Transforming Beta into Alpha

By Michael Melissinos

Introduction

In the following article, I explain why our firm's Eupatrid Global Trends (EGT) strategy favors an adaptive trend following approach over analyzing fundamentals and buy-and-hold.

Beta is random and unpredictable. Many investors prefer trying to find the next big thing, putting a lot of money into it and holding for a long time. Consistently picking winners is nearly impossible to do over the long run. Compound this shoddy practice with the popular non-adaptive buy-and-hold approach and you get a mediocre investing strategy.

Buying and holding a market or stock is a very inefficient way of compounding wealth over time. Many markets and stocks regularly experience significant drawdowns both in terms of size and length. We've even seen many stocks go to zero. Holding through substantial downtrends and flat periods drains capital and incurs massive opportunity costs.

Sobering buy-and-hold stats since the 1980's:
1) *~40% of stocks produced a negative return*
2) *~20% of stocks declined 75%*
3) *~67% of stocks underperformed the index*
4) *~25% of stocks accounted for all of the index's gains*

A buy-and-holder needs superhuman patience and fortitude (not to mention luck) to achieve positive performance over the long run. Gold topped out in 1980, fell 70% then took 30 years to make new highs. As recently as April 2020, Crude Oil was ~90% below its 2008 highs. Never mind individual stocks, stock indices themselves have experienced 80-90% losses at times over the past 100 years. Does sitting through drawdowns like this make sense? We don't think so.

We think there's a better way.

We believe an adaptive approach, one that systematically finds strong markets and positions with the prevailing trends with proper risk control, presents a much more efficient way of investing. Our EGT strategy does exactly this. It doesn't have preconceived notions about the markets or consider the fundamentals, which are often wrong or irrelevant to making money. It considers only the trend. It buys strong markets and sells weak markets. It does so in a repeatable systematic manner that greatly improves the odds of long-term success.

By the end of this article, I hope to shed light on the inefficiency of analyzing fundamentals, buy-and-hold and non-systematic investing as well as the benefits of employing an adaptive systematic approach like EGT.

Why the Buy-and-Hold Approach Doesn't Work

Buy-and-hold is not a system. It's built on hope, randomness and luck. Most buy-and-holders cannot explain how they handle two critical components of investing — how to choose which markets to invest in and when to get in and out of them.

On top of that, buy-and-hold adapts too slowly — or not at all. Belief, trust and faith drive most of the investing decisions. These characteristics come in handy when losses occur. Instead of facing the music and managing risk, they press on or worse — they double down.

Adapting, especially when you're wrong or don't want to, is critical for survival. It's a superhero skill. Many investors don't have it. They don't like to admit they're wrong and would rather hold out hope they'll eventually be right. After all, they've been telling themselves (and friends) for a long time that their stock was a surefire winner. They can't lose face. They must stand, fight and even go down with the ship. That's the honorable thing to do.

Some of the main issues with buy-and-hold:

Reliance on initial investments. Whatever a buy-and-holder picks first, they typically keep. Their ego prohibits them from selling. They believe in their picks. When you rely on your initial picks, you inhibit your ability to find new better performing investments.

One loser ruins everything. Many buy-and-hold strategies concentrate into a few investments, so it only takes one big loss to severely damage the portfolio. Think about how many people held tech stocks in 1999 or financials in 2008. I'm sure you even know a few people who lost buckets of money investing in their own company's stock as well. BlackBerry, Ford, Enron, Bear Stearns and Lehman are some recent examples that come to mind.

The strategy is to never get out; just believe and stick with it. That's the problem. It never adapts or respects the market. It believes in the investment's story so much that performance doesn't phase the buy-and-holder — not until it's too late anyway when they just can't take it anymore.

Similar to fundamentalists, buy-and-holders believe investments become more valuable as they decline. There can be periods where this proves true as price dips recoup and eventually make new highs. But it only takes one time for an innocent-looking dip to become a major bear market. That's what eventually kills the buy-and-holder.

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General Electric (GE)
1980 thru 2020

Leaders become laggards quite often in the markets

Opportunity cost. Missing out on opportunities is another major issue. Because buy-and-holders commit too much capital to their few favorite ideas, they cannot afford to take risk on other opportunities that come along. They're too committed to their favorites. Sitting through, what they might call, "temporary setbacks" can easily become years of stagnant (even negative) performance.

Does this make any sense? Are we supposed to sit and wait watching better performing investments pass us by? How long must we wait for proof that our idea was right? Years? Again, this is not an efficient way to invest.

