Equus Point Capital Market Neutral Strategy

Performance Update 31 August 2020

Net Returns	1m	3m	6m	1yr	Incept pa
Equus Point Capital	1.32%	5.44%	4.63%	-2.96%	2.54%
S&P/ASX 200 Accum	2.83%	6.04%	-4.48%	-5.08%	7.81%
Cash	0.02%	0.06%	0.14%	0.54%	0.89%
Excess v Cash	1.30%	5.38%	4.48%	-3.50%	1.65%

Risk Characteristics	
Volatility	8.9%
Beta	-0.03
Correlation to S&P/ASX 200	-0.07
Sharpe Ratio	0.2

Commentary

The Strategy returned 1.32% after fees for the month. Please note that with the Fund closed during May, the results for August are simulated returns.

On a gross basis stock selection generated 1.30% 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 0.12% alpha.

This month we thought we would briefly discuss a few of the core themes in the market. Namely:

- The concentration of returns in the US, or perhaps better referred to as the lack of breadth in US market performance;
- Valuations and the appropriate market multiple;
- Tendency for oversold stocks to rebound violently when the market snaps back.

US Market Breadth

Much has been discussed regarding the likes of high flying names in the US. The S&P500's FAANG stocks (Facebook, Alphabet, Amazon, Google and Netflix – one might also include Microsoft) collectively now represent more than 25.1% of the index by market capitalization (up from 8.9% in 2015). On average they have increased in value by almost 300% over the last five years, while the index as a whole is up a mere 77%. And on a year-to-date basis these stocks are up 60% versus the S&P500 up 8%. Ex the FAANGS (+M), the S&P500 would be down for the year, highlighting the concentrated nature of returns that has created concerns regarding the lack of breadth in index performance.

Put simply, the lack of breadth from the US market is cause for concern. If the index can be pushed higher on the back of a handful of technology stocks, it can also be pulled lower on any reversal of this focused trend.

	Weight	PER	5 Yr Return	YTD Return	Return since Mar
Amazon	5.0%	133.3	572.8%	86.8%	77.0%
Apple	7.5%	39.6	357.8%	75.8%	103.0%
Facebook	2.4%	36.7	227.9%	42.9%	75.8%
Google	3.4%	37.7	164.3%	22.2%	40.5%
Microsoft	5.9%	39.8	418.2%	43.0%	43.0%
Netflix	0.8%	90.5	360.4%	63.7%	41.0%
S&P ex FAANG's +M	74.9%	20.1			
S&P 500	100.0%	30.0	77.5%	8.3%	35.4%

Clearly the Coronavirus has accelerated already existing trends, being the adoption of new technology and services.

To a degree we have also had our share of stratospheric names in the local market benefit from this acceptance of change, with the likes of buy-now-pay-later players Afterpay perhaps the prime example. But Afterpay is just one name in a burgeoning information technology sector.

Now our information technology sector is a fraction of the size of the US where technology represents 27% of the S&P 500 and more than 49% of the NASDAQ, but the local technology sector is growing, with 13 constituents today, with a combined market weight of just over 4%. Ten years ago the sector had just 3 constituents and represented just 0.5% of the S&P/ASX 200.

Companies that have information technology at the core of their business can grow much faster than more traditional business, given they tend to be capital light in nature, have a potentially accelerated growth profile, and a non-cyclical revenue stream. Add to this the pull-forward of technology acceptance as a result of a virus induced lockdown and ultra-low interest rates, there is perhaps an argument that technology stocks have a tailwind to support earnings and price momentum.

Valuation Multiples

Howard Marks, the CEO of Oaktree Capital, in his recent 'Insights' blog noted the high valuation multiples being applied to the US market. Now, there are clear differences in makeup and performance between the US and Australian markets, but they remain highly correlated, so bear with us.

Marks proposed that the current valuations in the US market may well be justified given the extraordinary low rates used as the basis for comparing bonds and equities.

Investors often focus on the dividend yield as a measure of 'value', but the more important measure is the earnings yield (the inverse of the price to earnings ratio). If risk free rates are less than 1% and the traditional equity premium is applied, then Marks suggest this

might be quite reasonable to have market multiples of 25x.

In fact, if one were to strip out the valuation multiples of the FAANGS (+M) from the S&P500's 30x PE ratio, the remaining constituents have an average historical PE of just over 20. On this basis, the US market is not overly expensive, notwithstanding the skew of the large technology stocks, the ongoing risks to earnings during a recession and the weight of money from fiscal and monetary support for the economy and markets.

