPITAL PARTNERS

As the above analysis shows, a portfolio with a specific set of protective strategies (rather than a single strategy) is needed to deliver uncorrelated or even positive performance in a future drawdown period. Relying on a too narrow set of strategies bears the risk of not having exposure to strategies which offer protection in the next drawdown. Even more so because a strategy can lose its initial protective properties in the course of the same drawdown.

CLASSIFICATION OF DRAWDOWNS

Drawdowns can have a wide range of different characteristics. We apply a multi-dimensional classification of drawdowns to characterise different types in a comprehensive framework. This classification occurs along categories such as affected markets, depth of drawdown, speed of drawdown, length of drawdown, degree of volatility, as well as down-correlations across markets. The framework avoids neglecting crucial path dependencies when assessing the drawdown behaviour of a portfolio.

MAPPING STRATEGIES TO DRAWDOWNS

The classification of drawdowns represents the basis of the portfolio construction process: It demonstrates the necessity to access a diverse set of high quality convexity sources in order to map various drawdown scenarios with appropriate and efficient protective strategies. This mapping ensures that no plausible drawdown scenario is disregarded. The aim is not only to protect, but to profit from more plausible drawdown scenarios; in particular from those for which good risk-reward (i.e., cheap) protective strategies can be identified.

A PORTFOLIO OF DIVERSIFIED SOURCES OF CONVEXITIES

The outcome of the above is a diversified portfolio of different convexity strategies. Although both CTAs and Discretionary Global Macro do qualify as convex hedge fund strategies, the highest degree of differentiation characteristics is exhibited by Discretionary Global Macro strategies. While CTAs follow trends once they are established, Discretionary Global Macro strategies tend to anticipate them. In fact, they tend to be early, both on the way in and on the way out.

> The result is a diversified portfolio of different and changing convexity strategies.

At the same time, Discretionary Global Macro strategies tend to run more concentrated and options centered portfolios. However, not everything that is labelled macro has actual macro inside. The decade-long bull market tended to favour pseudo-macro strategies, which in reality were closer to long-biased multi-asset, rather than pure Discretionary Global Macro strategies. These varieties and fundamental differences across sub-styles within Trading strategies (CTAs, Global Macro) are the primary cause for substantial result dispersions during crisis scenarios.

The following is a non-exhaustive list of potential strategies for building a portfolio of convexities (protections):

- Discretionary Global Macro strategies
- Long Volatility strategies
- Funding and Credit Stress strategies
- Long Correlation and Dispersion strategies
- Short-term Trend-following CTAs
- Medium- to Long-term Trend-following CTAs
- Long Precious Metals strategies

The range of convexity sources used is dynamic depending on their attractiveness but also on the market context.

For instance, after the unprecedented dimensions of global monetary and fiscal stimulus measures announced in March 2020, inflation risk may be underestimated, increasing the convexity appeal offered by specific long-inflation strategies.

MORE THAN SIMPLY A TAIL HEDGE PORTFOLIO

The outlined portfolio is by no means a pure tail hedge portfolio or a one-trick pony. The vast majority of tail hedge portfolios fall short of delivering a positive return stream during up and sideways markets. Portfolios of convexities strive for a dual target function: namely 1) to reliably protect on the downside, while 2) delivering positive, attractive risk-adjusted returns when markets rise or move sideways.

A range of complementary convex strategies can deliver positive returns during benign markets. One or more of the several sources of convexity are likely to find ways to make money in a specific year leading to a decent absolute return stream.

> Portfolios of convexities strive for a dual target function: namely 1) to reliably protect on the downside, while 2) delivering positive returns when markets rise or go sideways.

Furthermore, selected Market Neutral strategies represent viable additions to a portfolio of convex strategies despite their generally concave return profile. Such strategies are known to deliver consistent and positive returns. However, in severe stress scenarios, arbitrage relationships are often exposed to temporary dislocations which may lead to mark-to-market losses. As long as Market Neutral strategies are not forced out of their positions during stress scenarios, they are able to benefit when arbitrage relationships normalise again.

