A Tale of Three Strategies

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A Tale of Three Strategies

- An experienced and patient investor identified what appeared to be three attractive long-term investment strategies
- Each strategy had a different approach and the investor was not sure which one might prove to be the best over time
- To test them, the investor put an equal amount of money into each strategy and color-coded them Red, Blue and Green

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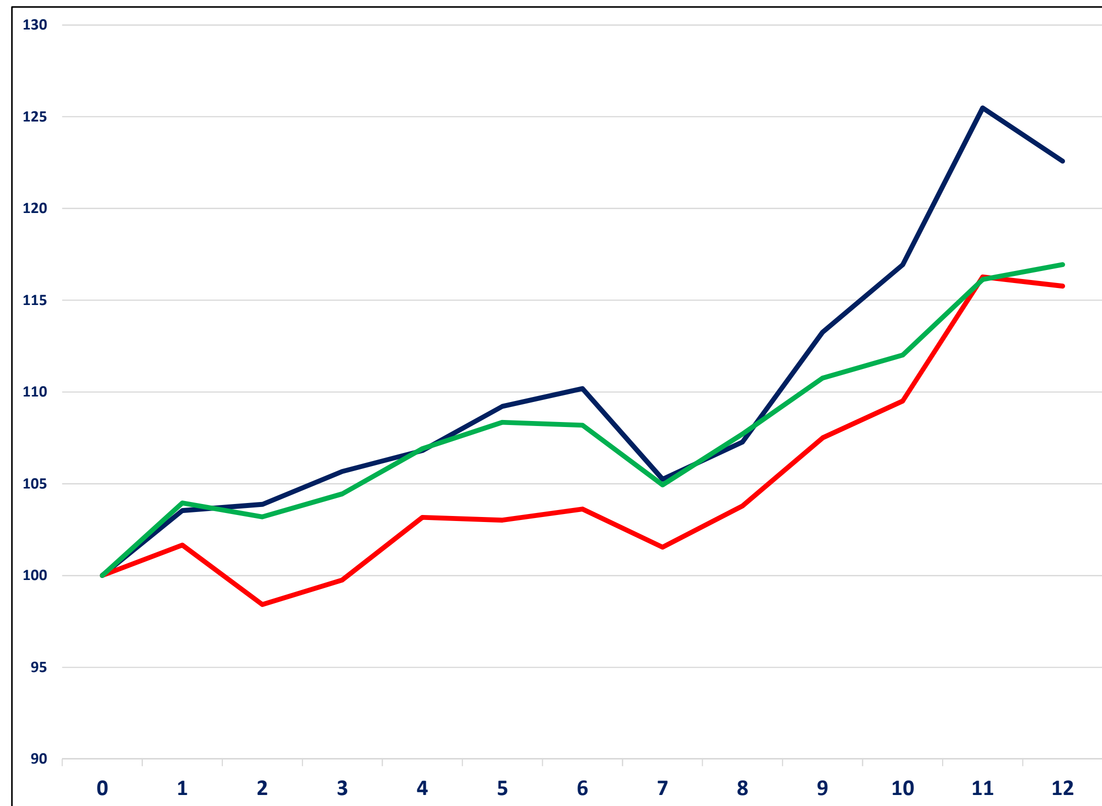
A Tale of Three Strategies – Year 1

At the end of the first year, Blue was up 23% while Red and Green were higher by 16% and 17%, respectively. Good results for all three and not enough time to clearly differentiate between the three strategies.



