MONOGRAM

NEWSLETTER

Making our wealth last a life time… and beyond… (Part II)

November 2017

The Fund returned 1.3% in October, bringing year-to-date net return to 9.5%. Global Equity (ACWI) markets were up +2.2%, Developed ex-US Equity (EAFE) was up 1.7% and US Equity (S&P) up 2.5%. US Investment Grade Bonds lost -0.1%, Gold -0.1% and High Yield Debt -0.3%.

'Smoothing' Returns to Achieve Higher Withdrawal Rates

Last month, we looked at the role of traditional asset diversification in achieving higher withdrawal rates for long-term investors. We acknowledged the popularity (albeit misplaced!) of conventional multi-asset funds, or Dynamic Growth Funds (DGFs) in the UK, and Target Date Funds (TDFs) in the US. The US university endowment investing strategy as popularised by David Swensen (and its imitators) is very much in that camp, too. To reduce risk, those investment practitioners typically adopt the position of Markowitz (1952)[1] – in order to lower portfolio risk without sacrificing return one can combine uncorrelated assets to increase diversification, i.e. holding uncorrelated assets should lead to lower portfolio risk. This theory rings true most of the time, except, unfortunately, in those periods when it is most needed, i.e. when markets crash, and correlations suddenly converge to unity. Thus, as true investors we need to do more than diversifying our holdings across asset classes – this by itself is not enough!

We also introduced the rather prosaic, but rarely discussed concept of **Sequence Risk** (an inconvenient or damaging for our wealth **order of returns**) – the avoidance of which is the main route to truly reducing investment risk and enhancing future withdrawals from any pool of wealth.

Lastly, we stated that 'smoothing' of returns is the most effective tool to mitigate Sequence Risk.

In an earlier newsletter, we had already showed that hedging with derivatives is a valid alternative, but prohibitively expensive way to 'smooth' returns.

So, how can an investor achieve efficient 'smoothing' of returns?

Targeting Reduction of Drawdown

If asset returns are unpredictable, how can one achieve favourable sequencing of returns? While the order of returns itself cannot be predicted, it is possible to construct investment strategies that offer substantially reduced risk, as measured *not* by *volatility*, but by *drawdown* where drawdown is defined as the *maximum* peak-to-trough decline over the lifetime of an investment.

A powerful technique to dramatically reduce drawdown is Momentum, or Trend Following. This entails investing in an asset only when it is in an uptrend and switching into Cash when that asset moves into a downtrend. The ability to move into Cash (up to 100% of the portfolio) is what causes the "smoothing" of returns and the avoidance of large drawdowns.

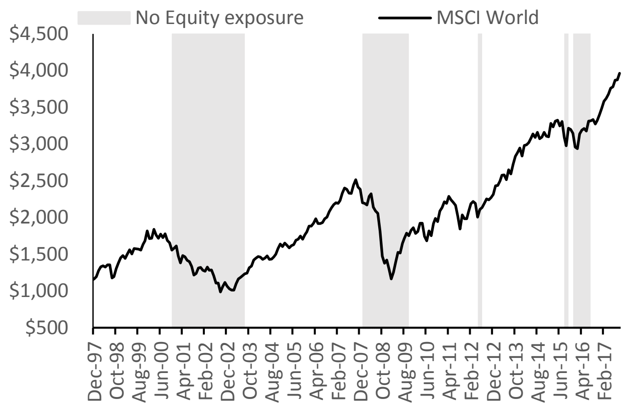
Momentum as a new class of investment strategies has gained much favour amongst the investment community in recent years, supported by empirical evidence over multiple asset classes and time-

[1] Markowitz H., Portfolio Selection (1952).

periods. The arrival of cheap Smart Beta exchange traded funds (ETFs) employing this strategy has further aided this development. But note that Momentum ETFs and mutual funds typically do ***not*** allow for switching meaningfully into Cash, which is in fact the key to preserving wealth and mitigating Sequence Risk, i.e. to 'smoothing' returns. At MONOGRAM, we build on a specific version of Momentum theory called "Dual Momentum" by pioneer researcher Gary Antonacci, which allows maximum flexibility with respect to moving into Cash.

Below is a selection of actual historical investing periods to illustrate how MONOGRAM's Dual Momentum strategy works in practice.

Example 1: Avoiding the crash -- Periods when our strategy allocates 100% to Cash and 0% to Equities[2]



Source: Thomson Reuters, Monogram Capital Management (Jan 1997 – Sept 2017).

Example 2: Momentum Overlay vs Simple Diversification[2]

Antonacci[3] demonstrated that over the period from 1974 to 2012 a portfolio of 60% US Equity and 40% US Treasuries was more correlated to the S&P 500 than a portfolio entirely composed of US Equity with a Momentum overlay.

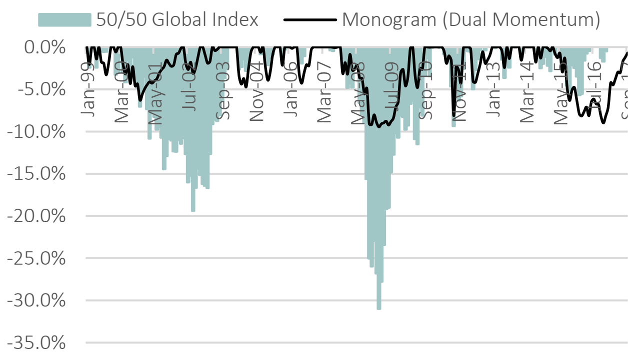
Portfolio	Sharpe Ratio	Max Drawdown (%)	Corr. to S&P 500	Corr. to 10 Yr Bond
60/40	0.5	-29	0.9	0.5
US Equity + Momentum Filter	0.6	-23	0.7	0.1
S&P 500	0.4	-51	1.0	0.1

This result contains a small yet critical point, namely, that the risk from a certain exposure such as US Equity can be mitigated more effectively by applying a momentum overlay to it than by employing conventional diversification across asset classes. This is clearly a challenge to traditional risk management!

