Equus Point Capital Market Neutral Strategy

Performance Update 30 November 2021

Net Returns	1m	3m	6m	1Yr	2yr pa	Incept pa
Equus Point Capital	1.02%	-4.86%	3.53%	14.32%	7.41%	4.97%
Cash	0.01%	0.02%	0.05%	0.10%	0.24%	0.57%
Excess v Cash	1.01%	-4.89%	3.48%	14.22%	7.17%	4.40%

Risk Characteristics	
Volatility	8.3%
Beta	0.13
Correlation to S&P/ASX 200	0.27
Sharpe Ratio	0.53

Commentary

The Strategy returned 1.02% after fees for the month. Please note that with the Fund closed during May 2020, the results for the month are simulated returns.

On a gross basis stock selection generated 0.98% alpha for the month, with long exposures contributing 1.34% alpha and a modest short exposure contributing -0.24% alpha. Our beta positioning contributed -0.12% alpha.

The volatility of returns since inception is 8.3% annualized versus 18.3% for the S&P/ASX 200 Accumulation Index.

Positive alpha contributions from stock positions included:

- Materials (+0.79%)
  - James Hardie +0.33%
  - Lynas +0.29%
  - Pilbara Minerals +0.27%
  - Orecobre +0.25%
  - Independence Group +0.24%
  - Regis Resources +0.26% (short position)
  - Nickel Mines -0.24% (short position)
- Communication Services (+0.30%)
  - Uniti Group +0.22%
- Utilities (+0.29%)
  - Spark Infrastructure +0.27%
- Consumer Discretionary (+0.19%)
  - ARB Corp +0.33%
  - Dominos -0.18%
  - IDP Education -0.15%
  - Kogan +0.22% (short position)
  - Pointsbet +0.17% (short position)

Negative alpha contributions included:

- Financials (-0.38%)
  - Virgin Money UK -0.33%
  - Bank of Queensland -0.18%
  - Suncorp -0.16%
- Information & Technology (-0.72%)
  - EML -0.29%
  - Tyro Payments -0.13%

Recently we were approached about how our investment process and stock selection could be applied to achieve a portfolio with bond like volatility, but with equity like returns. The strategy would need to remain beta neutral and uncorrelated with broader asset classes.

The conversation arose from discussing some of the major risks in allocating to particular assets in the current investment climate.

With the recent increase in inflation, investors are fretting about rising bond yields (and therefore lower bond prices) and the impact on equity valuations given higher bond yields imply higher risk-free rates.

There are some suggestions that inflation is only transitory and a function of short-term supply issues brought about by Covid, and that these issues will be resolved as economies and trade improves. Certainly the Fed has a view that inflation is a temporary spike that will moderate into 2022. Markets are not so sure, with US 10-year bonds spiking to 1.70%, up from 0.40% in March 2020 (although they have since moderated with emergence of the Omicron variant to 1.45%). Local Australian 10-year bond yields spiked to a three year high of 2.10%, before moderating to 1.70%.

What has changed is a subtle difference in the Fed's recent rhetoric, shifting from an employment focus to an inflation focus. With inflation for November at 6.8% and the highest level since the 1980's and employment at 4.2%, clearly the sands are shifting and the risks to inflation are on the upside. Granted there are definite short term supply issues contributing to the current spike, but there is an increasing expectation that we are entering a higher inflationary environment.

As an aside, the massive fiscal stimulus we have witnessed post GFC and through Covid raises questions on how this massive debt pile might be repaid.

The first way is through higher taxes, which is a vote killer if aimed at the personal income tax payers and difficult if aimed at the corporate tax payer given globally we have seen a race to the bottom in corporate tax rates in an effort to attract businesses to various jurisdictions (notwithstanding the recent efforts to create a minimal global rate of 15%).

The second approach is for governments to reign in spending programs in an effort to balance budgets. But communities are unforgiving when the government services are scaled back.

The third and final approach is to reinflate the economy, given debt repayments are in nominal terms and inflation makes future repayments cheaper. So there may well be some method to the madness in having inflation running higher than what we have become accustomed to in an effort to get debt balances to more manageable levels.