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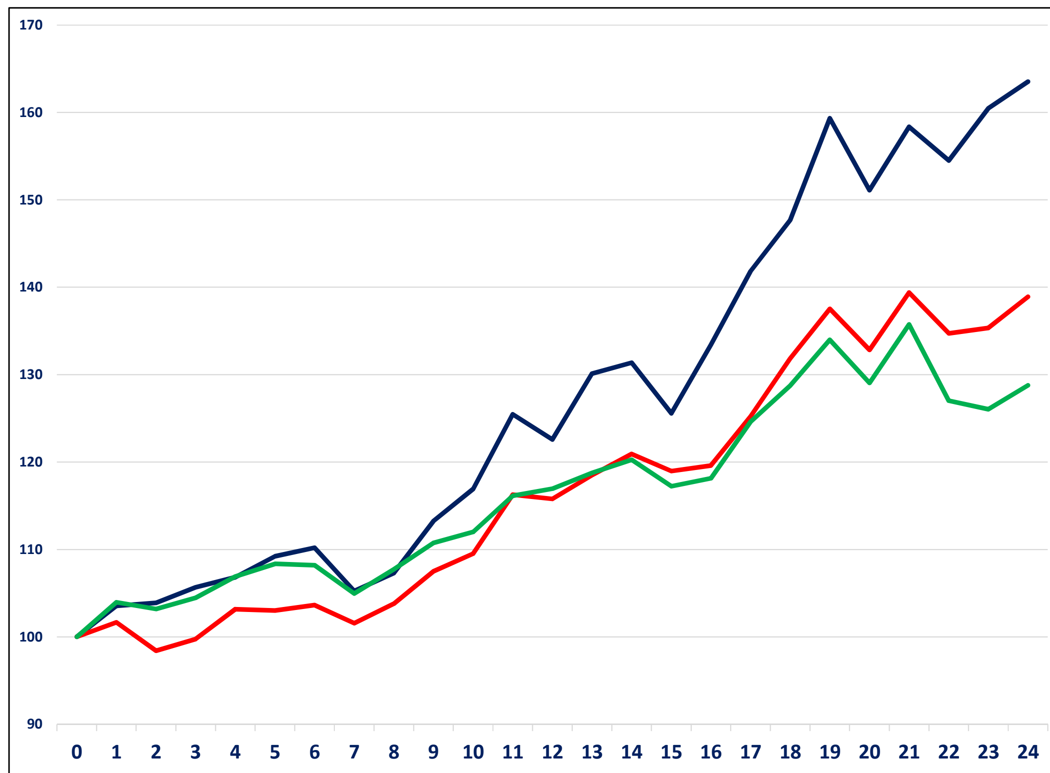
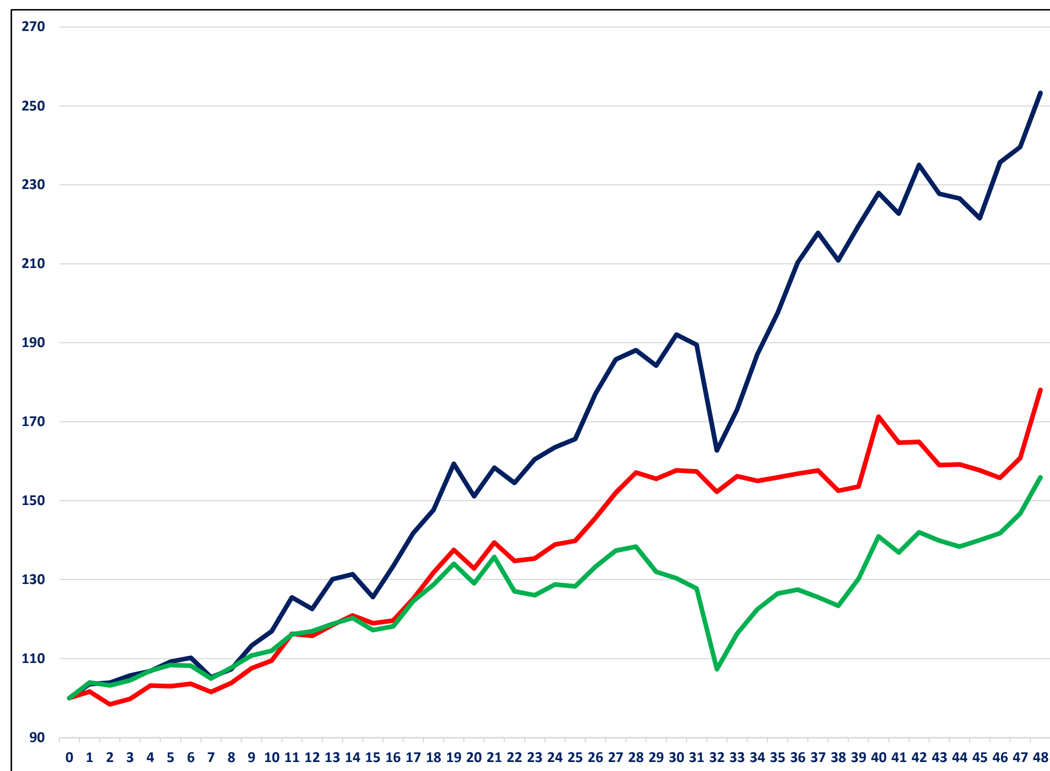
A Tale of Three Strategies – Year 2

