Our Role in Your Portfolio.

by Michael Melissinos

Something's gotta change. Today, many investors hold portfolios that are non-diversified and do not adapt to changing market conditions. These portfolios fail miserably when an unexpected crisis or a lengthy bear market occurs. Major setbacks, like the Financial Crisis and Dot-Com Bubble before it, put investors in a very weak financial position - often at or around the time they plan to retire, buy a house, start a family, etc.

The traditional investing approach does not, by design, have a way to protect assets in downtrends or capitalize on market opportunities outside of stocks, bonds and real estate. Not having an exit plan costs investors dearly in 2008 and 2000, and leaves the door open for serious losses in the future. No one knows when the next bear market will come or how severe it will be, but that does not mean we cannot prepare for it now. In addition, traditional investors routinely miss out on opportunities in other global markets such as commodities and currencies. Today, they depend entirely on producing profits in the highly concentrated and correlated mix of stocks, bonds and real estate.

To protect assets in an unpredictable world and capitalize on opportunities in *all* asset classes, I believe we must incorporate an adaptive investing strategy into our portfolios; one that aligns with trends, diversifies and manages risk. Melissinos Trading offers such a strategy.

In this paper, Michael Melissinos explains the role Melissinos Trading plays within the traditional portfolio; how it can assist in increasing returns while lowering volatility and drawdowns.

The Value of Power Hitters

For many investors, diversification fails when they need it most. During the Financial Crisis, traditional portfolios lose about half of their value. More sophisticated investors try improving their strategies by allocating to hedge funds. They believe hedge funds can at least protect some of their assets if and when a crisis occurs. This doesn't work too well as hedge funds prove to correlate highly with buy-and-hold strategies, especially during crises.

Every strategy has it's weak points. The traditional buy-and-hold strategy does a poor job of managing risk since it keeps losing positions on the books instead of cutting them quickly; in many cases, it even allocates more to them. And the strategy fails to capitalize on opportunities in many global markets including commodities and currencies.

Melissinos Trading combats traditional portfolio weaknesses by:

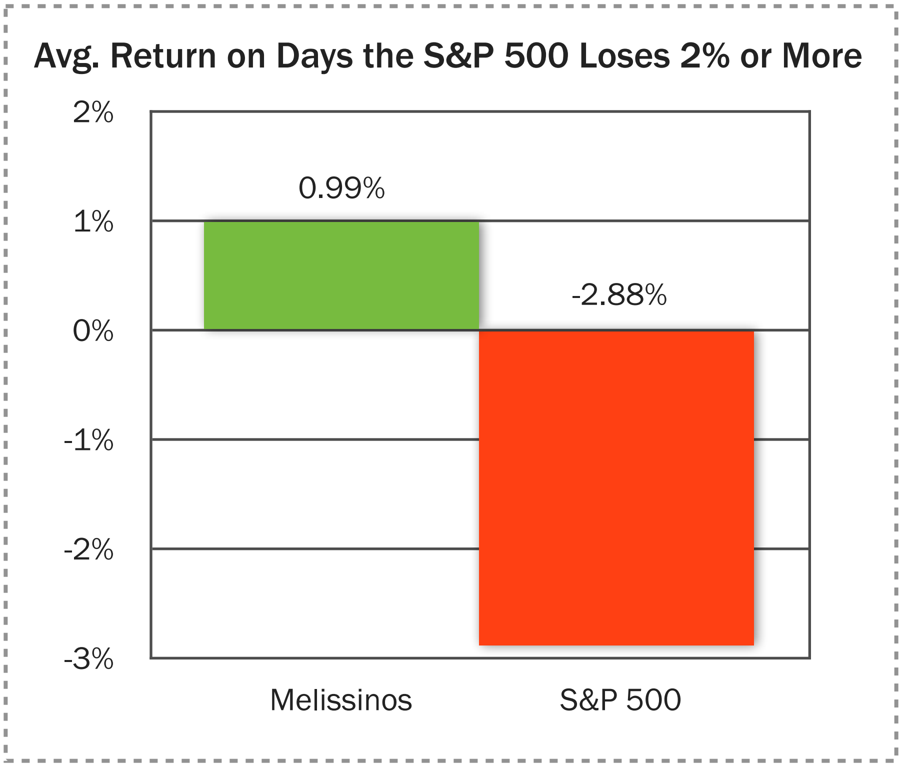
1) Implementing an exit plan for each investment we make *(we do not let small losses turn into big ones)*

