RCM Alternatives

9 Hedge Fund Strategies Capturing the Market Sell-off

318 W Adams St. 10th FL | Chicago, IL 60606 | 855-726-0060
www.rcmalternatives.com | invest@rcmam.com

9 Hedge Fund Strategies Capturing the Market **Sell-Off**

The Corona Virus sell off and market crash is a great time to look in the (portfolio) mirror and ask yourself what you see. As Taylor Pearson of Mutiny put it succinctly on Twitter:

> **Taylor Pearson** 😷
> @TaylorPearsonMe
>
> If the stock market dropping 5% causes you to freak out, it's probably a good time to re-evaluate either/both:
>
> 1. The effectiveness of your portfolio's diversification
>
> 2. Your emotional relationship with it.
>
> One of those two is likely out of whack
>
> ♡ 48 2:32 PM - Feb 24, 2020

The question from a portfolio/mirror/soul searching aspect is whether you were prepared for the 'decade' that happened last week. And the question in our little world here of diversification strategy and alternative investments is – how "Alt" was your Alts last week. Many so-called Alts, as we tweeted out, don't necessarily do much in the way of diversifying.

Who's performing?

They made a movie about the hedge fund managers who made a killing during the Financial Crisis (the real names of The Big Short managers can be found here). And what a tale it was, with some of the smartest people on the planet figuring out not just that there was a bubble about to pop, but also how to go about betting on that outcome in asymmetric ways. It didn't hurt that the story included some real characters, professional 'dancers', cocky mortgage brokers, and Beautiful Mind like hedgies.

Fast forward 12 years to Feb/Mar 2020 and we may have another movie script playing out, with the quickest bear market sell off in the history of the stock market behind fears of a global pandemic. Now, we don't think there were people in the same boat as the mortgage backed securities crisis, figuring out that a pandemic was coming, and positioning portfolios months in advance of it happening. But there are distinct winners emerging from this scare.

We are talking mostly about active Long Volatility strategies, of course – who don't predict when or why markets will sell off big, but nonetheless structure portfolios to take advantage of a market sell off (and the resulting volatility spike) when and if it should happen. The beauty of it all is that these professional traders didn't need to travel to Florida to talk to home owners not paying the mortgages, they didn't need an insider at Deutsche Bank, or need an ex-big bank trader to get them in the door. They didn't need banks to create credit default swaps for them or worry about counter-party risk should they be correct. It wasn't a few hedge fund managers correctly guessing the direction of the markets.

This is all about math, and in particular a concept called convexity. Now, that's just a fancy way of saying that these strategies don't make money in a straight line equal to the amount the stock market sells off (or lose it in a straight line as the market rallies.) No, they are designed to make more money the further the stock market drops, creating a curve on the profitability graph that has a 'convex' shape. Now, that convexity is achieved through the very structure of the markets these managers employ. For example, in the last week of February the stock market fell about -7%. The VIX spiked about +70%. However, the VIX didn't spike 10% for every 1% down move in stocks. It maybe did 5%, then 15%, then 35%. Instruments like the VIX and options that these managers use increase non-linearly. The quicker and deeper a market sell-off, the better those instruments will do. That price structure creates convexity in the return profile of the managers.

Here's a few of the hedge fund strategies who have found returns during the Covid-19 market sell off.

VIX and Volatility Traders:

1. Deep Field Capital VolArb (QEP):

How:

Swiss based Deep Field Capital offers three investment programs focused on long volatility: VolARB, ICA, and ICC. Vol Arb trades the VIX futures curve, ICA (Intra-day Crisis Alpha) takes long/short day only positions in world stock index futures, and ICC trades similarly to ICA but on VIX futures.

What we like:

Trying to capture short term market moves is no easy task, but the guys at Deepfield have proven adept at doing just that, with the addition of Asian and European markets allowing the program to capture overnight moves). Meanwhile, their deep experience in analyzing the VIX curve shows in the VolArb strategy, while they are one of the only firms doing a short term strategy on VIX futures.