At the end of year two, Blue was up a total of 64% while Red and Green reached 39% and 29%. All three were doing well, but Blue was clearly doing something different. Our investor was starting to think that Blue might be the better way to go but recognized that two years was still too short a time to draw any final conclusions.



A Tale of Three Strategies – Year 4

While our investor was patient, four years into the test it seemed clear that Blue was a distinctly superior strategy having more than doubled the original investment. The Blue position was worth 42% more than Red and 62% more than Green. ***What reason could there be to stick with Red and Green after they lagged so badly over a four-year period?***



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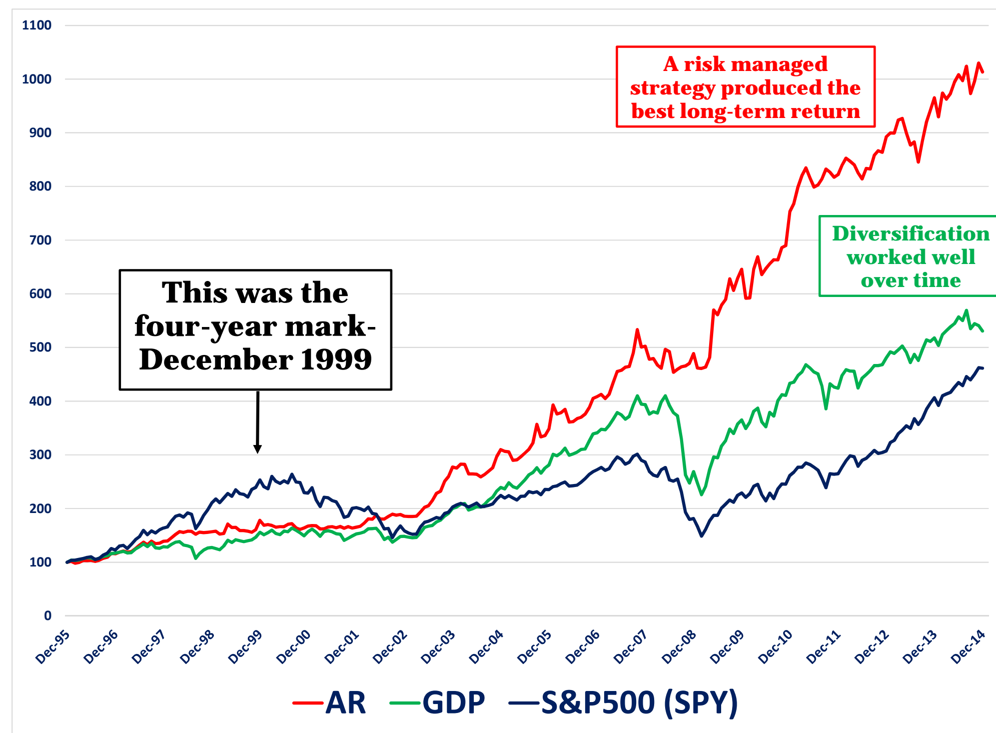
A Tale of Three Strategies – *Year 19*

The reason not to bet it all on Blue is that even four years can be too short a period to judge investment strategies. In this case, the initial four years was a bull phase from Jan 96 to Dec 99, Blue was the S&P 500, Green was the Global Diversified Portfolio we track, and Red was the LongRun Absolute Return strategy. Over the ***19 years*** through December 2014, AR grew 10x, GDP 5.3x and the S&P500 was up 4.6x. For AR, patience and discipline would have paid off handsomely.



