Equus Point Capital Market Neutral Strategy

Performance Update 30 June 2020

Net Returns	1m	3m	6m	1yr	Incept pa
Equus Point Capital	1.18%	4.00%	1.15%	-4.06%	0.02%
S&P/ASX 200 Accum	2.61%	16.48%	-10.42%	-7.68%	6.45%
Cash	0.02%	0.06%	0.22%	0.67%	0.96%
Excess v Cash	1.16%	3.94%	0.93%	-4.73%	-0.95%

Risk Characteristics	
Volatility	8.34%
Beta	0.17
Correlation to S&P/ASX 200	0.45
Sharpe Ratio	-0.11

Commentary

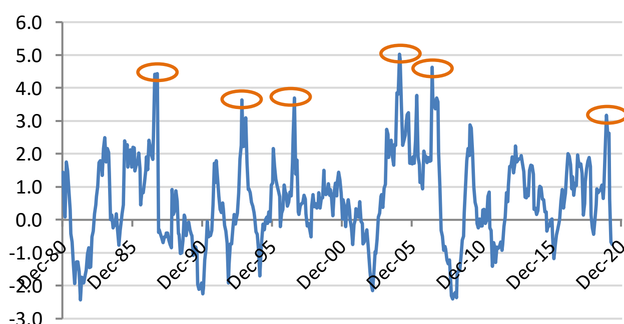
The Strategy returned 1.18% after fees for the month. Please note that with the Fund closed during May, the results for June are simulated returns.

Stock selection generated 0.42% alpha for the month, the result of long exposures with direct shorts having been closed out in favour of futures during March. Our beta positioning contributed 0.86% alpha.

At Equus Point Capital we have always focused on risk adjusted returns. That means we are acutely aware of the amount of return generated for every unit of risk. However, we also understand the fixation on headline returns. Investors are attracted to bull market returns, but also fail to appreciate the inherent risk that accumulates when investors enjoy super-natural short-term returns.

For example, in December we warned of the excessive returns generated by the equites market that did not reflect the potential underlying risks. When risk adjusted returns have been excessive, the market tends to incur an adjustment. Often painfully. We did not foresee the impact of the virus pandemic in December – at that time it had not been fully announced nor appreciated – but it was the prick that punctured the stock markets bubble.

In short, excessive historical returns often reflect a build up of risk that is not fully appreciated by investors.



This begs the question – can investors hedge the inherent market risk?

Diversification: the first potential avenue to reduce risk in a portfolio is through diversification. However, a well diversified equities portfolio will not remove the inherent beta risks. Even a diversified portfolio across different asset classes will not adequately protect a portfolio from downside effects. When markets come under stress the results tend to reflect an increased correlation across asset classes, and the benefits of diversification rarely perform the way modelling would suggest. For example, an exposure to fixed interest securities during the GFC and COVID saw corporate bond spreads blow-out (due to illiquidity and increased risks of default), leading to losses on corporate bonds, despite decreases in sovereign bond yields.

There might also be questions regarding the efficacy of the traditional 60:40 portfolio given bond yields are at historical lows and may not provide the income and return that has traditionally been associated with a fixed interest portfolio. In effect investors are being forced to accept higher risk by placing funds in equities to meet long term investment goals. This deliberate monetary and fiscal stimulus (combined with localized success in controlling infection rates) has created a wave of demand for equities and goes a long way in explaining the recent snap back in the equities market.

In the event inflation at some point in the future increases, rising cash rates and bond yields would result in losses on bond portfolios, and given equities are priced off the risk free rate, there would likely be a similar negative impact on equity prices. However we would suggest that any initial increase in official rates due to inflation concerns might also be viewed in the initial stages as positive for equities given it would imply a 'normalization' of the economy (short of a stagflation outcome).

Cash: the easiest way to avoid a decline on an equity portfolio is to simply move to cash. This at least preserves capital in the event of a decline in the equity market, but does require an element of timing. Getting that timing wrong can lead to opportunity costs. And of course depending on an investor's particular situation there will be potential tax implications in crystalizing any gains on an equities portfolio.

Index Futures: selling index futures is one way an investor could partially or substantially reduce market risk within a portfolio, depending on the extent of the hedge and whether it was dollar hedged to beta hedged. Index futures are a good proxy for the index, and so represent a good way of removing broad market risk in a diversified equities portfolio. Note, however, an investor would be hedging the underlying market risk, but would still be exposed to company specific risk. In addition, removing the beta risk of a portfolio also carries the potential risk of disappointment if the market rallies (opportunity cost). An investor, in employing a short index futures position, needs to understand that while the downside risk may be negated, but there will be an upside opportunity cost in the event the market rallies.