This is not to discount the risks that remain in the market, which we have listed in earlier reports, but just to highlight that there are arguments that rationalize the multiples being applied to equity markets.

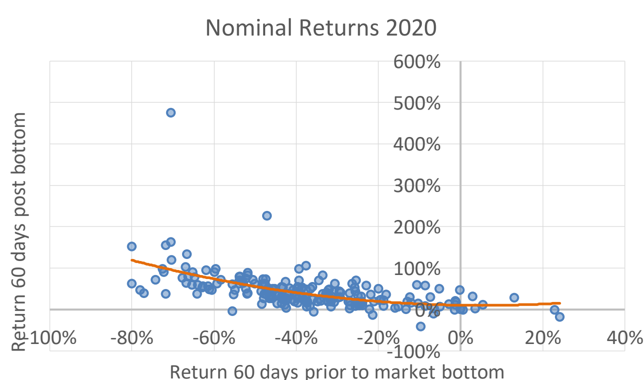
On balance, valuation multiples for technology stocks (FAANG's +M) may be warranted. Certainly the market to date would support that idea. Or to quote Howard Marks, "to be bearish one has to have a thesis on why they should fall".

Granted one can rationalize technology stock valuations, but we remain more cautious given the focus on a limited number of larger US technology names driving the US market higher and the need for a more broad based market recovery to warrant conviction in the direction of the equity market.

Snapback Events

We have witnessed some spectacular gains from a number of stocks post the March bottoming of the market.

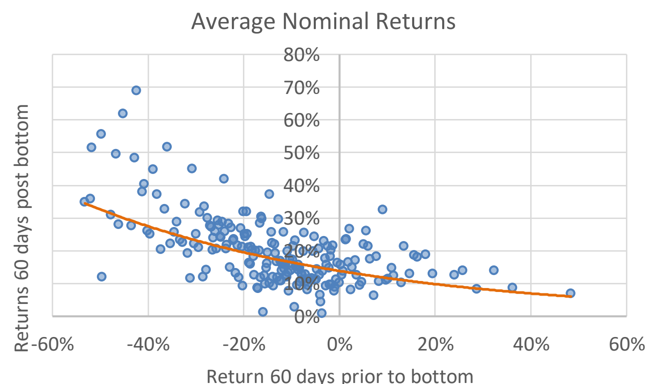
The following chart maps the 60-day returns leading up to and post the market bottom on 23 March. What it demonstrates is the tendency for the worst performing stocks leading up to the market bottom to snap back the hardest.



Part of the decline can be related to the underlying stock's beta. Put simply, high beta names are by definition, more sensitive to movements in the market, and as such any negative move by the market will tend to have an amplified impact on those high beta names.

The other interesting point is that the beaten down names tend to also witness a beta expansion on snap back. Essentially stocks with the worst historical returns tend to experience an increase in beta (i.e. sensitivity to general market movements) on any market recovery, thereby creating an additional tailwind.

This tendency for beaten down stocks to rebound strongly is not unique to the recent example in March. In fact, it is repeated through the more significant drawdown events over the last twenty years. The following chart is the average of the nine events since 2000 where the market has declined at least 10%.



Of course, being able to pick the bottom of any market and capturing that short to medium term reversal is difficult. Hindsight is wonderful, but it does not play a part in day-to-day investment decision making. One can only work on the balance of probabilities and understand that timing market turning points whilst in amongst the turmoil is extremely difficult.

For example, in our December report we highlighted our concerns around the complacency in the market. The Sharpe Ratio was highly elevated and this historical was cause for concern around the ongoing strength of the market.

The Sharpe Ratio is a measure of return per unit of risk, calculated as the excess return over the risk-free rate, divided by market volatility. For the S&P/ASX 200 Accumulation Index the Sharpe Ratio for the end Dec 2019 for the last twelve months was 2.6 versus its forty year average of 0.25[1]. The one year risk adjusted return

[1] ASX All Ordinaries Accumulation Index for period from Dec 1980 to Apr 2000 and S&P/ASX 200 Accumulation Index from Apr 2000 to Aug 2020.

