

Diversifying your portfolio to weather market 'down days'

October 2018 – Patrick Hodgens, Managing Director & Portfolio Manager

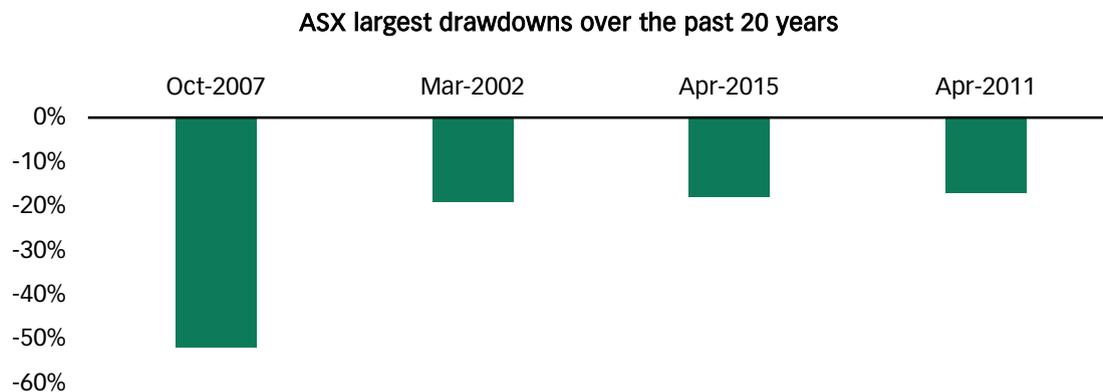
Investors received a timely reminder yesterday that equity markets do not always rise. For only the second time this year the Australian equity market fell by more than 2% in a day, returning -2.7%. The only larger daily decline this year occurred on February 6 when the market fell -3.2%.

During the week the market has fallen -5%, whilst the Firetrail Absolute Return Strategy has delivered positive returns of 1.2%, outperforming the market by over +6%. When uncertainty and volatility begin to show themselves, adding a market neutral strategy to your portfolio can be a good way to diversify your returns to weather a market downturn.

With markets at all-time highs, we believe now is the time to add an uncorrelated source of returns like the Firetrail Absolute Return strategy to your investment portfolio.

The largest drawdowns over the past 20 years

Equity markets can be volatile. Despite being a great investment over the long term, there have been significant drawdowns as highlighted in the chart below.



Source: Bloomberg

The largest drawdown was the Global Financial Crisis (GFC) when the Australian market fell over 50%. These significant falls can have a severe impact on your portfolio's returns and can take a long time to recover from. The market took over five and a half years to recover from the lows of the GFC.

The key question investors may be asking is how do I avoid these significant market drawdowns?

Some investors try to time the market and move between equities and cash. However, in over 30 years investing in equity markets I am yet to come across an investor who can time the market with the accuracy and consistency required to add value.

One of the great investors of our time Peter Lynch sums market timing up wisely, "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections."

Diversifying your portfolio to weather market 'down days'

Rather than trying to anticipate the next market downturn, a far more prudent approach is to mix in a portfolio of uncorrelated assets that can weather different market environments. Adding alternative investments to a diversified portfolio is also a good way to hedge your portfolio's exposure to equities and provide an alternative source of returns.

In our experience managing market-neutral strategies, you can diversify your portfolio for the 'down days' by adding alternative strategies to your portfolio that mitigate two key risks prevalent in equity market investing:

1. **Market risk** - Reducing your portfolios net market exposure to zero at all times ensures portfolio returns are not affected by market movements
2. **Macroeconomic risk** - Reducing your exposure to unpredictable macroeconomic risks such as interest rate movements, currency fluctuations or political decisions is key to reducing the volatility of your portfolio's returns. Whether and when the China/US trade war is resolved or predicting interest rate rises are binary bets that can either