Add to the equation equity markets at or near all-time highs, on valuation levels akin to the tech boom at the turn of the century, and there are clear risks for investors.

This raises the question: if cash and bond markets offer negative real returns in the medium term and equity markets are vulnerable to higher risk-free rates, where can investors turn to find a return stream that offers positive real returns without equity market risk?

One of the beauties of our strategy is the ability to scale portfolio diversification whilst remaining market neutral. Increasing portfolio diversification reduces the potential return, but also reduces the inherent volatility of that return stream.

The following analysis applies the same stock selection process and risk management process as our standard approach, however we have increased the number of holdings (and therefore reduced the maximum size of any single position) to achieve a return stream that has bond like volatility but with equity like returns.

The key items to note of the results are as follows:

- Headline returns are 3% pa above the S&P/ASX 200 Accumulation Index and almost 6% pa above the Bloomberg All Composite Bond Index
- Volatility of 5% pa is a small premium to that of the Bloomberg All Compositive Index of 3% pa (note current bond index volatility is 6% given recent yield movements) and substantially lower than equity market volatility of 13% pa
- Drawdowns nicely constrained at less than 10% (note the maximum drawdown for the bond index of -5.3% was achieved in November given increases in bond yields and inflationary concerns)
- Superior risk adjusted return outcomes (Reward to Risk, Sharpe Ratio, Sortino Ratio and Information Ratio) largely in response to the lower volatility outcome
- Beta zero and uncorrelated to the equities market

At face value such a strategy would have real appeal to investors seeking a higher return than bonds but without equity market volatility. Or flip it around, equity like returns with bond market volatility.

	Strategy*	Equities*	Bonds*
Return	866.91%	436.32%	212.19%
Return pa pre fees	11.2%	8.2%	5.5%
Excess over Cash	7.5%	4.5%	1.8%
Volatility	5.1%	13.2%	3.1%
Downside Volatility	2.8%	10.8%	2.2%
Reward / Risk	2.2	0.6	1.8
Sharpe	1.5	0.3	0.6
Sortino	2.7	0.4	0.8
Tracking Error v Cash	5.0%	13.2%	3.0%
Information Ratio	1.5	0.3	0.6
Drawdown	-7.9%	-47.2%	-5.3%
Drawdown Length	18	70	13
Drawdown Length Average	4	17	4
Beta	0.02	1.00	-0.04
Correlation	0.05	1.00	-0.18
Hit Rate	73.2%	63.4%	72.4%
Average Return	0.9%	0.7%	0.4%
Av Positive	1.6%	3.0%	0.8%
Av Negative	-0.9%	-3.2%	-0.6%
Av Up Markets	1.1%	3.0%	0.8%
Av Down Markets	0.6%	-3.2%	-0.6%
Monthly Max	5.8%	10.2%	3.1%
Monthly Min	-3.7%	-20.7%	-3.6%
VaR Monthly @ 95% CI	-1.5%	-5.5%	-1.0%
VaR Annual @ 95% CI	2.8%	-13.5%	0.4%
12m Maximum	29.1%	44.7%	15.2%
12m Minimum	-7.8%	-40.0%	-5.3%
Cash Return pa	3.6%		

* Strategy results stated after costs (commission, funding and borrow costs) and before fees. Results for the period from Jun 2000 to Nov 2021. Equities refers to the S&P/ASX 200 Accumulation Index. Bonds refers to the Bloomberg All Composite Bond Index.

Regular readers would know we are proponents of using charts to demonstrate the nature of concepts and how a portfolio behaves. To that end the following charts break down the results of this low volatility model.