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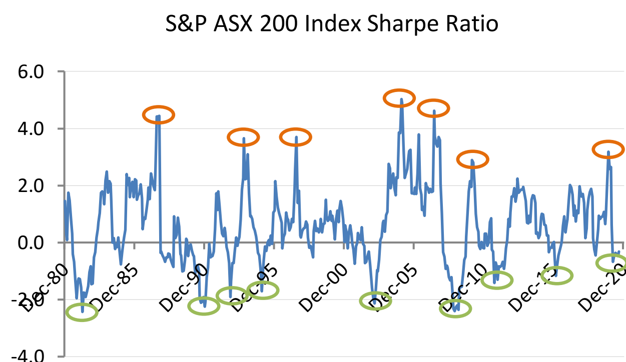
for the Index had only been higher on five occasions over the prior forty years. Those five occasions were:

- Sept 1987 – prior to the '87 Crash
- Oct 1993 – prior to the US Fed interest rate increases of early 1994
- July 1997 – prior to the Asian Crisis
- Jan 2005 – recovery after the tech crash and the beginning of the resources boom
- Oct 2007 – prior to the GFC



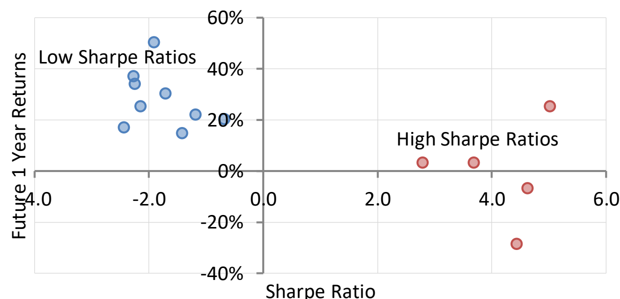
In a similar vein we can use the Sharpe Ratio to identify periods of excessively poor risk adjusted returns. That is when risk adjusted returns have been decidedly negative, which have tended to be solid indicators of above average future returns:

- Mar 1982 – the depths of recession and the start of the 1980's boom market
- Dec 1990 – the start of recession
- Oct 1992 – the extension of recession plus the invasion of Kuwait
- Jan 1995 – the full effects of the Fed's surprise rate increases from a year earlier
- Feb 2003 – post the tech crash and the start of the noughties resources led market ascent
- Dec 2008 – prior to the bottom of the market during the GFC
- Sep 2011 – post the European debt crisis and Japanese earthquake
- Feb 2016 – the volatility spike early in the year brought on by falling oil prices, concerns of the slowdown in Chinese growth and the flagged end of US Federal Reserve near-zero interest rate policy

We can now add March 2020 to that list.

However, even though we have had the sharpest fall in history, we have not reached the extremes of prior negative Sharpe Ratio's due to the extreme volatility we have witnessed. The rally from March has occurred while volatility has remained high and as such one has to question the strength of the market given the unique volatility environment.

On each prior occasion when the Sharpe Ratio's have been at extreme negative levels we have witnessed future returns significantly higher than long term average. The point being that times of market turmoil often present the best opportunities for out-sized, above average returns.



In summary, there may well be a case for technology stocks to trade at a premium given tailwinds (low interest rates, pulled forward acceptance of the benefits of technology for the home and business, higher growth rates than alternative, more traditional businesses), but we are concerned about the narrow focus of US returns. And by inference the implications for the local market given the high degree of correlation between the US market direction and the local market. We would also note the VIX (the volatility index used as a measure of fear and greed) remains elevated suggesting potential concerns for downside risks.

Having an exposure to liquid alternatives such as a market neutral strategy can mitigate the impact of severe volatility episodes. 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.

While we have gradually increased exposure to the long equities portfolio we remain cautious in the current environment.

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EQUUS POINT CAPITAL

Net Monthly Performance

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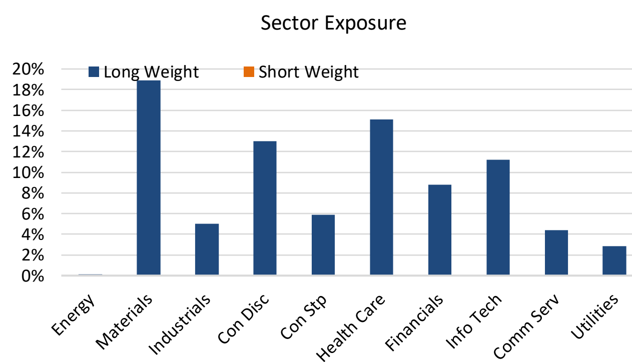
Risk Characteristics	
Volatility	8.9%
Beta	-0.03
Correlation to S&P/ASX 200	-0.07
Sharpe Ratio	0.2