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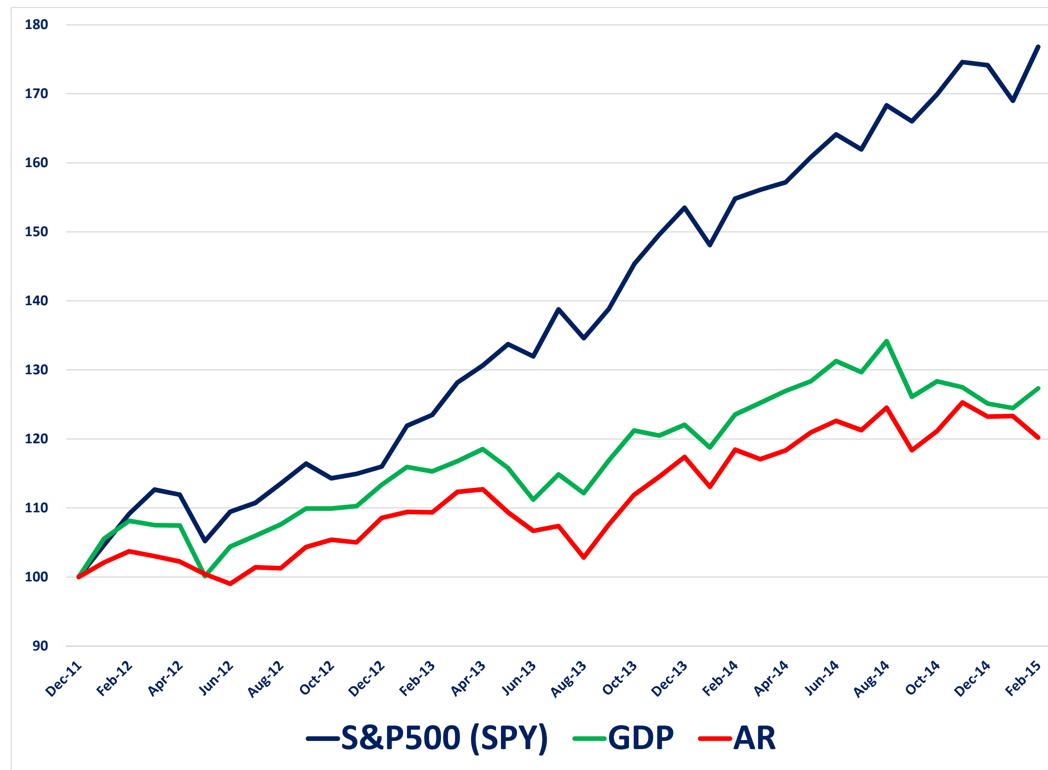
Does This Look Familiar?

After the 20% correction in the Fall of 2011, US equities have outperformed again, with the S&P 500 almost doubling since the start of 2012. Diversification (Global Diversified) and risk management (AR) have shown positive returns but look ugly by comparison. No one knows if history will repeat itself, but anyone betting on Blue needs a solid exit strategy.