The application of a Momentum overlay in combination with "traditional" diversification across asset classes should result in a portfolio with considerably lower drawdown. This hypothesis is the foundation of MONOGRAM's investment strategy, which targets minimising drawdown over and above the conventional focus on volatility.

Example 3: Drawdown Profile – Targeting 10% maximum peak-to-through loss[2]

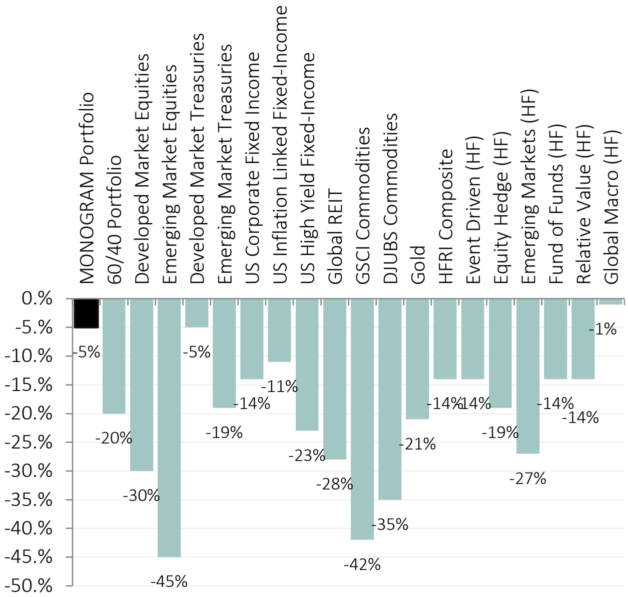
Below is an illustration of how the drawdown profile of our Dual Momentum strategy compares to that of a 50% Equity / 50% Bond benchmark. During periods of market stress, a 50/50 benchmark (which represents the ratio of equity to bonds that Target-Date-Funds typically hold 10 years before retirement) experienced losses in excess of -30%, while losses for our strategy did not exceed -10%.



[2] Performance of the Monogram strategy is provided for illustrative purposes to highlight the capabilities of Monogram Capital Management LLP as a fund manager. It refers to simulated past performance, which is not a reliable indicator of future performance.

[3] Antonacci, G. (2014) Absolute Momentum: A Simple Rule Based Strategy and Universal Trend-Following Overlay.

Example 4: Return Profile During the 2008 Financial Crisis (August to October 2008)[2]

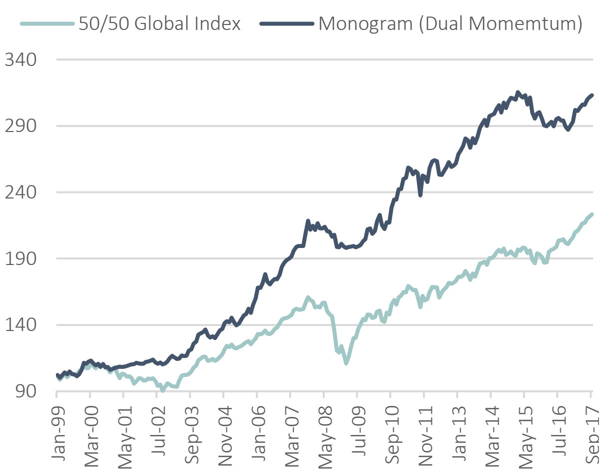


Source: Thomson Reuters, Monogram Capital Management

It is this preservation of wealth through drawdown prevention, which ensures the smoothing of returns and mitigation of *Sequence Risk*. It benefits investors in both, accumulation and decumulation phases.

This in turn aids the generation of superior returns over longer periods of time as we are always compounding with no major negative drawdown periods – the power of compounding.

Example 5: Superior Cumulative Returns[2]



Source: Thomson Reuters, Monogram Capital Management (Jan 1999 – Sept 2017).

In summary, the hypothesis underpinning MONOGRAM's investment approach is that applying a Momentum overlay to any series of asset returns reduces risk, maintains or increases returns over longer periods, and substantially reduces maximum peak-to-through losses (drawdown) along the way. It is this reduction in drawdown, which is directly related to lower Sequence Risk, that Pension funds, Endowments and their peers have so far largely been overlooking.

Portfolio Positioning

For the month of November our indicators favour US, Japanese and Emerging Asia Equities as well as High Yield and Short and Ultrashort Investment Grade Bonds.

About MONOGRAM

MONOGRAM Capital Management is an investment boutique founded in 2014 and headquartered in London. We take an innovative empirical, evidence-based approach to investing and believe there are fundamental, identifiable, persistent, and exploitable sources of return; risk is the permanent impairment of capital (peak-to-trough drawdown) and not volatility in its various forms.

There are two options for investors to access MONOGRAM's investment strategy. Investors can invest in the Luxembourg Domiciled MONOGRAM Fund or in MONOGRAM's bespoke segregated managed account, provided the investors meet the minimum subscription requirements. Further details are available on request.

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