Similar to fundamentalists, buy-and-holders typically choose "good companies" or attractive stories to invest in. Some of the better skilled stock pickers out there may take early positions in eventual high-flyers (recent examples include TSLA, ZM, SHOP), but early success typically serves as a downfall. They get romantic and cannot betray their picks by selling out. They wind up sticking with them for too long after the trend reverses.

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Tesla Inc (TSLA)
2013 thru 2020

"It's a fraud!" The real crime is missing the trend.

The emotional drain of trying to stick with it. Frustration, impatience and despair ultimately break the buy-and-holder. Without a clear portfolio selection methodology, the buy-and-holder eventually makes a few bad picks and sticks with them for too long. A run of a few bad picks effectively puts the buy-and-holder out of commission.

Even some of the best performing assets suffer excruciating losses from time to time. Apple has experienced *12* drawdowns of -20% or more (including five over -50% and three over -70%).

Looking over long-term charts of Apple imaging how much money you could've made doesn't help you. It only reinforces the idea that you need to find the next big thing, make a big bet and stick with it longer next time. In all likelihood, you won't pick the next big thing. Decades of data has proven this. It reinforces the wrong behavior — to concentrate risk, to bet big and stick with it if you believe in it enough. Very dangerous.

If you did, in fact, invest in Apple at some point, can you remember why you sold it? Did you invest too much and were unable to stomach the volatility? Did you lose faith in the story? Did a sexier stock come along? Did you get bored? Why didn't you get back in? I have a hunch that emotions got the best of you. Without a system, we're all susceptible to erratic investing behavior and bound to make mistakes that cost us lots of money.

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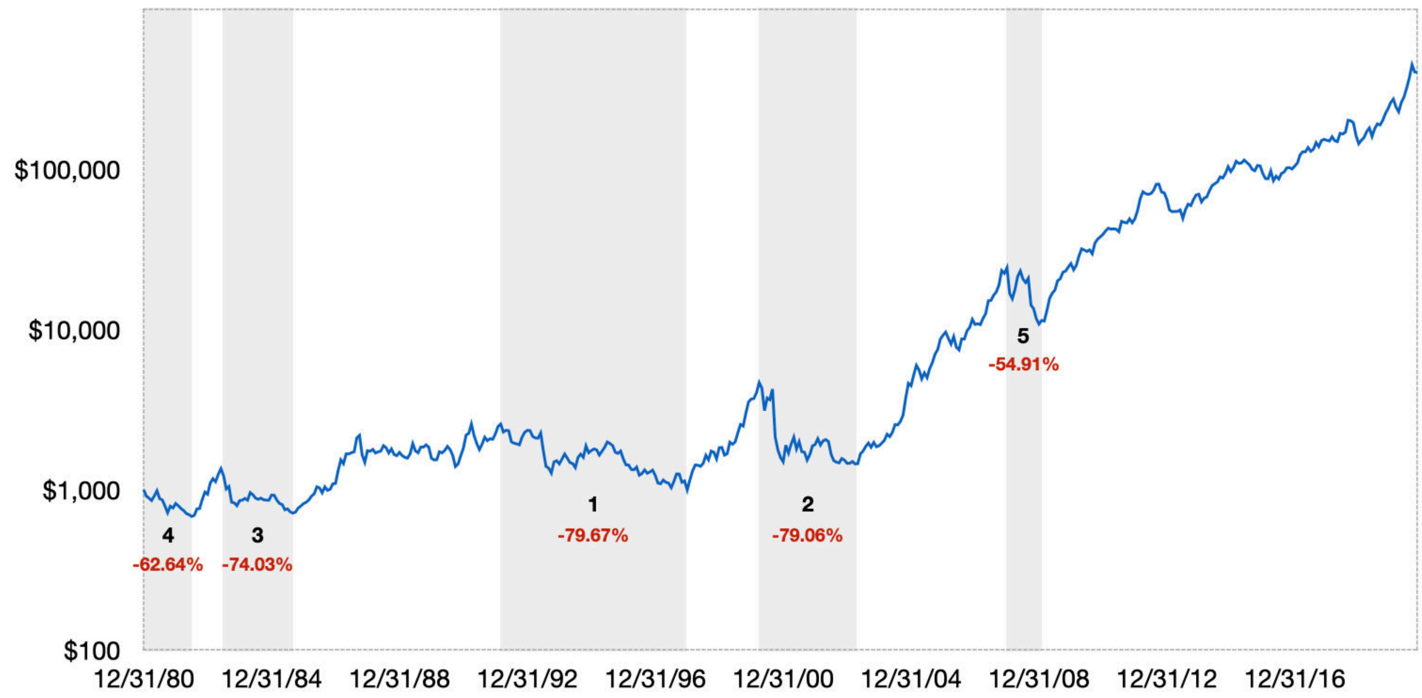
Apple Inc (AAPL)
1980 thru 2020



Top 5 largest drawdowns highlighted above. Logarithmic scale.