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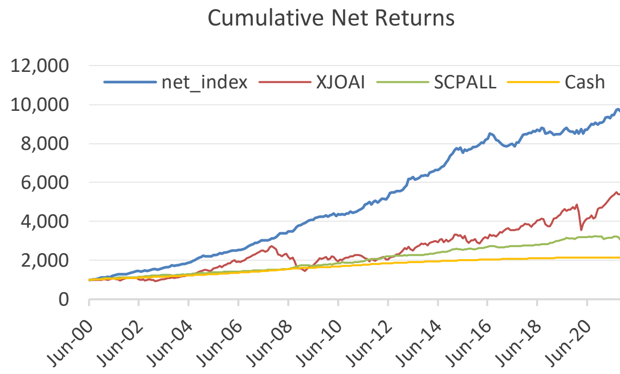
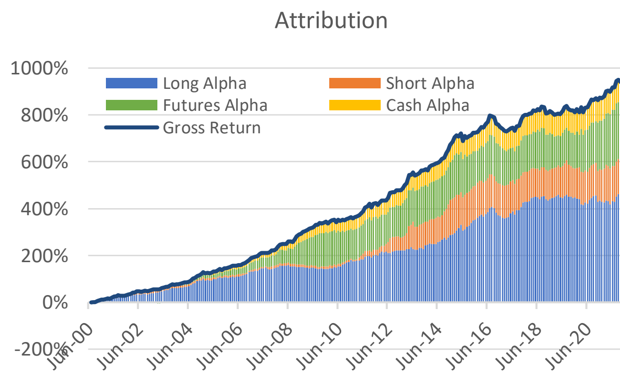
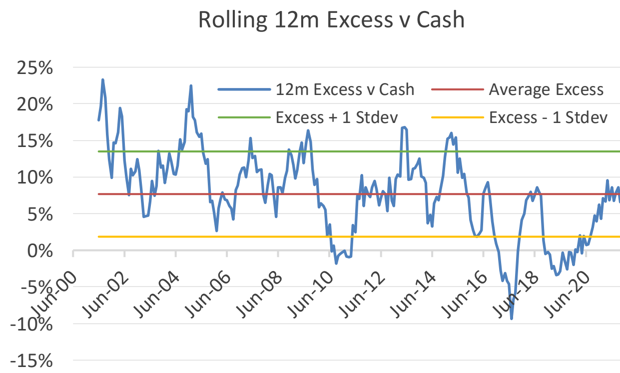
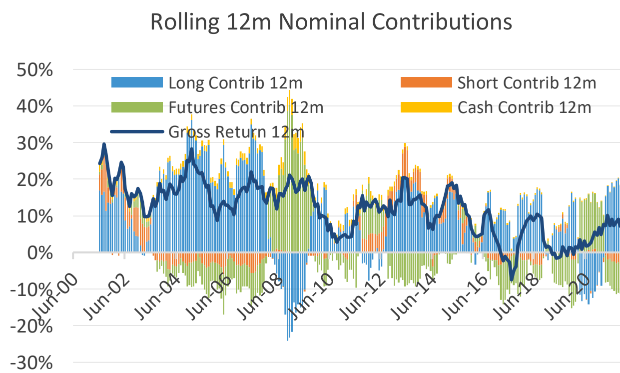
EQUUS
POINT CAPITAL