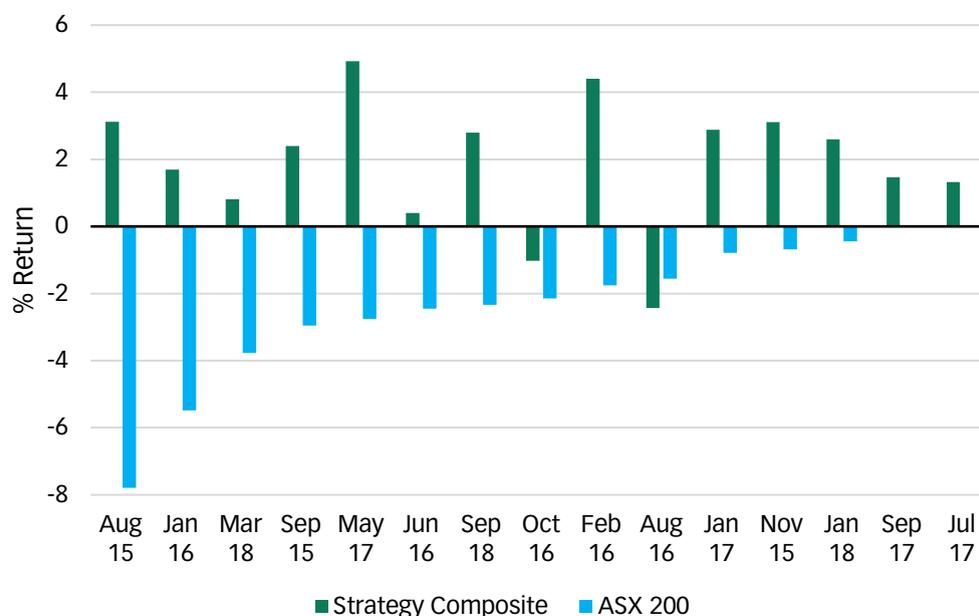
significantly amplify or reduce portfolio returns. In our view, you need to reduce your exposure to these key risks and focus on investing in companies from a fundamental perspective, rather than unpredictable macroeconomic themes.

An alternative investment from Firetrail

The Firetrail Absolute Return Strategy is a market-neutral, alternative investment strategy that invests in Australian shares but hedges its exposure to the underlying share market, with a portfolio of short positions that are equal to its long positions. It is designed to deliver returns that are uncorrelated to, or independent from, movements in the underlying share market.

The portfolio has a history of delivering uncorrelated returns, particularly during market drawdowns. As the chart below highlights, during the strategy's full history, there have been 15 monthly market drawdowns shown in blue. Of these, the strategy (in green) has only has two drawdowns where the market was also negative. It is a true alternative source of returns uncorrelated to the underlying share market.

ASX 200 Monthly Drawdowns vs Firetrail Absolute Return Strategy Composite Returns



Past Performance is not a reliable indicator of future returns

Source: *Composite returns using Macquarie Pure Alpha Fund returns. Pro-rata adjusted to apply to current management fee of 1.5% to the performance history since July 2015. Combined with Firetrail Absolute Return Fund returns since inception on 14 March 2018. The Firetrail Absolute Return Fund employs the same investment approach as was used by the same investment team that managed the Macquarie Pure Alpha Fund until October 2017.

In a market that has fallen over -5% in a week, the Firetrail Absolute Return Strategy has delivered positive returns of +1.2%, outperforming the market by over +6%. Over the past week we have benefited from a focus on fundamentals with long positions in defensive companies Amcor Limited, Northern Star and Woolworths which have all outperformed relative to the market. Importantly, the short portfolio has provided significant downside protection, delivering +0.3% of the total 1.2% outperformance during the week.

Conclusion – Now is the time to diversify your portfolio

It can sometimes take a timely market correction to remind investors of the benefits of diversifying your portfolio. In particular, if you are looking to hedge some of your equity market exposure risk, the Firetrail Absolute Return strategy is an alternative investment strategy that stays truly market-neutral. Providing returns that are independent of the underlying share market and reducing your portfolio's exposure to unpredictable macroeconomic risk.

With markets at all-time highs, and uncertainty and volatility beginning to show, we believe now is the time to add an uncorrelated source of returns like the Firetrail Absolute Return strategy to your investment portfolio.

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