Gross Monthly Performance

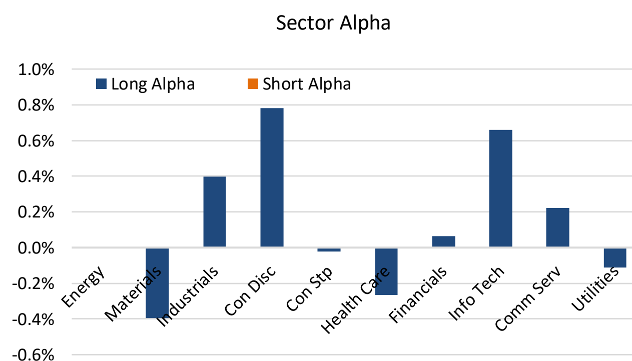
Asset	Positions	Weight	Contrib	Alpha
Long	55	85.4%	3.04%	1.30%
Short	0	0.0%	0.00%	0.00%
Futures		-73.4%	-1.60%	0.12%
Cash		14.6%	0.00%	0.00%
	55	100.00%	1.42%	1.42%
Cash				0.02%
Excess				1.40%

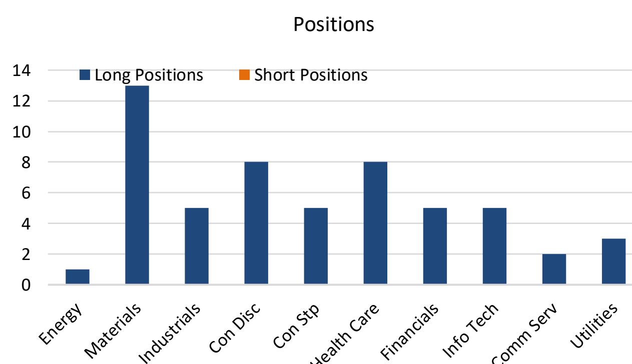


Exposure and Gross Monthly Alpha

Sector Name	Long Weight	Short Weight	Active Weight	Alpha Contrib
Energy	0.1%	0.0%	0.1%	0.00%
Materials	18.9%	0.0%	18.9%	-0.40%
Industrials	5.0%	0.0%	5.0%	0.40%
Cons Disc	13.0%	0.0%	13.0%	0.77%
Cons Staples	5.9%	0.0%	5.9%	-0.02%
Health Care	15.1%	0.0%	15.1%	-0.27%
Financials	8.8%	0.0%	8.8%	0.06%
Info Tech	11.2%	0.0%	11.2%	0.65%
Comm Serv	4.4%	0.0%	4.4%	0.22%
Utilities	2.8%	0.0%	2.8%	-0.11%
Stock Total	85.4%	0.0%	85.4%	1.30%
Futures			-73.4%	0.12%
Cash			14.6%	0.00%
Total			100.0%	1.42%

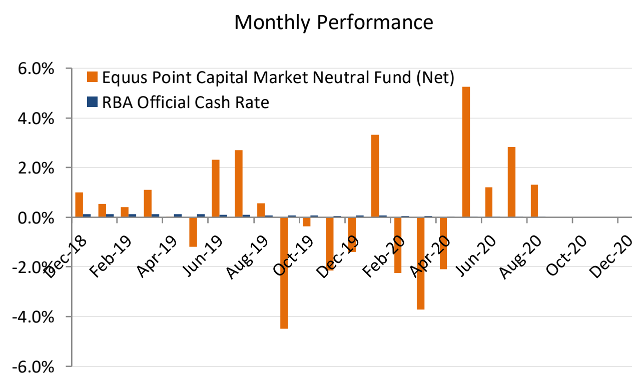
Net Exposure	12.0%
Gross Exposure excluding Futures	85.4%
Gross Exposure including Futures	158.8%





Major Alpha Contributors

Name	Weight	Contrib	Alpha
Top Five Contributors			
Megaport Limited	2.57%	0.59%	0.53%
Mineral Resources	3.22%	0.48%	0.40%
Cleanway	2.32%	0.44%	0.40%
Domino's Pizza	3.83%	0.33%	0.30%
Mesoblast Limited	1.58%	0.30%	0.27%
Bottom Five Contributors			
Resmed Inc	2.70%	-0.42%	-0.46%
Gold Road Resources	1.34%	-0.24%	-0.27%
Silver Lake Resources	1.53%	-0.20%	-0.25%
Saracen Minerals	1.41%	-0.21%	-0.24%
Regis Resources Ltd	1.57%	-0.12%	-0.15%



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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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