2) Expanding the portfolio to include markets in commodity, currency, interest rate and stock sectors *(why limit our ability to profit in only one or two markets?)*

3) Proportionally adjusting allocations to market volatility *(i.e. use the brakes when roads become dangerous)*

Clutch Performance

Melissinos Trading performs well when you need it to. Since our 2011 inception, on days the S&P 500 falls 2% or more (28 days), we produce gains on 23 of those days for an average return of 0.99%. The positive returns do not necessarily come from holding a short S&P 500 position, but from our completely different investing process altogether. In fact, we only hold a short S&P 500 position on 5 of the days.



Non-Correlation

A baseball lineup of only slap hitters has trouble driving in runs since most of the hits are singles. It does not have the ability to score the bulk of its runs on one or two swings. This is something that power hitters offer. Adding power hitters to the lineup can improve the scoring efficiency of the lineup. A robust lineup includes hitters of all kinds – slap hitters, power hitters, clutch hitters and those with high OBP. Each player has his/her own unique role.

Portfolios work the same way. Investing in highly correlated similarly performing assets can leave the portfolio exposed in certain, and often critical, situations. Traditional buy-and-hold strategies typically suffer painful losses during economic contractions and bear markets. Adding in a non-correlated performer like Melissinos Trading can improve the traditional portfolio's performance.

Melissinos Trading displays very little correlation with traditional assets, even hedge funds. The chart below displays the correlation figures since January 2011.

Correlation Matrix: Traditional & Alternative Asset Classes

	Melissinos	U.S. Stocks	U.S. Bonds	S&P Case Schiller	World Stocks	Commodities	Hedge Funds
Melissinos	1						
U.S. Stocks	-0.20	1					
U.S. Bonds	0.35	-0.28	1				
S&P Case Schiller	0.00	0.11	-0.16	1			
World Stocks	-0.32	0.84	-0.20	0.13	1		
Commodities	-0.13	0.58	-0.17	-0.18	0.60	1	
Hedge Funds	-0.19	0.88	-0.23	0.22	0.88	0.59	1

Notice our low correlation with other asset classes. This suggests that we are, in fact, doing something different than the others. Further, this may suggest that we have a place in the "lineup" and can help out a traditional portfolio.

In the next section, we show how adding Melissinos Trading to the traditional portfolio improves its overall performance - increasing returns while lowering volatility and maximum loss.

The Results – Bringing Stability to Fragile Portfolios

Results speak for themselves. Since inception, Melissinos Trading shows it can increase returns while simultaneously reducing volatility and drawdowns of traditional portfolios. As a stand-alone investment, and despite launching during one of the worst market environments for trends in history, Melissinos holds its own against stocks and bonds.

Over the next couple of pages, we conduct an exercise that shows how Melissinos positively influences the performance of traditional portfolios.

Increase Returns, Lower Volatility & Drawdowns

Before we start this exercise, let's take a look at the stand-alone performance of traditional portfolio components of stocks, bonds and Melissinos since 2011.

Performance Statistics: Jan 2011 thru Mar 2015

	Stocks - S&P 500	**Bonds -** U.S. 10yr Tsy	**Melissinos**
CAGR	12.41%	1.80%	10.68%
Annual Volatility	11.34%	5.53%	16.63%
Max Loss	-17.04%	-9.20%	-22.71%

You may notice that Melissinos's volatility and maximum loss both exceed stocks and bonds. You may ask yourself, *"How can adding a strategy with a higher volatility and maximum loss actually lower those of the traditional portfolio?"* We'll get to this in a little bit but here's a hint: non-correlation.

First, let's see what happens when we combine stocks and bonds into the standard 60/40 portfolio (60% stocks, 40% bonds), rebalanced annually.

The 60/40 results look pretty good. At first blush, it appears that blending two asset classes with a fairly low correlation to one another (-0.28, see page 3) creates a better performing product. Returns remain stable while the maximum loss decreases to an amount lower than each component.

The real magic happens when we look at risk-adjusted performance. When adjusting the returns relative to risk taken, performance drastically improves; that is, we get much more bang for our buck. Sharpe and MAR ratios increase, on average, 187% and 487% respectively - well above each separate component.