For a traditional long only portfolio that tracks a benchmark, say the S&P/ASX 200, and where the mandate requires maximum limits on cash exposure and on gross exposure, a manager is limited in employing this type of hedge. In addition, it has the potential to cause tracking error between the portfolio and the benchmark, and between the manager and peers.

Index Options: another way to reduce or hedge the risk of losses is to buy put options over the index. A put option gives the owner the right, but not the obligation, to sell upon exercise the value of the underlying index at the stated exercise (strike) price before the option expires. The risk to buying index puts is limited to the premium paid, and the potential profit is capped at the index level, less the premium paid, as the index can never go to zero. By retaining an equities exposure and incurring the cost of index put options an investor limits downside risk while also participating in potential upside from the retained equities exposure.

However buying index puts can be expensive if the option strategy is applied constantly over an equities portfolio. This creates a natural drag on performance when equity markets are positive. This cost could be mitigated through timing the use of index put options, but as we all know, timing is a difficult exercise and prone to error. And insuring the downside on an equity portfolio is generally most expensive when risks are elevated and volatility is high.

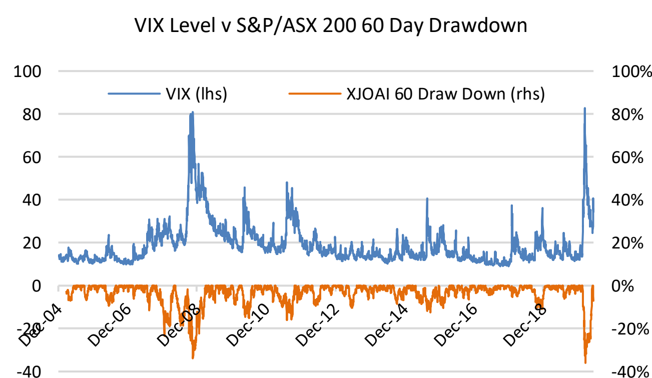
Of course there are a multitude of specific options strategies that could be employed to hedge (or leverage) risks within a broad equities portfolio. These more exotic combinations are numerous and it is not our intention to walk readers through these at times complex strategies. Rather we provide a simple example where hedging ones equities portfolio can be achieved relatively easily.

VIX Futures: the final potential hedge is to buy VIX futures. The VIX is the Chicago Board Options Exchange Market Volatility Index. VIX futures are a futures contract tied to the forward 30-day implied volatility of the S&P500 index in real time. When the equity market declines the implied volatility of S&P500 index options tends to increase, and therefore the VIX level increases. Hence the frequent reference to the VIX as being the 'fear index'.

Now at face value one would propose the VIX is not a logical hedge for an Australian equities portfolio. However the VIX and the S&P/ASX 200 are nicely negatively correlated, with that negative correlation increasing in times of market stress, providing some protection in the event of a market decline.

The difficulty in applying a long VIX strategy is the implied carry cost from maintaining a long exposure VIX. Markets are positive roughly 75% of the time and using a long VIX strategy requires either a rapid change or a sustained increase in volatility to be profitable. In short, including VIX futures in a portfolio as a hedge for an equity exposure requires the payoff from any market decline to be significant enough to offset the ongoing costs of carrying the VIX futures position. This is essentially no different to the cost of insuring a portfolio by buying puts on the index.

VIX Level v S&P/ASX 200 60 Day Drawdown

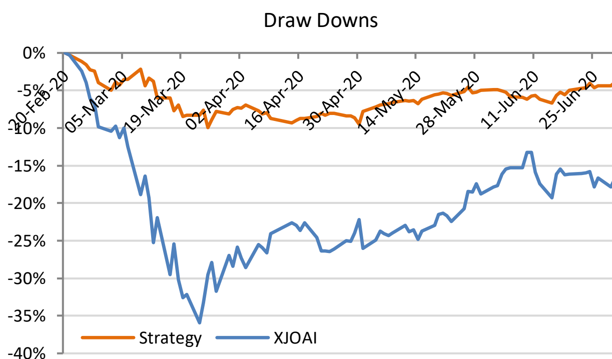


The list of opportunities described above to hedge or reduce underlying market risk within a portfolio is by no means exhaustive. It is merely designed to provide a high level guide to the opportunities, costs and impacts of such strategies in reducing equity losses.

Basically, there is no free lunch. Hedging involves a cost to potential returns and timing risk. Either explicitly, being the cost of any hedging strategy employed, or implicitly, being the opportunity cost of getting the hedge wrong.

The alternative is to diversify your return drivers. Liquid alternatives such as a market neutral strategy can to a large degree remove the impact of the market (beta risk). The benefits of this alternative exposure to standard long only strategies is that by removing the impact of beta from the portfolio one can also reduce the volatility of the return stream and preserve capital when markets are under stress.