FEB + MAR Return **+15.05%**

*estimate as of Mar 13th

Overall*

Comp ROR: 14.56%

Max DD: -12.80%

Launched: 12/2014

Min Investment: 1mm

*through Feb '20

View This Program's Full Stats in the **RCM Database**

Source: March return numbers for managed futures programs are from manager estimates and RCM tracking of live accounts. Mutual Fund data:YCharts.com

2. Logica Absolute Return (LAR):

How:

Los Angeles based Logica Capital Advisors is a hedge fund specializing in the long convexity trade. This program is always long volatility with positive skew (aka good fat tails) through targeting long volatility through straddles on stock indices and proxies to those. But what sets it apart is a gamma scalping strategy to attempt to create some positive carry which helps limit the bleed when market volatility is low.

What we like:

Long volatility without trading VIX makes this one a little different from all the rest. And, you'll be hard pressed to find a more engaging speaker on portfolio construction and convexity than founder Wayne Himmelsein (you can hear our podcast episode with them here).

FEB + MAR Return **+15.32%**

*estimate as of Mar 13th

Overall*

Comp ROR: 16.60%

Max DD: -16.10%

Launched: 1/2015

Min Investment: 500k, 10mm SMA

*through Feb '20

Please call for More Data

3. QTS Capital Management Tail Reaper (QEP):

How:

A PM with a PhD in theoretical physics that has led big data, AI, and quant algorithms research at IBM and Morgan Stanley and Credit Suisse has developed three separate strategies aimed at targeting convex, long volatility, fat tail moves. The QTS Tail Reaper Strategy is a fully automated, intraday trading strategy using E-mini S&P 500 index futures. VIX Timer Strategy trades VIX futures algorithmically and a 3rd program blends the two.

What we like:

This strong team with a deep understanding of algorithmic strategies has applied that to finding convexity & positive skew inside of equity markets during both normal times and periods of market stress.

FEB + MAR Return **+48.70%**

**estimate as of Mar 13th*

Overall*

Comp ROR: 12.80%

Max DD: -14.57%

Launched: 8/2012

Min Investment: 100k

**through Feb '20*

View This Program's
Full Stats in the **RCM Database**

4. Pearl Capital Hedged VIX (QEP):

How:

Pearl Capital is one of the OGs of the CTA volatility space trading implied vs realized volatility trading VIX and emini S&P futures. This program was one of the best performers in the Vixmaggedon in February, 2018. It struggled since then, but is turning it on now.

What we like:

Drawdowns aren't fun for anyone. Credit to Pearl for keeping their nose to the grindstone and using the drawdown to up their R&D chops. The program is bouncing when investors need it and we still think these guys have an edge despite the tough run.

FEB + MAR Return **+4.80%**

**estimate as of Mar 13th*

Overall*

Comp ROR: 5.71%

Max DD: -16.46%

Launched: 10/2015

Min Investment: 500k

**through Feb '20*

View This Program's
Full Stats in the **RCM Database**

5. Covenant Total Volatility:

How:

Former trend following trader Scot Billington went back to his roots as a volatility trader launching the Covenant Total Volatility Fund a few years back. The fund takes a long/short exposure across the VIX curve, while also mixing implied vs realized volatility exposure and long S&P.

What we Like:

TAs Scot says, this is an aggressive program. But with a lower investment minimum of $100,00 this program provides can provide a nice bang for the buck for investors looking to get volatility exposure at a minimum investment level available to most investors.

FEB + MAR Return **+16.09%**

**estimate as of Mar 13th*

Overall*

Comp ROR: 14.70%

Max DD: -13.84%

Launched: 1/2018

Min Investment: 100k

**through Feb '20*

View This Program's
Full Stats in the **RCM Database**

Global Macro / Dynamic Parity

6. Breakout Funds:

How:

Two ex-prop traders Aaron Larkin and Matt Laviolette teamed up with quant Bryan Leavitt to form Breakout Funds in 2018. The fund is short term discretionary macro using trading rules developed from their many years of prop trading experience.

What we like:

This isn't your father's global macro fund that builds up positions and expects to hold them over longer periods of time. Breakout looks to identify short term opportunities in the market. Successful trades are held for days, not weeks while stringent risk management rules have them exit losers even quicker. You can hear our podcast episode with them here.

FEB + MAR Return **+3.70%**

**estimate as of Mar 13th*

Overall*

Comp ROR: 10.20%

Max DD: -5.07%

Launched: 2/2018

Min Investment: 1mm

**through Feb '20*

View This Program's
Full Stats in the **RCM Database**

7. EVE Global Tactical Allocation Program (GEP) *(TICKER:GTAP)*

How:

By combining risk parity with trend following, former Monroe Trout and Crabel PM Kevin Doyle has created a sort of dynamic parity program aiming for diversified long stock/bond market exposure with the risk management of a trend following strategy to avoid large drawdowns.