Performance Statistics: Jan 2011 thru Mar 2015

	Stocks - S&P 500	**Bonds -** U.S. 10yr Tsy	**60/40**
CAGR	12.41%	1.80%	**8.56%**
Annual Volatility	11.34%	5.53%	**6.67%**
Max Loss	-17.04%	-9.20%	**-7.98%**
Sharpe*	1.07	0.27	**1.24**
MAR Ratio^	0.72	0.19	**1.07**

Now, let's see if a non-correlated asset like Melissinos can help improve these numbers. In the next exercise, we allocate 25% to Melissinos and proportionally reduce the allocations to stocks and bonds.

* Assuming a risk-free rate of return (3-month LIBOR)
* Sharpe = (CAGR - Risk Free Rate) / Annual Volatility
^ MAR Ratio = CAGR / Maximum Loss

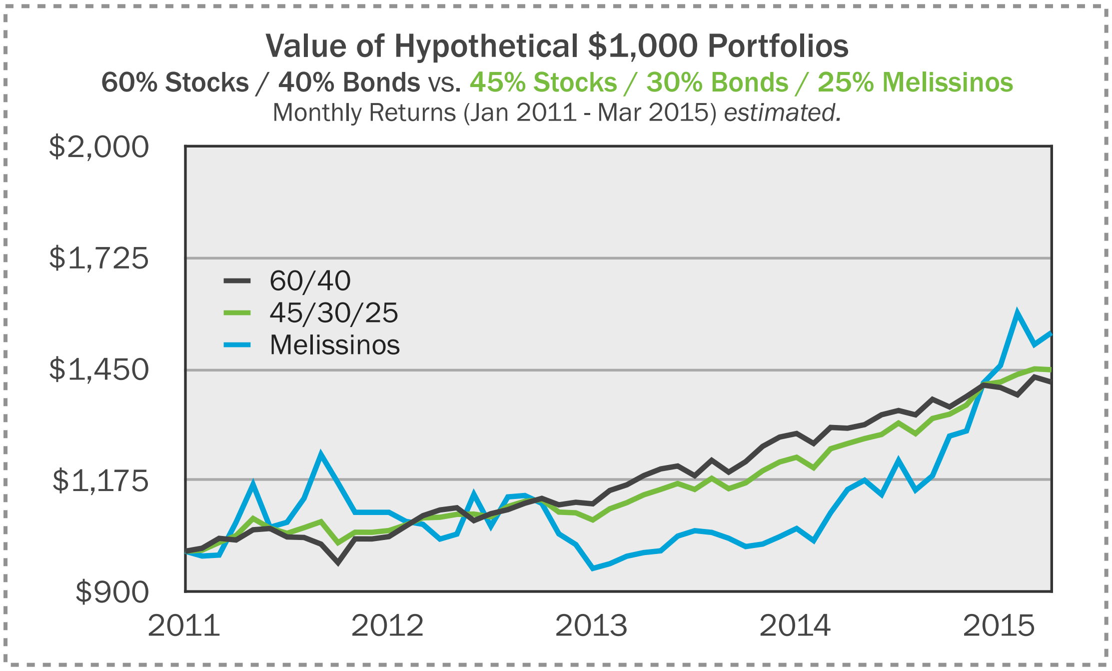
The 60/40's risk-adjusted statistics easily exceed those of Melissinos's, but that doesn't matter too much. When inserting a new strategy to a portfolio, the new strategy's raw performance is not as important as its correlation to the current group. In this case, Melissinos does not correlate highly with stocks (-0.20) or bonds (0.35), so it makes for a good fit.

A portfolio with a 25% allocation to Melissinos increases returns and lowers volatility and maximum loss of the 60/40 portfolio. Also, Sharpe and MAR ratios increase 16% and 50%, respectfully. This experiment looks like a success.

Performance Statistics: Jan 2011 thru Mar 2015

	60/40	Melissinos	45/30/25
CAGR	8.56%	10.68%	**9.11%**
Annual Volatility	6.67%	16.63%	**6.10%**
Max Loss	-7.98%	-22.71%	**-5.53%**
Sharpe*	1.24	0.62	**1.44**
MAR Ratio	1.07	0.46	**1.60**

Below, we see how both portfolios perform over time. Notice the 45/30/25 mix underperforms the 60/40 throughout most of the run. This is due to Melissinos dragging down performance while it experiences a flat performance period from 2011-2013. Then, in 2014, the story changes when Melissinos earns a return of ~38% = lifting the 45/30/25 portfolio ahead.