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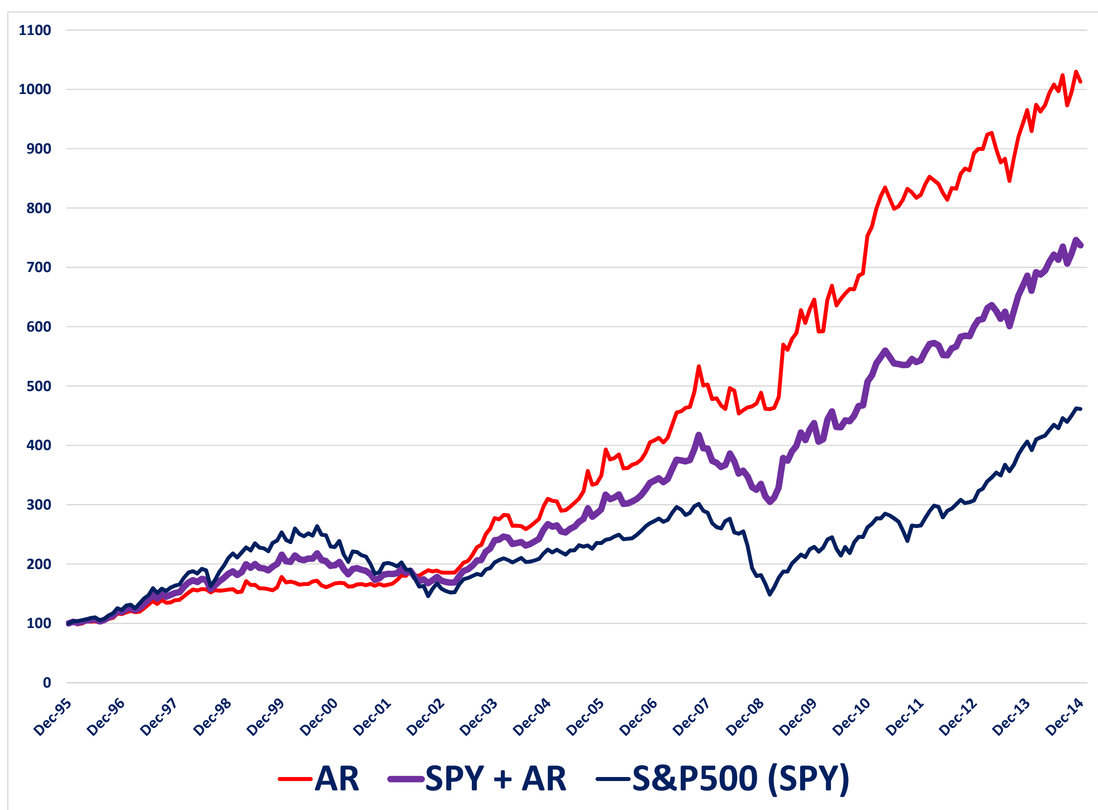
What To Do About It (#1)

Based on the evidence, one approach is to combine an investment in the S&P 500 with one in the LongRun Absolute Return strategy. No surprise that a 50/50 blend of the two (Purple) splits the difference – better than the S&P 500 but not as good as Absolute Return over the 19 year lookback.



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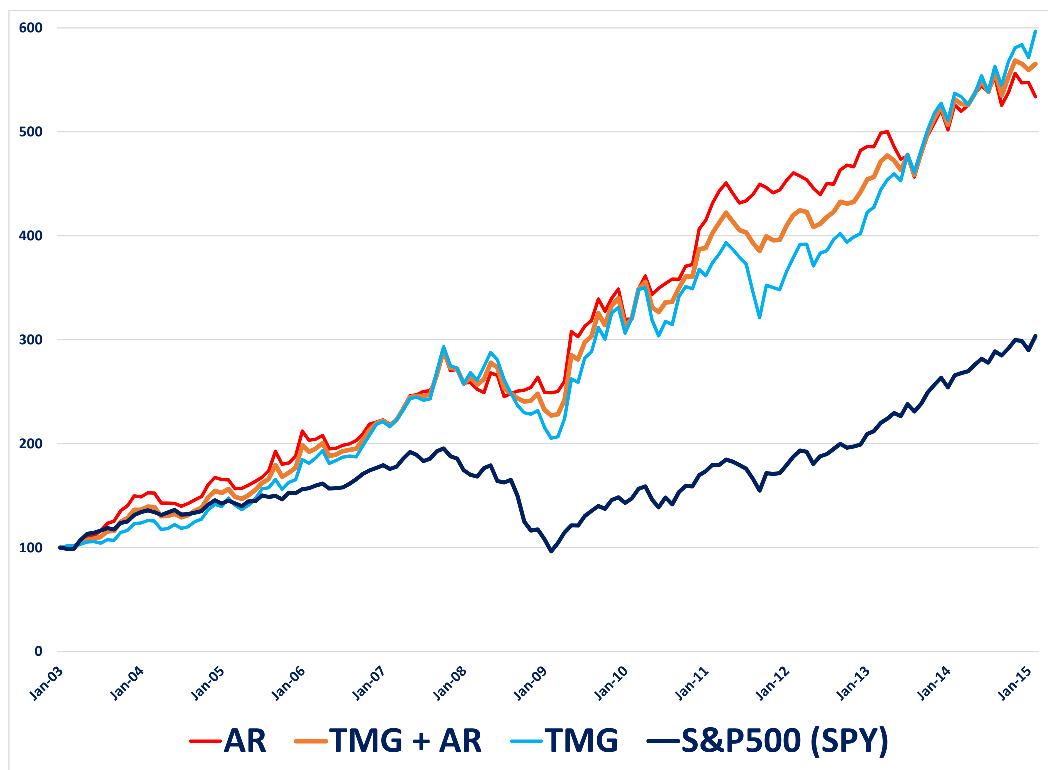
What To Do About It (#2a)