A Better Way — An Adaptive Approach

To consistently find and capitalize on big opportunities with proper risk control, an investment strategy must have a clear and consistent process for two key areas:

1) Portfolio Selection
2) Entry and Exit Tactics

What these rules do is systematically watch for, locate and position with trends. They get you on board positive performing investments and keep you out of the laggards. They constantly adapt and recycle capital into more productive assets, thus keeping your portfolio healthy.

At Melissinos Trading, we watch lots of different markets, such as stocks, bonds, real estate, currencies and commodities. We watch all of these because we don't want to miss anything. The combination of portfolio selection and trend following tactics put us in a position to find and ride trends consistently over time. When we see a trend developing, we make a small bet. We hold it if it performs well and get rid of it if it isn't. Simple.

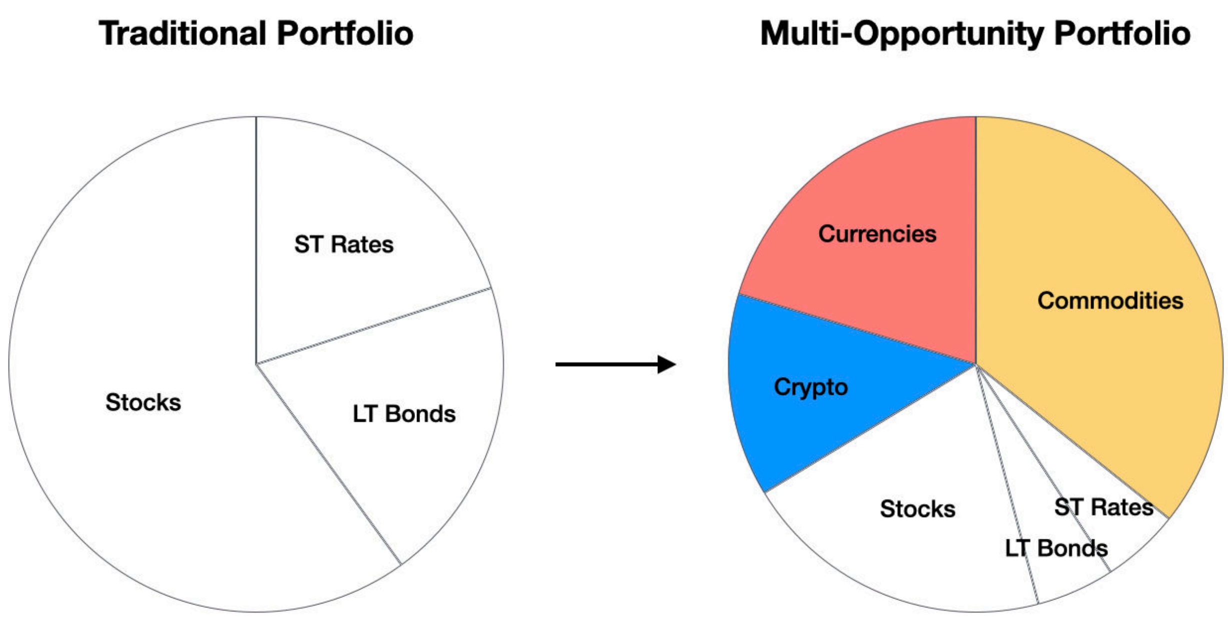
<u>**Portfolio Selection**</u>

Think about the investments in your portfolio right now. Where did they come from? How did you choose them? Did someone else choose them for you? How do you know you're not missing opportunities elsewhere? Are you diversified? Have you run any correlation analysis? Which markets are you tracking right now? Why are you tracking these, in particular?

Every prepared investor has answers to these questions. They're tough questions, but necessary to clarify the investing process.

Our Eupatrid Global Trends (EGT) strategy monitors a massive watchlist of over 100 futures markets and 1,000 stocks. We don't know which markets are going to heat up or cool down, so the more of them we watch, the higher the odds we have of finding a big winner. If and when a trend develops, we locate it and make an investment within our risk budget. EGT's portfolio selection rules make sure we diversify, don't risk too much in any particular investment, sector or asset class. Being slightly overweight is OK. Being obese is not.