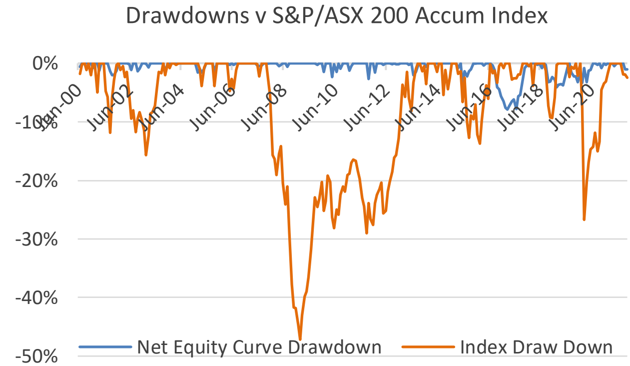




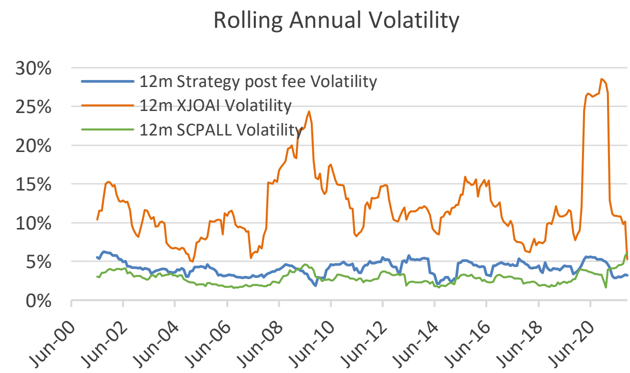


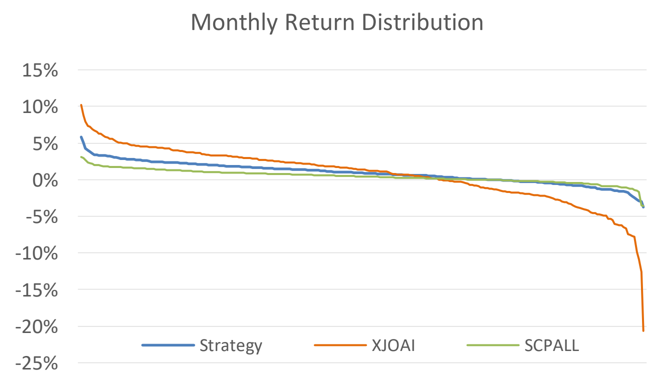


Drawdowns are nicely restricted to less than 10% and are indeed more akin to the drawdowns expected from a broad based composite bond index. Whilst the drawdown from the S&P/ASX 200 Accumulation Index extended to -47% during the GFC and a rapid -36% during Covid. In contrast the strategy maximum drawdown was just under -8%.



If we were to highlight one chart that demonstrates the attractiveness of this return stream it would be the following. The volatility outcome is more like that of the bond index, albeit with a small premium, but constrained at an average of 5% pa.





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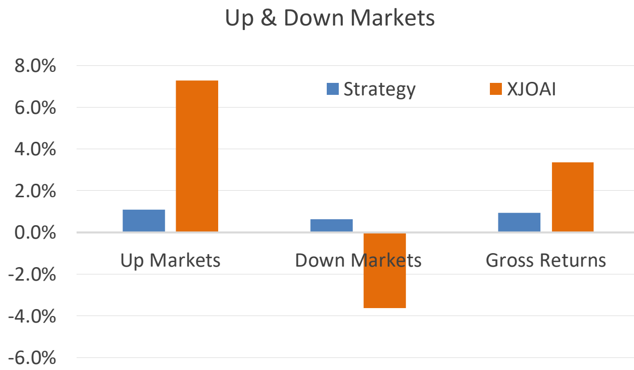
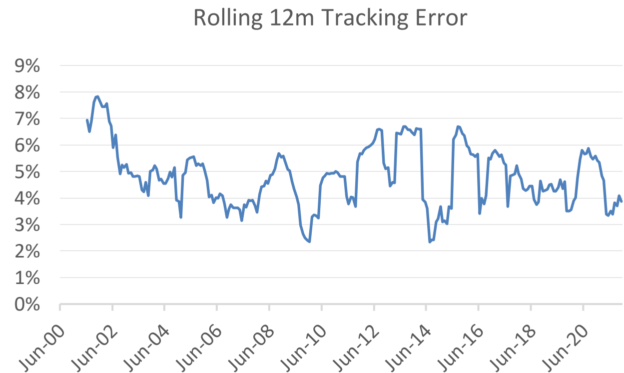
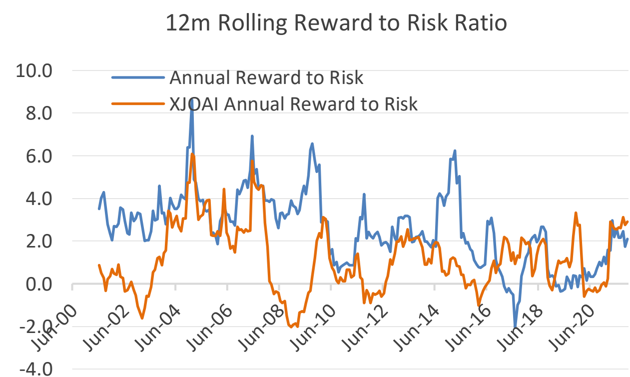
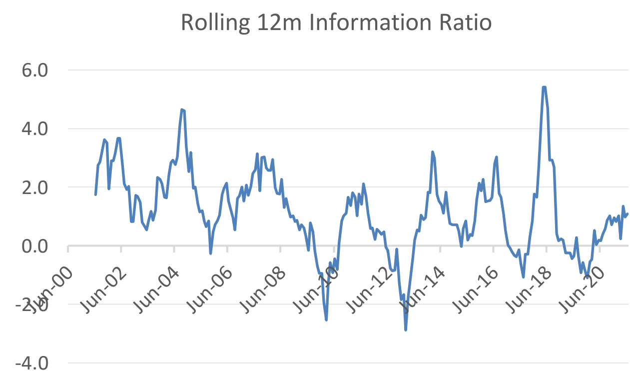