Another approach is to combine Absolute Return with the LongRun Tax Managed Growth strategy. Research on TMG only goes back to 2003, but has shown outperformance vs. the S&P 500. TMG +AR (Orange) demonstrated great returns over this period with another advantage you'll see on the next slide.



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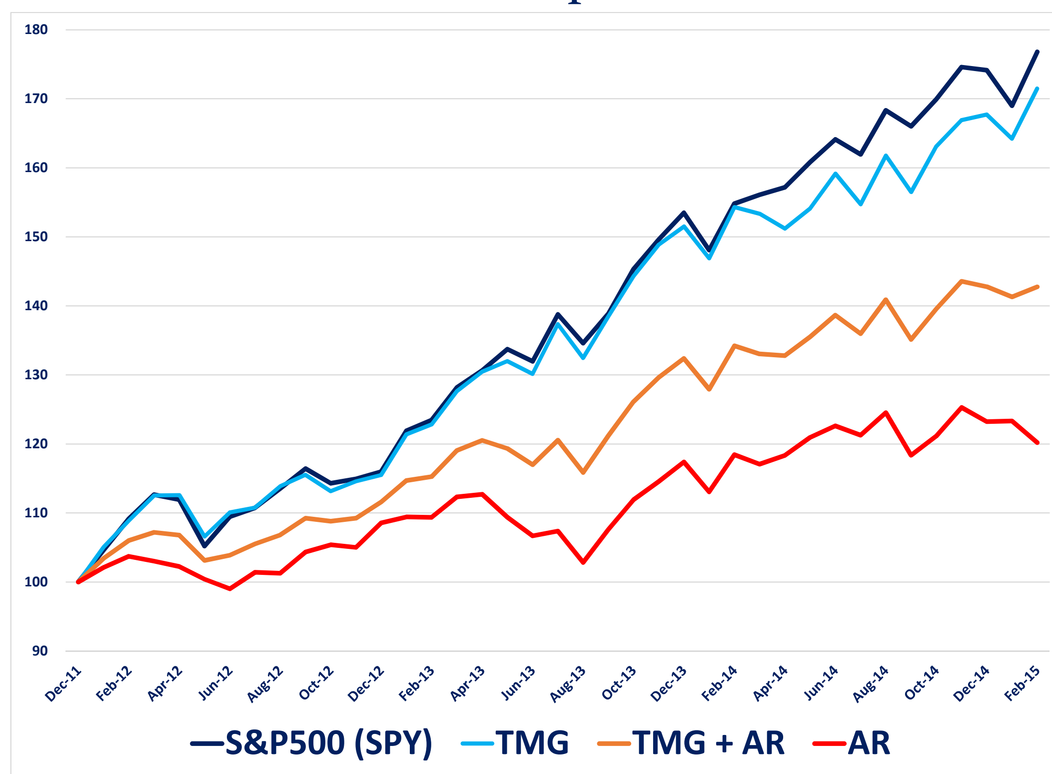
What To Do About It (#2b)

In addition to showing outperformance versus the S&P 500 over a longer period, TMG has closely tracked SPY in the bull phase since the start of 2012. Combining TMG with AR (50/50 shown here) improves bull market performance while retaining some of AR's downside protection whenever the broader market enters its next bear phase.