THE PROOF IS IN THE PUDDING

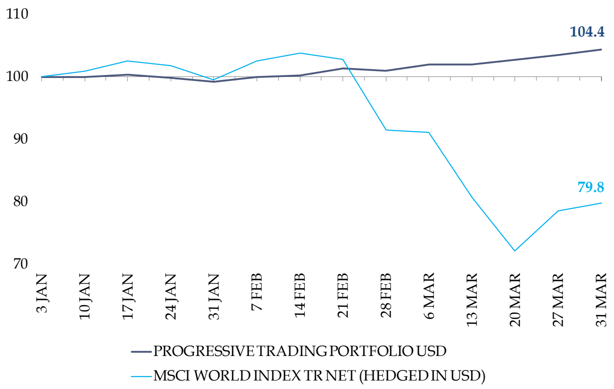
Theoretical concepts often sound straightforward and promising. The actual implementation usually proves to be more challenging. Nevertheless, there are a few examples confirming the feasibility of a successful implementation of the concept outlined in this paper. One of those is embodied in the Progressive Trading Portfolio, a long-standing trading strategy that focuses on both generating attractive risk-adjusted returns across market cycles, while being able to profit from market downturns and dislocations.

A prime example to exhibit this is 2019 and the first quarter of 2020. These periods will be remembered as two contrary phases in terms of market behaviour. 2019 was a year in which global equity markets returned around +30% by ending the year at all-time-highs with high levels of liquidity, narrow spreads and low volatility in most asset classes and markets.

The first quarter of 2020, in contrast, was a period in which global equity markets exhibited some of the largest losses over the last few decades, liquidity dried up, spreads widened even more than during the GFC, and volatilities reached levels never seen before.

Nevertheless, the Progressive Trading Portfolio succeeded to deliver mid-single-digit returns in each of them by generating +5.7% net to investors in 2019. In the first quarter of 2020 it posted +4.4%, significantly outperforming global equity markets (see chart 2).

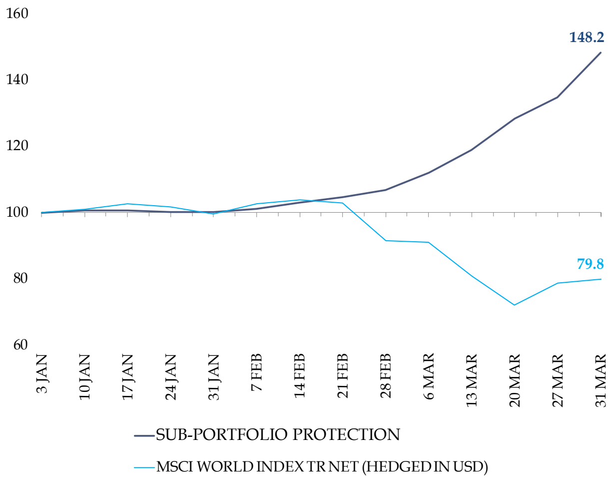
CHART 2: RETURNS OF THE PROGRESSIVE TRADING PORTFOLIO VS. THE MSCI WORLD INDEX[4] DURING Q1 2020



SOURCE: BLOOMBERG, PROGRESSIVE CAPITAL PARTNERS

The allocation to protective strategies (Sub-Portfolio Protection) of the Progressive Trading Portfolio was a key contributor to the overall performance in the first quarter of 2020. As depicted in chart 3, the allocation to the Sub-Portfolio Protection delivered an absolute return of +48.2% during the outbreak of the Covid-19 pandemic (Q1 2020).

CHART 3: RETURNS OF THE SUB-PORTFOLIO PROTECTION VS. THE MSCI WORLD INDEX[4] DURING Q1 2020



SOURCE: BLOOMBERG, PROGRESSIVE CAPITAL PARTNERS

CONCLUSION

This data shows that history is not repeating itself. The remedy of the last financial market drawdown cannot be relied on as a bulletproof protective strategy for the next sell-off. To deliver uncorrelated or even positive performance in a future drawdown period a portfolio with a set of convex strategies is required.

One successful implementation of this concept is the Progressive Trading Portfolio which was launched in 2005. Since inception, the portfolio returned +4.6% (p.a.) with an annualised volatility of 5.3%. 2019 and the first quarter of 2020 turned out to be the proof of concept for the portfolio which delivered positive returns in both environments: +5.7% in 2019 (benign period) and +4.4% in Q1 2020 (Covid-19 crisis).

1 SG Trend Index
2 Eurekahedge Macro Hedge Fund Index
3 Gold Spot USD per Troy Ounce
4 MSCI World Index TR Net (hedged in USD)

THE AUTHORS

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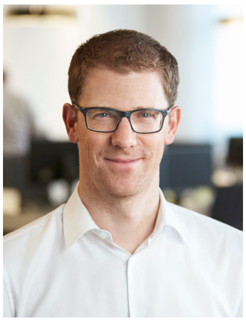

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