What we like:

While Bridgewater and other risk parity are having one of their worst periods ever, GTAP has weathered the storm nicely so far with long fixed income and gold positions, outpacing the S&P Risk Parity index by a good amount.

FEB + MAR Return **-1.10%**

**estimate as of Mar 13th*

Overall*

Comp ROR: 6.70%

Max DD: -3.54%

Launched: 4/2017

Min Investment: 100k

**through Feb '20*

View This Program's Full Stats in the **RCM Database**

Hedged Equity / Hedged Fixed Income / Alts Mutual Funds

8. Standpoint Multi-Asset Fund *(TICKER:BLNDX)*

How:

Former Longboard Funds CIO ~ Eric Crittenden launched Standpoint in January 2020 as an alternative to traditional trend following mutual funds. This fund splits its risk with long equity exposure and futures trend following a formula that has proven to be successful for other fund families.

What we like:

We've always been a fan of trend followers that actually have commodity exposure and Standpoint's short energy exposure has helped in a big way this month. Long fixed income across the curve has also helped as well.

MAR Return **+0.50%**

**estimate as of Mar 13th*

Overall*

Comp ROR: -2.60%

3yr Return: n/a

5yr Ann ROR: n/a

**through Feb '20*

View This Program's **Full Stats**

9. AlphaCentric Premium Opportunity *(TICKER: HMXAX):*

How:

A systematic, rules based options strategy that includes premium collection, volatility trading and trend following based on AI fueled algorithms going long and short call and put options with the goal of absolute returns with low correlation to the stock market.

What we like:

This doesn't act like a naive option program just collecting premium until a nightmare happens. As the name alludes to, we like it looking for opportunity in and around option premium, sometime collecting, sometimes purchasing, to be dynamic in the volatility exposure – while also mitigating risk by staggering position maturity dates and strikes.

MAR Return **+13.76%**

**estimate as of Mar 13th*

Overall*

3yr Ann ROR: 3.22%

5yr Ann ROR: n/a

Max DD (5yr): n/a

**through Feb '20*

View This Program's **Full Stats**

SIDEBAR - What Type of Alts are you Really Looking For?

As you look through these Alternative Investments and others, ask yourself, which of these four categories they fall into:

- How much of it is an Equity Replacement
- How much is an Absolute Return Strategy
- How much is a Diversifier
- and How much is a Hedge

The difficult part is that the above are all very different kinds of Alternative Investment, but are all already in the overall Alts bucket (that's a lot of Alt/all alliteration). And that all are typically sold as some combination of those terms (our super great fund XYZ is an absolute return vehicle providing diversification). The trick is knowing beforehand how your particular Alts investment is likely to perform during a market rout, and whether you are comfortable with that return/risk profile.

Absolute Return or Diversifier or Hedge

So while you're looking in the portfolio mirror after/during the Corona Virus sell-off, ask yourself what you really want out of your Alts. Because it is all too easy to get lured into this Hedge Fund or that one expecting negative correlation during a market sell off when it really only provides NON-correlation (sometimes moving the opposite way in a crisis, sometimes not). It's all too easy to think you're in Alts that may protect your portfolio in a market sell-off, but they're really designed to just give you equity exposure with less risk. To help you identify just what you're invested in, and what it's likely to do in a market sell off, here's the basic buckets we view Alts in:

Equity Market Replacement

(Correlation in a Crisis = Highly Positive)

Many Alts follow the game plan identified by BMO Global Asset Management in a 2016 paper, "A good alternative [investment] should give the portfolio either a higher return for the same amount of risk or the same return for a lower amount of risk". These Alternative Investments aren't actively trying to provide positive returns during a market sell-off. No, they are trying to beat the stock market on a relative basis in one of two important ways: higher returns with similar risk, or similar returns with lower risk. We're talking Alts here like Private Equity, Venture Cap, a lot of Long/Short Equity Hedge Funds, and sector region focused Hedge Funds (Asia, Healthcare, etc.). Basically, anything that relies on a growing economic cycle, functioning credit markets, and discounted future cash flows. These types of funds/strategies were, generally speaking, down alongside the market during the Covid-19 sell off; but down less. We'll also throw option sellers and outright short volatility traders (VIX Arb with Short Vol Bias) in this bucket, as they provide a near identical long stock profile, usually with less risk in the short term, but more hidden risk over the long term.