Picking one asset class to invest in doesn't make much statistical sense. Let's say professional sports teams only recruited from colleges in close proximity to their stadiums. The idea is so foolish that no one would even take it seriously. If teams did that, they'd be missing out on lots of talent from other areas — and lose lots of games. Same idea in investing: if you only invest in one area, you miss out on opportunities in others.



Entry and Exit Tactics

To profit from trends, everyone needs to buy and sell within the direction of the trend. For a trend follower like us, that means buying high and rising prices and selling low and falling prices. Investors who regularly miss out on big trends often take the opposite approach — buying low and selling high. This is a popular approach because humans love the feeling of being right and smart, but it comes at a steep cost.

I believe there are two main reasons why investors miss trends:

1) They wait to buy low on a retracement that never occurs
2) They sell too early when the price gets "too high"

Buying into the momentum is how you capture the big trends. You don't let them run away without you on board. This is a major risk of fundamental investing and for buy-and-holders using a fundamentalist entry/exit approach. When you buy low, you may set your entry point too low and it never gets hit. Instead, it dips a bit (or not at all) and runs away to new highs and beyond — without you.

At Melissinos Trading, we buy into uptrends and sell into downtrends. We have rules that define the trend to be up or down. When we get signals that a new uptrend is forming, we buy. When we get signals that the trend is stalling out and reversing, we sell. Through trend following, we accomplish two things: capturing trends and protecting capital.

All-time highs to out of business within 15 months

A systematic process for portfolio selection and entering/exiting investments is how you improve upon the randomized fundamentalist and buy-and-hold approach. This is how to proactively address FOMO. If you don't want to miss out, then you cannot throw darts at a board, expect to hit the next big thing and hope you'll have the stomach to sit through the inevitable volatility. Without a rules-based strategy, one you've tested and have confidence in, expect random (and mostly negative) investing results. Banking on luck doesn't work.

We Can Do Better than Index Funds

Index funds are investing systems. The S&P 500, for example, has rules for portfolio selection, weighting and positioning. I believe investing in index funds present a better option than the other two I've spoken so negatively about in this paper. However, I think they have major flaws and historical performance supports that.

For one, indexes are too concentrated. They typically only track one asset class and often only a small sub-set of an asset class. Investing in one index can be very risky. To combat this, many investors may elect to invest in multiple indexes — large cap, small cap, international and emerging markets for example. There's still a big problem though.

Most index funds are highly correlated to one another. They trade similar assets (usually stocks or bonds), thus not providing much diversification. Whether you invest in one or eight, it doesn't really matter. You're getting exposure to similar performing products. They may have different and clever names, such as Large Cap Growth, Core Opportunities, Focused Growth and Equity Select, etc but when you run the date, they behave similarly.

Correlation Matrix of Global Equities Indices
2005 thru 2020

	S&P 500	NASDAQ	DJIA	Euro Stoxx	FTSE 100 (UK)	DAX (Germany)	Nikkei	Emerging Mkt Index	S&P 60 (Canada)	SPI 200 (Australia)
S&P 500										
Nasdaq	92%									
DJIA	97%	88%								
Euro Stoxx	88%	79%	86%							
FTSE 100 (UK)	87%	77%	85%	94%						
DAX (Germany)	84%	77%	83%	95%	88%					
Nikkei	77%	71%	76%	77%	75%	75%				
Emerging Mkt Index	85%	80%	83%	85%	84%	82%	76%			
S&P 60 (Canada)	81%	72%	78%	81%	81%	77%	66%	79%		
SPI 200 (Australia)	83%	74%	81%	84%	83%	80%	72%	83%	80%	

Another big issue is that index funds never reduce risk. They just shuffle it around. In environments where correlations increase, it doesn't really matter where you shuffle risk because you lose when all of the components decline. Indexes could benefit from an adaptive trend following rule to eliminate or drastically reduce risk when prices begin declining. Shifting risk to assets that are declining less is OK, but it's not the optimal solution. We can do better.

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Nikkei index Futures

1986 thru 2020

The Japanese understand the benefits of Trend Following better than most

Many index funds produce poor risk-adjusted returns over time. The S&P 500 has a history of ~8% returns and 50% drawdowns. That's a MAR of 0.16. As a comparison, many diversified adaptive trend following strategies generally produce MARs of 0.30-0.80. Other U.S. indices have experienced worse drawdowns (e.g. NASDAQ -77% in 2002 or the DJIA -89% in 1932). Many foreign indices are currently experiencing lost decades. This has happened in the U.S. several times as well (most recently from 2000-2013) and it's likely to happen again.