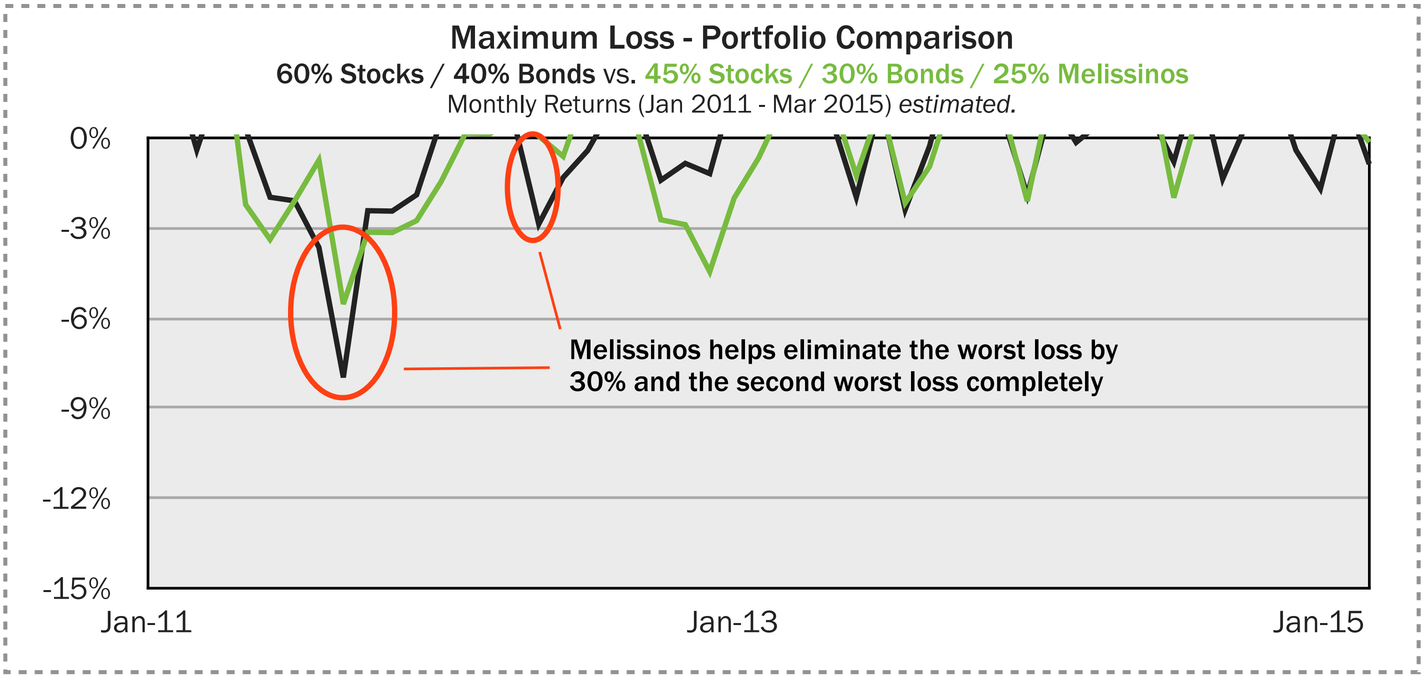
Bottom line: As a stand-alone investment, Melissinos performs fairly well. In fact, on an absolute return basis, it beats both portfolios. But it does incur more volatility and suffer larger losses. When combining our unique investing style into a traditional portfolio of stocks and bonds, performance improves across the board - returns increase while volatility and losses decrease.

*Assuming a risk-free rate of return (3-month LIBOR)