Absolute Return

(Correlation in a Crisis = Unknown and Unreliable – could be highly positive, could be low, could be negative)

These Alts aren't directly tied to the stock market, doing things tangential to it, but may or may not have the same negative skew profile (lots of small gains interspersed with less frequent large losses). Here we're talking certain delta neutral long/short equity and options strategies, Risk Parity, and certain stat, debt, and Convertible Arb strategies, Distressed Debt, and Alternative Debt. As well as managers doing unique things in Commodity Markets (think energy traders, Ag traders), Short Term Systematic Strategies, and newer AI quant models without much directional exposure. Absolute Returns sound great, and indeed are typically great at being non-correlated on average, but that on average part is the killer. If your hog trader just happens to be down -5% in the same month equities are down -7%, they will remain non-correlated on any meaningful lookback – but they won't feel so Alt right there in that month that you needed them. Absolute Return is great for your portfolio as long as you understand and accept that it won't be there for you in a crisis. It may be, but it will be tough to count on.

True Diversifier

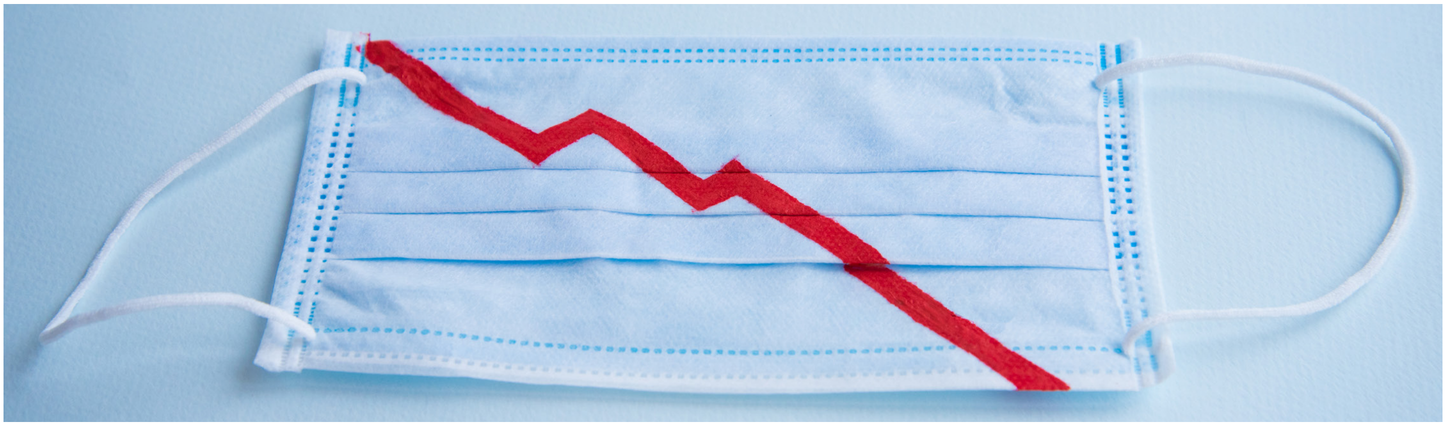
(Correlation in a Crisis = potentially high in beginning, negative in extended market rout)

These Alts are similar to Absolute Return investments most of the time, providing (on average) non-correlation to equity markets. But there is a key difference in that they have positive skew profiles and the ability to capture extended down moves in the stock market. We're talking classic managed futures strategies here like Trend Following and Diversified, multi-market long volatility focused systematic quant funds (was that enough adjectives), and classic diversifiers like Gold and Bonds. Managed Futures as an alternative allows for crisis period performance when it is needed – while also having the ability to perform some in a rallying stock market in sort of a best of both worlds. The rub, however, is that they are an imperfect option on a short-term market crash (like last week), where their ability to have negative correlation (i.e. positive performance) during a market rout depends on how they are positioned coming into that rout. If they are already long Bonds, they'll do well as Bonds see a flight to quality. If they come in long stocks, they'll under-perform until those up trends end. For them to really perform, the ideal is a 2008 type of slow-moving months on end market crisis. A quick note on bonds in this category; while true that bonds have been a flight to safety diversifier that shows negative correlation in a short term market rout – that hasn't always been the case when looking back 50 to 100 years (see here). And there's the little bit of an issue of bonds being near the zero bound, theoretically limiting the hedge characteristics of bonds (unless they go into negative yielding territory).