Historical Performance of Global Equities Indices

2005 thru 2020

	Start Date	CAGR	Max Loss	Annual Volatility	MAR (CAGR/MaxLoss)	Sharpe
S&P 500	Feb-1950	7.77%	-52.56%	14.23%	0.15	0.55
Nasdaq	Feb-1971	9.95%	-77.04%	20.79%	0.13	0.48
DJIA	Feb-1985	8.95%	-49.30%	15.00%	0.18	0.60
Euro Stoxx	Jun-1998	3.74%	-59.72%	17.59%	0.06	0.21
FTSE 100 (UK)	May-1984	3.71%	-72.76%	20.31%	0.05	0.18
DAX (Germany)	Nov-1990	3.52%	-61.78%	16.62%	0.06	0.21
Nikkei	Sep-1986	0.15%	-89.60%	26.09%	0.00	0.01
Emerging Markets	Apr-1993	10.06%	-60.43%	21.95%	0.17	0.46
S&P 60 (Canada)	Sep-1999	5.48%	-63.95%	18.68%	0.09	0.29
SPI 200 (Australia)	Feb-1983	4.32%	-59.38%	15.67%	0.07	0.28
Average	—	**5.77%**	**-64.65%**	**18.69%**	**0.10**	**0.33**

To sum up, I believe index funds represent a better strategy than random stock picking with fundamentalist and buy-and-hold tendencies (what most investors do). However, index funds are very concentrated and risky. Their returns relative to their volatility and loss potential is pretty terrible. We believe we can improve upon the index fund approach by investing in all asset classes (not just one or two) as well as implementing clear rules for portfolio selection, entries/exits and risk management.

A Quick Note on "Stock Picking"

I don't want to go off on a rant here, but I'd like to point out that there are many investment managers who portray themselves as stock pickers. They typically analyze fundamentals to make their picks and make a big investment in a particular stock. Sine even talk it up in the media. People mistakingly assume that the managers hold it forever. This is simply not true.

The best stock pickers, and investors in general, manage risk and cut losses quickly. If a manager's well-publicized stock pick falters, guess what they do? They sell it. They manage risk. They don't let their ego get in the way. They care more about survival than they do about their picks and saving face.

if you observe the investing activity of popular "stock pickers", they routinely hold well-known names, especially ones that represent large weightings in index funds. Their success isn't reliant on finding diamonds in the rough, but on riding trends and allocating properly. Less of their success comes from their hidden gem picks, but more from investing in the strongest trends and risk management.

The best investors in the world have a low win rate. They only make money on a small fraction of their positions, but because their average winner is much higher than their average loser they win over the long run. They accomplish this by holding onto their winners and cutting their losers.

They adapt! This is what we do at Melissinos Trading. The only thing we do differently is that we systematize the process of portfolio selection, investment timing and risk management. We don't incorporate gut and feel into the process. Fundamentalists buy instruments with strong underlying financials (and stories) while we buy those with favorable underlying conditions such as momentum, correlation, liquidity and volatility. Last thing: if you go with the trend, ride winners, cut losers and manage risk then how you do it doesn't really matter.

About the Author

Michael Melissinos | Founder & CEO — In January 2011, four partners contributed a total of $300,000 to help Michael launch his investment management career. Since day one, he has assumed research and trading responsibilities. In addition to researching markets and ways to improve the firm's investing strategy, he also works on his emotional and mental game through the help of his local Trading Tribe. The Tribe helps him maintain discipline through tough performance periods, remain inventive and always push the envelope of improving the firm's investing and marketing strategy. He previously held positions at Rothstein Kass, Bear Stearns and JP Morgan. He graduated with a BS in accounting from Seton Hall University. He currently splits his time between New York City and the Jersey Shore with his wife Marisa.

About Melissinos Trading

Melissinos Trading is an investment firm with the intention to produce consistent attractive returns by capitalizing on trends in all asset classes (stocks, bonds, currencies, crypto and commodities).

The firm trades a widely diverse portfolio utilizing trend following techniques with robust risk controls in a systematic manner. The firm's portfolio is managed by Michael Melissinos.

Today, the firm manages funds for high net worth individuals, entrepreneurs, local business owners and family offices. The firm was founded in 2011.

MELISSINOS TRADING

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The data sources for the Correlation Matrix and Historical Performance graphs derive from futures contracts.