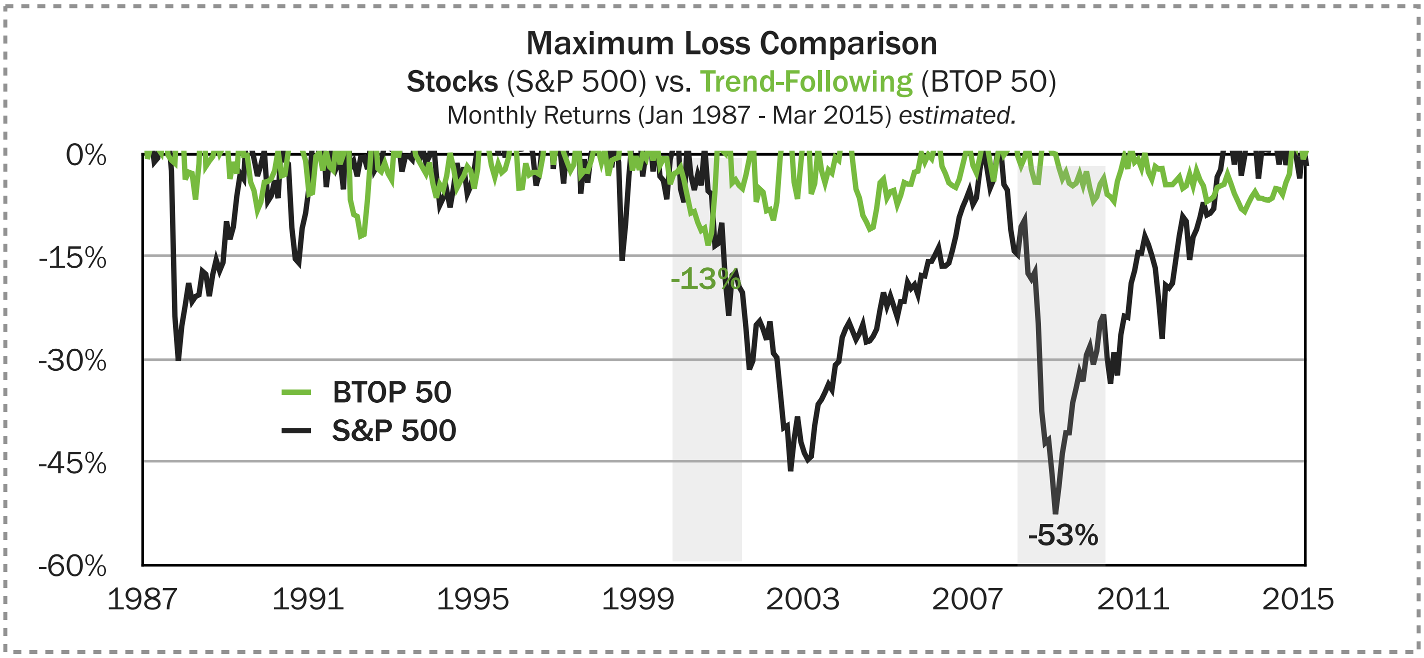
Reducing the Most Painful Losses

Losses always sting, but they especially hurt when we lose money at a time we need it most. Ask those who set their sights on retiring or buying a house back in 2008-2009 or other previous bear markets.

Melissinos helps lessen the losses that occur during the most severe bear markets.