Finally, the strategy is uncorrelated to the equities market – consistent with a market neutral objective – and other asset classes. As a result such a strategy would provide real diversification benefits within a broader portfolio. This could prove vital in an environment where the correlation between bonds and equities has been rising and the historical correlation relationships may not be achieved in the medium term.



	Strategy	ASX200	REIT's	Int'l Eq	Bond	Cash
Strategy	1.00					
ASX 200	0.05	1.00				
REIT's	0.07	0.70	1.00			
Int'l Eq	-0.11	0.57	0.35	1.00		
Bond	0.21	-0.19	0.13	-0.23	1.00	
Cash	0.24	-0.08	-0.09	-0.14	0.18	1.00



There are four issues with such a strategy that perhaps require further consideration:

- Tracking error
- Active share
- Portfolio turnover and tax considerations
- Capacity

Firstly, the tracking error (defined as the volatility of excess returns) for such a portfolio is about 5% against its cash benchmark (remember the strategy is market neutral, with equity market movements effectively removed from the return stream). To put this into perspective the tracking error for a typical equity index fund would be less then 0.5% and an actively managed equity fund would have a tracking error of anything from 4% for a broad-based fund to 8% for a concentrated fund, against an equities benchmark. So on balance, a tracking error of 5% is consistent with a standard long only actively managed portfolio.

Secondly, the model is a well diversified actively managed portfolio with an active share greater than 100%. Active share is defined as the sum of the absolute difference between a portfolio's stock weights and index weights. Typically, an index fund might have an active share of less than 5% and standard active funds might have an active share of 60% to 120%. On this basis the strategy has an exposure to a equities portfolio that deviates significantly from that of the index.

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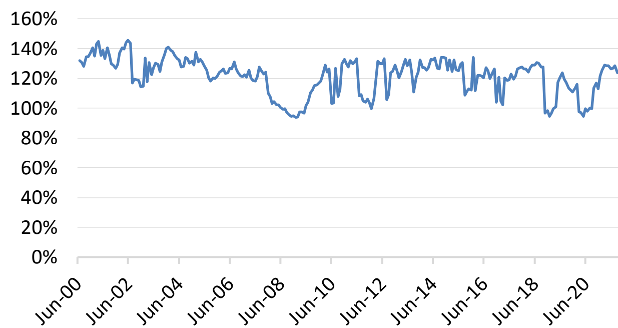
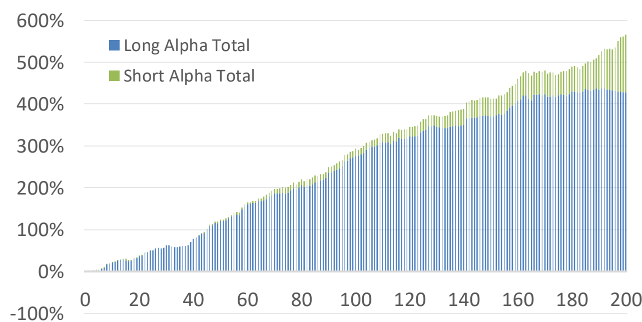


Attributing returns across the index it is apparent that the strategy derives its returns evenly across market cap, a product of taking positions that vary substantially from the index – and hence the high active share component. Put simply, the model does not hug an index like the majority of actively managed long only funds.