Active Long Vol:
(Correlation in a Crisis = highly negative)

Which brings us to the most direct hedge available in the Alts toolbox these days, dedicated, active long volatility strategies. Otherwise known as tail risk or convexity strategies. Now, there's lots of stuff out there which is labeled tail risk but is actually only Bonds or Gold or some other type of diversifier – so be careful and be sure to look under the hood. But true, actual Active Long Volatility strategies are different in that they actively look to profit from a market sell-off. They don't rely on their portfolio eventually becoming negatively correlated to stocks (ehh hemm Managed Futures). They don't rely on their historical negative correlation to stocks like Gold and Bonds. And they don't rely on just being statistically non-correlated (the absolute return bucket). They actively set up their trades and portfolios to make money (at an increasing rate – what we call convexity) when the market sells off. The simple example to this is buying Puts, which payoff when prices fall – not because that's what's always happened, but because that's how the investment is actually structured. It can't not make money when the market falls. More advanced examples or being long and short VIX futures at the same time – the long portion typically in the front months where volatility spikes most, and the short portion being in the back months which don't spike as much – and erode similarly to help pay for the long exposure.

As alluded to there, the trick with this strategy is being able to limit the cost of owning this long volatility exposure. In the owning Puts example, you would have to pay the premium month after month until the markets move down past your Puts. That gets expensive and is essentially the reason you see the long VIX ETFs lose money month after month. The professional managers in this strategy use several methods to limit this bleed, including many different flavors and methodologies in and around the aforementioned long/short VIX strategy, the use of cheaper proxies to own Put options on stock down moves (like Bonds or Gold), and the use of short term down capture strategies which use different flavors of volatility breakout type models to try and capture short term sell-offs. So far during the Covid-19 sell-off, these active long vol strategies have done quite well – as they are designed to do.



In conclusion

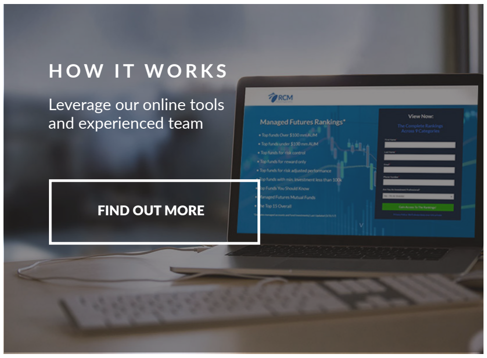
So as you look in the portfolio mirror to do your post sell-off self-evaluation. Or head down whatever path Google leads you down after you decide to Google [Alternative Investments], make sure you check the signposts and mile markers to make sure you know what Alts path you're actually headed down.

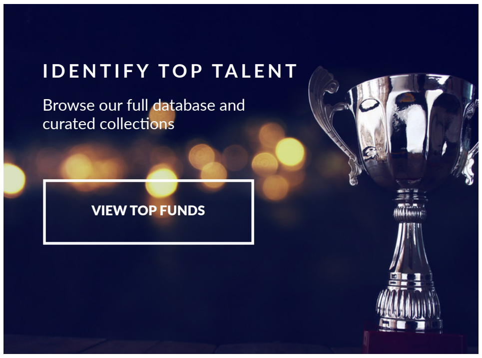
You could be on the Equity Replacement path, the Absolute Return path, the Diversifier path, or the Active Long Vol path. Any of those may be marketed as an alternative path but may in fact be a parallel path to the stock market journey you're already on. And maybe you're fine with that…maybe that works for you. But if you're after something truly different, something truly alternative, something that is designed to make money during a market sell-off – make sure you're getting what you're after with your 'alternative investment'.

For us, that means continuing to help our clients look for dynamic investment strategies that react to paradigm shifts and get on board with them. Things that do well in volatility spikes, but also when the spikes don't happen. Things that do well in extended down moves, but don't crumble the rest of the time. Antifragile alternative investments that are setup for the Black Swan, but ever aware of the White Moose.

So, take a look in your portfolio mirror….and let us know what you see.

Jeff Malec, CAIA
Managing Director & Partner





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RCM Alternatives

318 W Adams St. 10th FL
Chicago, IL 60606
855-726-0060

www.rcmalternatives.com
invest@rcmam.com