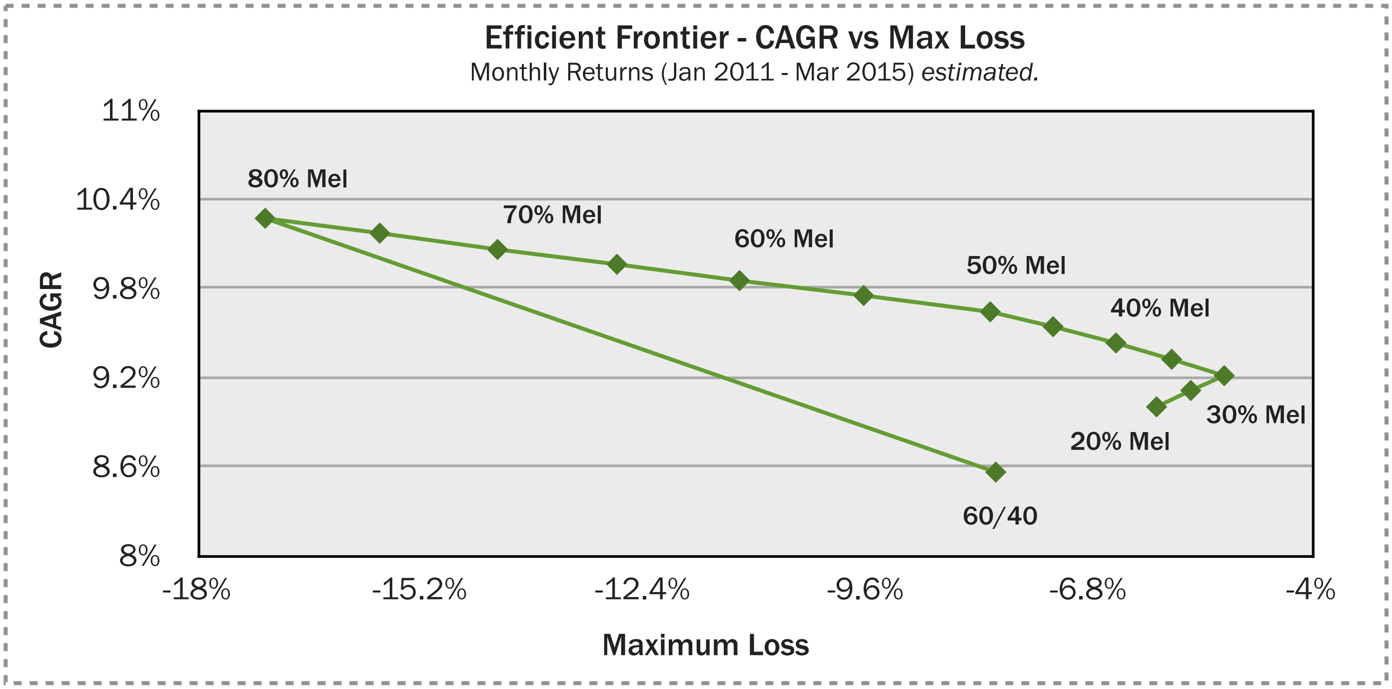


The chart below shows how the BTOP 50, an index that highly correlates to Melissinos trading strategy, keeps losses small since 1987. It does not have a single losing period of 15% or more, while the S&P 500 has five. The BTOP's worst drawdown is 13% versus the S&P 500's 53%. Since January 1987, the BTOP's CAGR is 8.41% versus the S&P 500's at 7.89%.

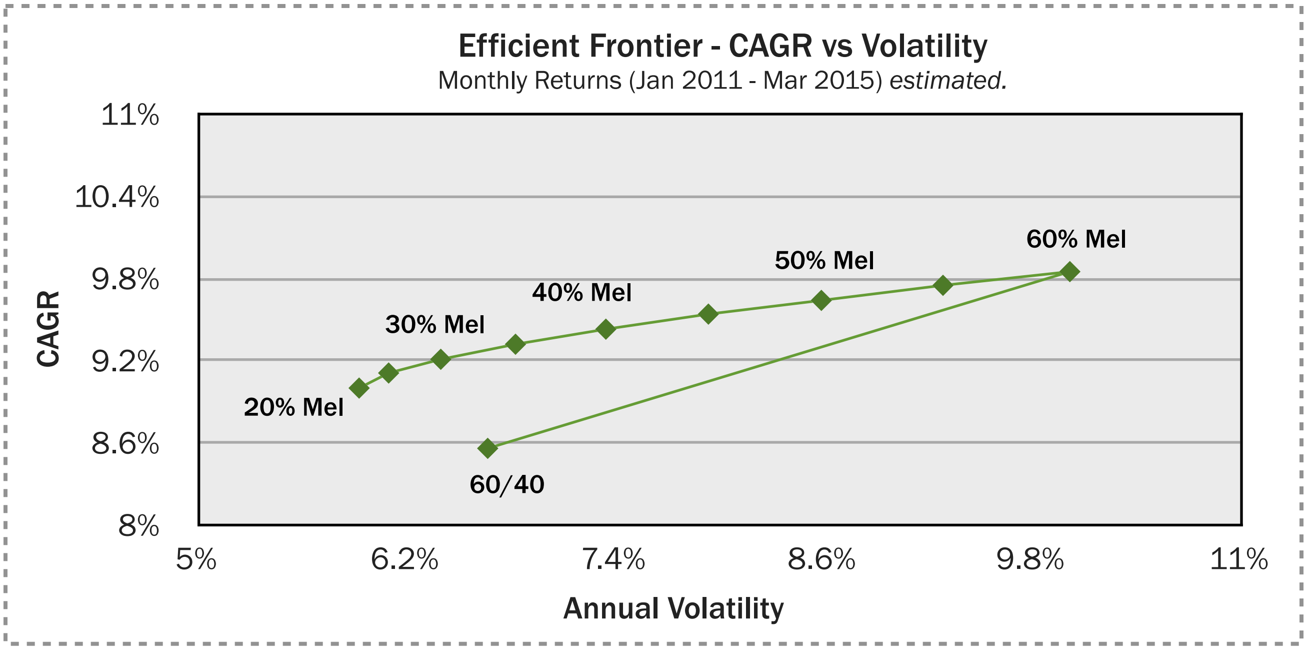


Efficient Frontier - How Much to Allocate?