With annual turnover approaching 100% one would need to would consider the tax implications of a strategy that yields a large degree of its return stream from realized capital gains. Such a strategy as part of a broader exposure to equities (say an index fund where a buy and hold approach yields low turnover) or within the right tax environment (such as a super fund or pension fund) would help to offset these tax issues.

Finally, one would need to address the issue of capacity. A strategy that requires a higher degree of turnover needs to find a balance between portfolio size and being able to achieve excess returns. The larger a portfolio becomes, employing a higher turnover strategy that derives a large part of its returns from mid and small market cap stocks will incur costs associated with market impact. One needs to balance those market impact costs and available liquidity with fund size.

If a manager decides to focus on growing the fund, then returns must naturally suffer or the manager is forced to invest in more liquid stocks (i.e. become more of an index hugging portfolio). This might be good for the manager given they derive fees from funds under management. Alternatively, if the manager was focused on maximizing the potential for out-sized returns and limiting fund size, then that is clearly to the benefit of investors.

In summary, one needs to balance the pros of the model (headline returns, risk adjusted returns and shallower drawdowns) with the cons (tracking error, higher turnover and tax implications).

That said, as a part of a broader exposure to Australian equities and a capacity constrained focus, such a strategy would prove valuable for the investor seeking a product that is materially different to standard equity products.

More importantly, in an environment where defensive assets (cash and bonds) are likely to struggle to provide positive real returns in a higher inflationary environment and where growth assets (i.e. equities) look expensive on valuation grounds (and where valuations are likely to be tested where risk free rates are higher) investors are forced to make tough asset allocation decisions.

Defensive assets are unlikely to provide returns that meet longer term needs, and the diversification benefits are less apparent when correlation between bond returns and equity returns is increasing. In recent years investors have been forced to accept higher risk assets as there has been no alternative. Now, however, investors are being forced to seek higher returns in an environment where valuations are stretched and equities look increasingly vulnerable. The easy money has been made in recent years. The future looks very different.

Accordingly, a strategy that is uncorrelated to equity markets, provides equity like returns with bond like volatility would be a highly valued addition to a portfolio.

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EQUUS POINT CAPITAL

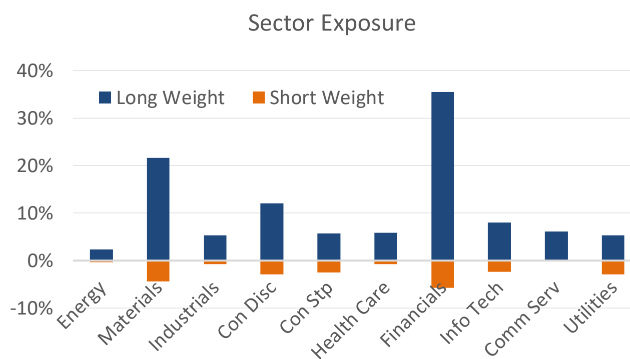
Net Monthly Performance

Net Returns	1m	3m	6m	1Yr	2Yr pa	Incept pa
Equus Point Capital	1.02%	-4.86%	3.53%	14.32%	7.41%	4.97%
Cash	0.01%	0.02%	0.05%	0.10%	0.24%	0.57%
Excess v Cash	1.01%	-4.89%	3.48%	14.22%	7.17%	4.40%

Risk Characteristics	
Volatility	8.3%
Beta	0.13
Correlation to S&P/ASX 200	0.27
Sharpe Ratio	0.53

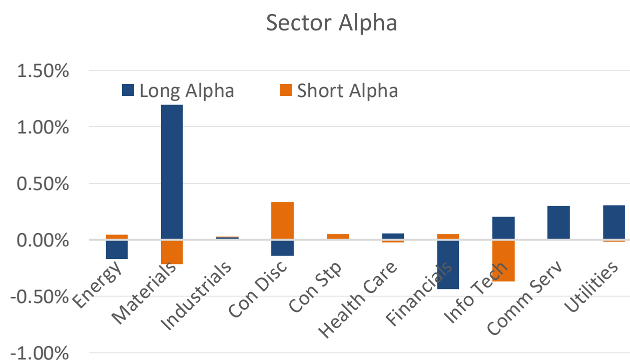
Gross Monthly Performance

Asset	Positions	Weight	Contrib	Alpha
Long	96	107.8%	0.84%	1.34%
Short	29	-25.2%	0.02%	-0.24%
Futures		-42.5%	0.12%	-0.12%
Cash		17.4%	0.00%	0.00%
		100.0%	0.98%	0.98%
Cash				0.01%
Excess				0.97%