Certainly this was apparent in our own recent results. Whilst we have not participated in the snap back in April and May – because we seek to remove the impact of market from returns – we also did not participate in the steep market decline of February and March. From the market peak in late February the strategy's drawdown was less than 10% compared to the index of 36%. And the volatility of our returns has been less than 9% since inception, compared with the volatility of the index which has been almost 24% over the same period.

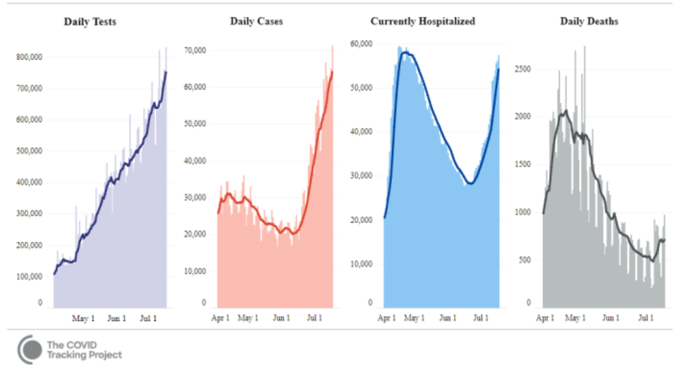


Whilst the partial recovery from the March lows has encouraging, the risks to the market remain.

Infection rates in the United States continue to reach new highs with more than 3 million cases and 140,000 deaths. The US's lack of a coordinated approach to reducing infection rates, poor contact tracing, unilateral decisions by states to reopen economies, individuals disregard to simple hygiene solutions recommended by medical experts and medical facilities approaching capacity increasingly points towards a situation in the US where COVID-19 will not be contained. This will continue to put stress on individuals and businesses.

The local experience has demonstrated the need for vigilance of infection rates are to remain controlled and a reopening of the economy allowed to continue.

The US market recovery has been narrow in focus and driven by a handful of names, and is supported by some $3 trillion US in monetary support from the Federal Reserve.



The likes of Apple, Microsoft, Amazon, Google and Facebook account for almost all of the recent gains on the US market (collectively up an average of 62% from they're March lows). The combined index weight of these giant five has doubled in just over three years, to represent more than 20% of the S&P500.

And with a Biden election win looking more likely at this stage, and potentially the Democrats winning both the House and the Senate, Wall Street will increasingly turn its attention to the implications of that result. Being a roll back of tax cuts and increased regulation. Although one might also suggest that a Biden presidency could also be a source of stability, given the on-again, off-again trade, tariff and technology war with China feeding into market volatility.

The much vaunted V-shaped recovery is highly unlikely. Similarly a depression is also unlikely given the wave of monetary and fiscal support. We are more likely to incur a U-shaped recovery, where the reopening of the economy is drawn out and punctuated by localized spikes in infections. Market volatility will remain elevated and investors should be prepared for bouts of fear and greed. The development, manufacture and distribution of a vaccine may well be the final solution to economic and market stability, but the scarring left on business and individuals may take years to fully recover.

Accordingly, we remain cautious in the current environment with portfolio positioning reflecting that conviction.

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Net Monthly Performance

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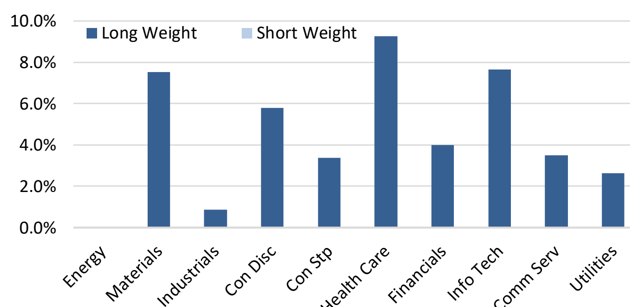
Gross Monthly Performance

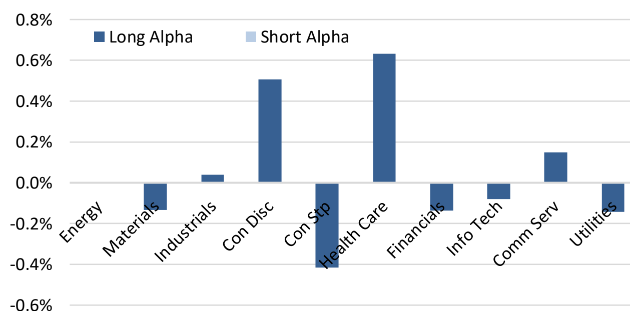
Asset	Positions	Weight	Contrib	Alpha
Long	52	44.6%	1.53%	0.42%
Short	0	0.0%	0.00%	0.00%
Futures		-11.8%	-0.25%	0.86%
Cash		55.4%	0.01%	0.01%
	52	100.0%	1.29%	1.29%
Cash				0.02%
Excess				1.27%