Continuing with this exercise, we now take a look at how portfolio performance changes when increasing the allocation to Melissinos. The following charts illustrate the results.



The efficient frontier above shows how Melissinos reduces the maximum drawdown at different allocation levels. At a 30% allocation, Melissinos helps the portfolio achieve its smallest maximum loss. Beyond this, the maximum loss starts increasing. At a 50% allocation, the portfolio earns a full 1% CAGR higher than the 60/40 and does not suffer any additional drawdown.

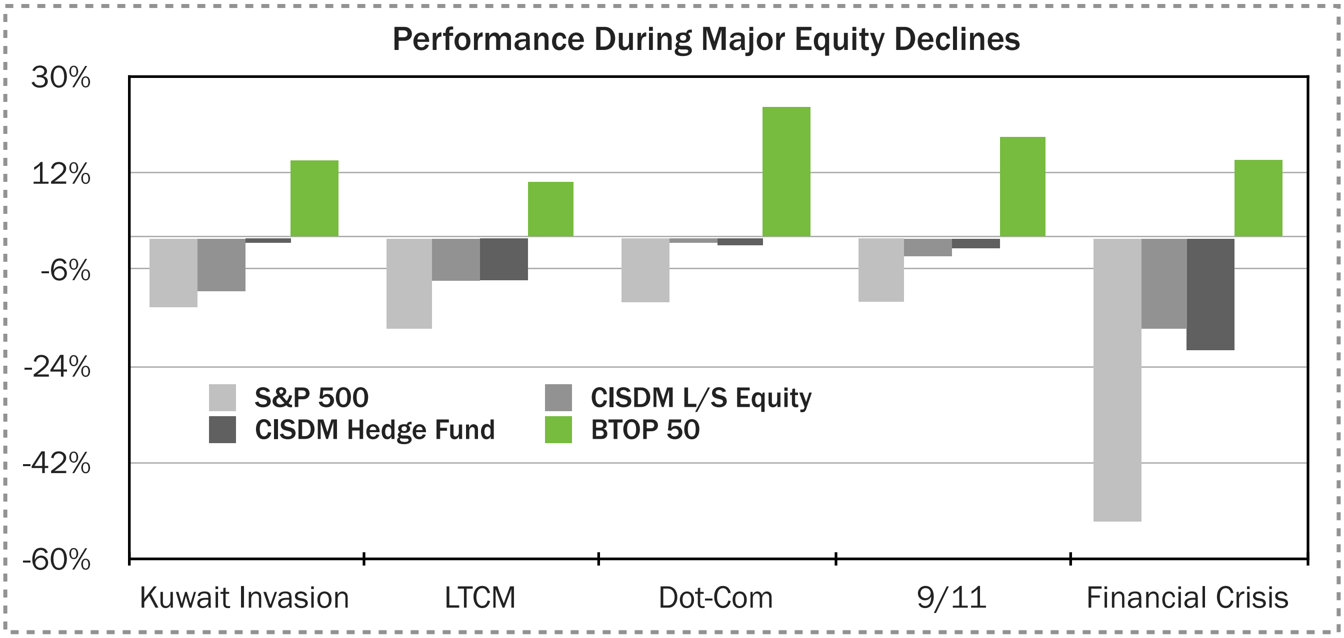


The second efficient frontier illustrates how volatility changes when allocating different amounts to Melissinos. The optimal allocation is 20% (Sharpe Ratio is highest). To achieve the same volatility as the 60/40, one needs to allocate ~35% of their portfolio to Melissinos. At this amount, the new portfolio earns ~0.80% more per year.