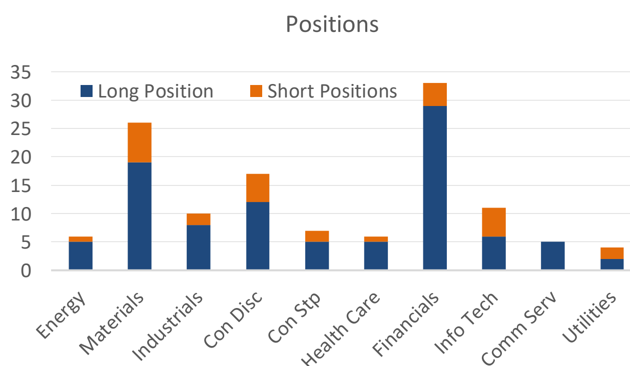


Exposure and Gross Monthly Alpha

Sector Name	Long Weight	Short Weight	Active Weight	Alpha Contrib
Energy	2.34%	-0.36%	1.99%	-0.12%
Materials	21.69%	-4.38%	14.55%	0.98%
Industrials	5.34%	-0.77%	4.57%	0.03%
Cons Disc	12.04%	-2.93%	9.11%	0.19%
Cons Staples	5.77%	-2.44%	3.33%	0.04%
Health Care	5.80%	-0.69%	5.10%	0.03%
Financials	35.49%	-5.69%	29.79%	-0.38%
Info Tech	7.97%	-2.35%	5.61%	-0.16%
Comm Serv	6.14%	0.00%	6.14%	0.30%
Utilities	5.27%	-2.84%	2.43%	0.29%
Stock Total	107.83%	-22.46%	82.62%	1.10%
Futures			-42.47%	-0.12%
Cash			17.38%	0.00%
Total			100.00%	0.98%

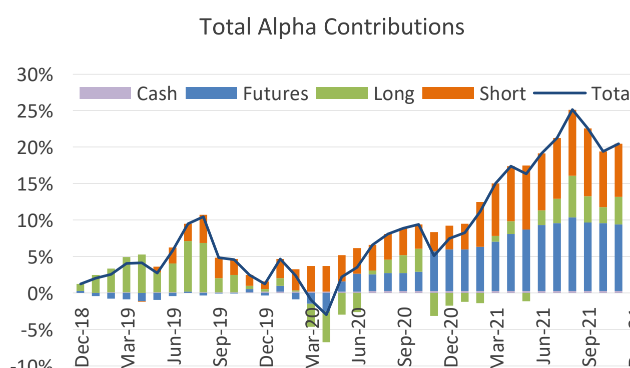


Net exposure including futures	40.2%
Gross exposure excluding futures	133.0%
Gross exposure including futures	175.5%



Major Alpha Contributors

Name	Weight	Contrib	Alpha
Top Five Contributors			
ARB Corp Ltd	3.21%	0.31%	0.33%
Hardie (James) Ends.	3.55%	0.30%	0.33%
Lynas Corporation	1.44%	0.28%	0.29%
Pilbara Minerals	1.49%	0.25%	0.27%
Spark Infrastructure	4.01%	0.26%	0.27%
Bottom Five Contributors			
Domino's Pizza	1.77%	-0.16%	-0.18%
Nickel Mines Ltd	-0.86%	-0.24%	-0.24%
Evolution Mining Ltd	-1.61%	-0.25%	-0.24%
EML Payments	-0.77%	-0.26%	-0.29%
Virgin Money UK PLC	1.12%	-0.28%	-0.33%



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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 behavioral 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 behavioral 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 using 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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