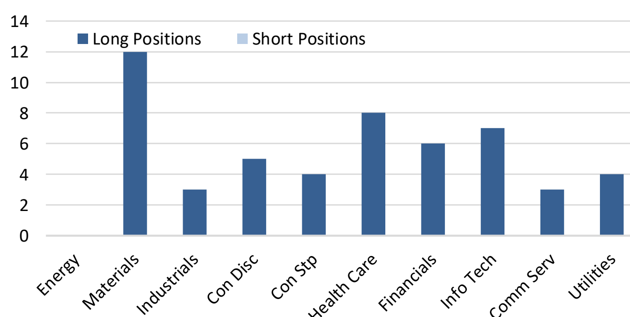


Exposure and Gross Monthly Alpha

Sector Name	Long Weight	Short Weight	Active Weight	Alpha Contrib
Energy	0.0%	0.0%	0.0%	0.00%
Materials	7.5%	0.0%	7.5%	-0.13%
Industrials	0.9%	0.0%	0.9%	0.04%
Cons Disc	5.8%	0.0%	5.8%	0.51%
Cons Staples	3.4%	0.0%	3.4%	-0.41%
Health Care	9.3%	0.0%	9.3%	0.63%
Financials	4.0%	0.0%	4.0%	-0.14%
Info Tech	7.6%	0.0%	7.6%	-0.08%
Comm Serv	3.5%	0.0%	3.5%	0.15%
Utilities	2.6%	0.0%	2.6%	-0.14%
Stock Total	44.6%	0.0%	44.6%	0.42%
Futures			-11.8%	0.86%
Cash			55.4%	0.01%
Total			100.0%	1.29%

Net Exposure	32.8%
Gross Exposure excluding Futures	44.6%
Gross Exposure including Futures	56.4%





Major Alpha Contributors

Name	Weight	Contrib	Alpha
Top Five Contributors			
Fisher & Paykel	1.93%	0.33%	0.29%
Resmed Inc	2.02%	0.29%	0.26%
Domino's Pizza	1.90%	0.19%	0.15%
JB Hi-Fi Limited	1.54%	0.18%	0.14%
Mineral Resources	1.64%	0.19%	0.13%
Bottom Five Contributors			
Gold Road Resources	0.60%	-0.12%	-0.17%
Elders Ltd	2.00%	-0.10%	-0.15%
Altium Limited	0.47%	-0.10%	-0.14%
Nanosonics	1.44%	-0.04%	-0.12%
Silver Lake	1.33%	-0.01%	-0.09%

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Investment Manager

Equus Point Capital is a boutique fund manager focused on producing meaningful risk adjusted returns from the Australian equities market. Equus Point was founded in 2017.

Equus Point's investment process is systematic, designed to produce a return stream irrespective of market direction over the long term, with low volatility and uncorrelated to traditional asset classes.

Strategy Objective

To deliver absolute returns above the RBA Official Cash Rate over a rolling five-year period, with low volatility and a low correlation to traditional asset classes.

Investment Philosophy

Equus Point uses a systematic approach to investing, seeking to harvest meaningful risk adjusted returns from behavioural biases in the Australian equities market. The strategy uses both long and short positions coupled with index futures to achieve a market neutral portfolio that seeks to produce positive returns irrespective of equity market direction and uncorrelated to traditional assets. Equus Point's robust risk management approach limits to portfolio's beta positioning, portfolio volatility, individual stock positioning, and long and short portfolio positioning.

The Strategy employs a proprietary systematic investment process. The Fund invest exclusively in Australian equities and equity derivatives.

We believe in the following:

- In the short to medium term behavioural biases of investors can influence stock prices leading to both momentum and reversion effects. Momentum is where stocks with positive historical returns tend to be rewarded with a continuation of positive returns, and stocks with negative historical returns tend to underperform with a continuation of negative returns. Reversion is where stock prices initially overshoot before returning to a perceived fair value.
- Meaningful risk adjusted returns can be achieved through a portfolio of both long and short positions seeking to harvest positive and negative momentum.
- Managing the risks of the potential for stock price reversion, stock volatility, portfolio volatility and beta exposure are a core part of the investment process.
- Market neutral positioning between long and short portfolios is ensured through the use of index futures to offset residual beta risks.
- Combining the above dynamics with acceptable leverage delivers a portfolio that is designed to provide superior risk adjusted returns through market cycles.

Benefits of the Strategy

1. A systematic strategy with a disciplined focus on risk management.
2. Attractive risk adjusted returns over the long term.
3. Low volatility return stream uncorrelated to traditional asset classes over a rolling five year time frame.
4. Expected to preserve capital in volatile and negative equity markets.

Further information: www.equuspointcapital.com
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