More Clutch than Hedge Funds

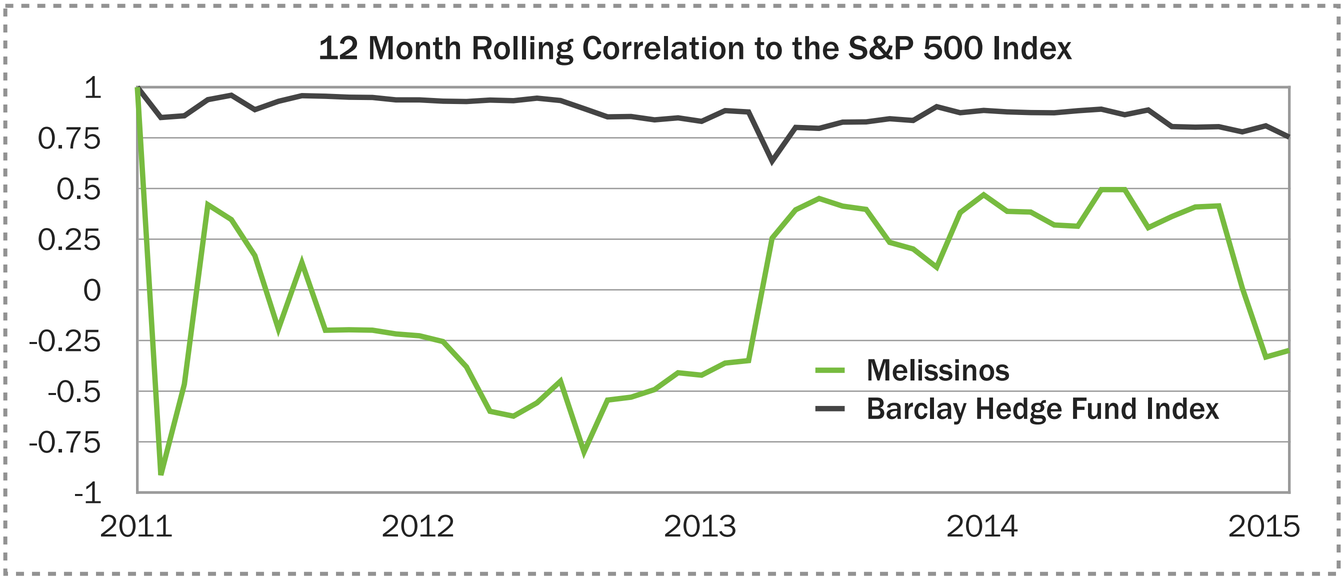
Since 2011, stocks and bonds do not experience extended bear markets. The next time they do, the need for a firm like Melissinos may increase. Melissinos expects to serve traditional portfolios by protecting a portion of its assets when crises and bear markets occur. It does this through diversification, aligning with trends and managing risk.

Hedge funds, on the other hand, fail to provide meaningful diversification when traditional portfolios need it. During the last five major crises, hedge funds fail to protect assets much less produce any gains. Below, the chart illustrates the performance of the S&P 500, two hedge fund indexes and the BTOP 50.



Melissinos doesn't exist during these events, but we believe the BTOP 50 represents a fair illustration of how Melissinos likely would have performed. Note: correlation between the BTOP 50 and Melissinos comes is 60%.

Below, we can see how hedge funds consistently correlate to the S&P 500. On the other hand, Melissinos does not display much correlation to the S&P 500 or hedge funds at all. This may suggest that Melissinos may be better at out-hedging hedge funds during the next bear market.



To further prove that Melissinos does not classify as a hedge fund, below we show how little we correlate to popular hedge fund strategies.

Correlation: Hedge Funds vs. Melissinos

Strategy	Correlation vs. Melissinos
Convertible Arbitrage	-0.19
Distressed Securities	-0.25
Equity L/S	-0.18
Market Neutral	0.01
Event Driven	-0.24
Global Macro	0.23
Multi Strategy	-0.08
Emerging Mkts	-0.18
Fixed Income Arb	-0.17

To sum up, hedge funds regularly fail to protect capital when portfolios need it most. They do not diversify a traditional portfolio very well, but appear to execute a similar strategy as the S&P 500. In order to achieve meaningful diversification and protect against stock and bond market losses, one may consider looking at incorporating non-correlated adaptive strategies like Melissinos into their portfolio.

Mel's Role in Your Portfolio

Melissinos, as a stand-alone investment, offers a truly diversified and adaptive approach that cannot be found in many other investments including hedge funds.

We can provide portfolios with reliable non-correlation. Our strategy improves upon traditional strategies by expanding the portfolio to include all available markets (not just stocks and bonds), adapting to ever-changing market trends and managing risk as volatility expands and contracts.

In conclusion, Melissinos can serve a portfolio by increasing its returns while lowering its volatility and losses.

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