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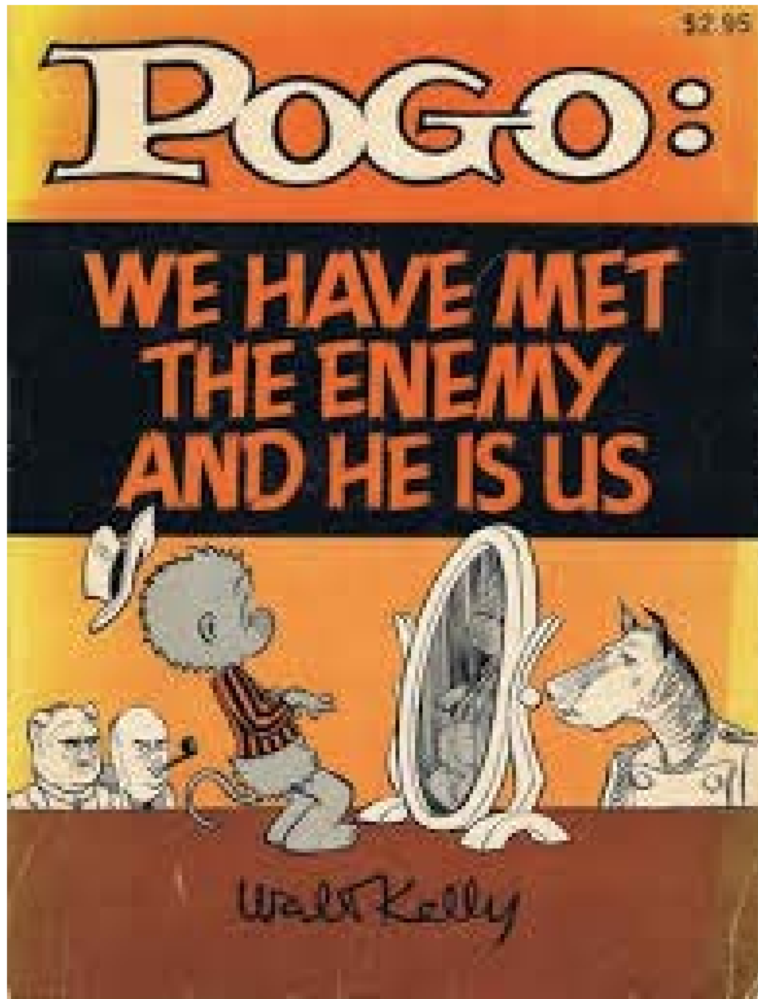
The Moral of the Story – Part 1



- Most investors are heavily influenced by recency bias – the tendency to believe that prominent patterns will extend into the future (e.g., that S&P 500 outperformance will continue)
- However, even "experts" have an extremely poor track record at making accurate predictions
- In addition, professional investors have "career risk" when a strategy underperforms and may change their approach to avoid being fired
- Many investors make poor decisions that damage investment results

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The Moral of the Story – Part 2

- Markets operate over long timeframes and don’t care about your individual time horizon
- Time-tested principles like diversification can be made to look like stupid strategies over multi-year periods; the same holds for active strategies
- No single strategy will give investors all of the upside in a bull market while also eliminating the downside in a bear market
- Many investors (perhaps most) don’t have the patience and confidence to stick with a strategy during extended periods of underperformance (even if returns are positive but trail a prominent benchmark)
- It’s easy to view relative underperformance as proof that a strategy is “broken” and needs to be replaced with one that “works”
- ***Concerned investors would be well-served to combine different strategies to reduce periodic performance envy and thereby increase the odds of maintaining discipline and meeting objectives***

Important Disclosures

- **Strategies:** Absolute Return ("AR") and Tax-Managed Growth ("TMG" and, together, the "Strategies") are rules-based tactical allocation strategies developed by LongRun Capital based on a quantitative methodology known as relative strength. Relative strength involves ranking a selected universe of potential investments based primarily on recent rate of return and then allocating a portfolio to a subset of investments at the top of the performance ranking. For purposes of this presentation, AR is a combination of the original strategy introduced in 2011 and ARv2 introduced in August 2013. Backtest results represent the original AR strategy starting in January 1996 through its introduction in January 2011. The results shown for AR from 2003 through 2014 are also a combination of original AR and ARv2, resulting in returns lower than those shown in backtests of ARv2 for the same period. Original AR used a universe of 14 ETFs, ARv2 uses a universe of 33 ETFs and TMG uses a universe of 36 ETFs. AR and TMG incorporate rules designed to be defensive in adverse market conditions. These defensive rules may result in AR and TMG periodically holding as much as 100% in cash. Rankings are reviewed monthly for AR and holdings turn over frequently. TMG employs a slower moving methodology and changes are significantly less frequent.
- **ETF universe:** The ETFs used for the Strategies were selected as representative of the global equity and fixed income asset classes that would commonly be used to construct a prudently diversified portfolio. Each ETF universe will be held constant unless one or more cease trading, in which case we will seek to use a reasonable substitute representing the same asset class. In addition, we may occasionally substitute an equivalent ETF as part of a tax loss harvesting strategy or to reduce transaction expenses. Clients will incur direct expenses associated with the purchase and sale of ETFs as well as the indirect expenses associated with management of the ETFs by their sponsors (e.g. iShares).
- **Global Diversified Portfolio (GDP):** The S&P 500 is a benchmark commonly used as a proxy for the US equity market. To represent a more diversified portfolio, we developed GDP to measure the aggregate performance of the 14 ETFs used for the original Absolute Return strategy. GDP assigns an equal weighting to each of the 14 ETFs and rebalances those weightings each month. The resulting portfolio is approximately 70% equity and 30% fixed income with approximately 40% allocated to US equities and 30% allocated to international equities.
- **Backtest:** LongRun Capital constructed backtests for each of the Strategies designed to replicate historical performance based on the selection rules and security universe of the particular strategy. In the case of original AR, this involved using a combination of the selected ETFs and mutual funds representing the same asset classes for time periods prior to the inception of the ETFs currently being used. The rule-sets used to determine the holdings of the Strategies were applied consistently for the entire backtest period. As a result, there was no manager discretion involved in portfolio management. Backtest returns reflect the deduction of a 1% per annum management fee and an expense ratio of 0.15% per annum designed to approximate the transaction expenses associated with implementation of the Strategies. Underlying data has been obtained from sources believed to be reliable and we are not responsible for errors or omissions. The results achieved in actual accounts may vary from those that would be indicated from backtest results. Details of the backtest research are available upon request. Backtest performance of the strategies provides no guarantee of future results.
- **Composite Results:** LongRun Capital is an independent investment advisory firm that manages assets on a discretionary basis. Clients may elect to have their assets managed on a customized basis and may utilize the Strategies for some or all of their portfolio managed by LongRun Capital. Unaudited composites for each of the Strategies are maintained by LongRun Capital and returns are presented net of actual investment management fees and transaction expenses. LongRun Capital's top management fee tier is 1% per annum. Internal fees and expenses associated with the ETFs are reflected in the price of each ETF. Dividends, income and capital gains are reinvested when allocation changes are made. Past performance is no guarantee of future results. Information regarding LongRun Capital's management fees and the value of assets included in the composite results is available upon request. In addition, LongRun Capital's disclosure document, Form ADV Part 2A, is available online at www.adviserinfo.sec.gov or upon request.