RPM EDUCATIONAL
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Reflections on Q1 2018

RPM investments
DIFFERENT MOVES.

REFLECTIONS ON Q1 2018

Key point: Market action in early February and the effects on CTA returns caused some consternation in the investor community. In this RPM Educational we want to summarize what happened in the run-up to and during the event, how CTAs responded, and if this was within expectations.

WHAT HAPPENED?

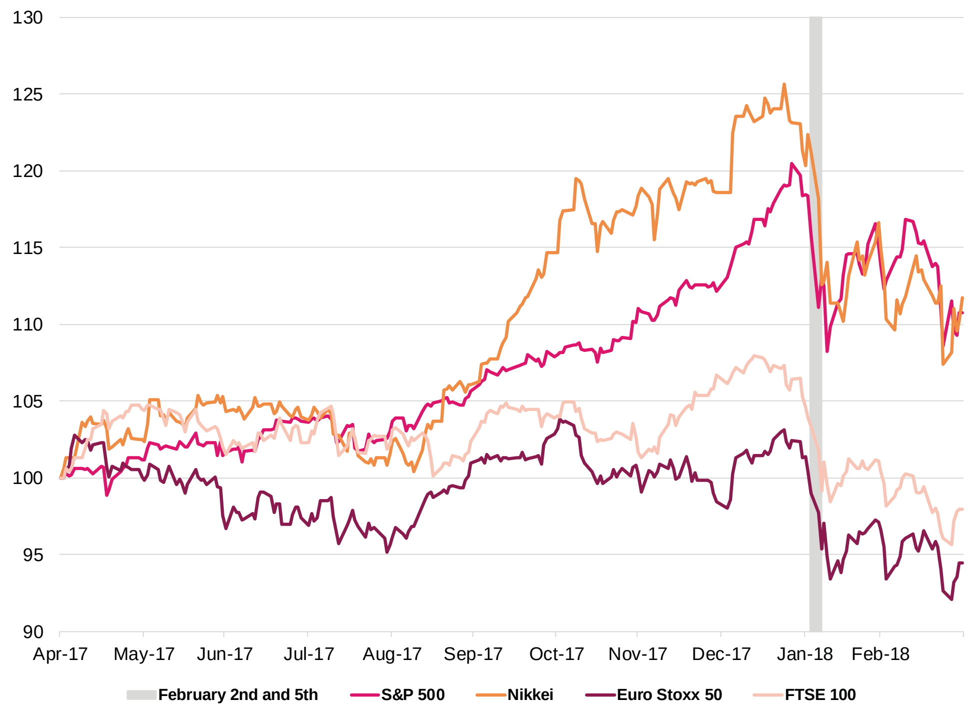
In January 2018, broad-based market trendiness made an impressive comeback, reaching levels not seen since the second half of 2014. Trends were fueled by strong US data, rising energy prices, and less political uncertainty in Germany and in the US.

Going into February, the CTA industry and RPM's funds had enjoyed strong returns on the back of these broad trends not only in equities but in energy and bonds as well. Portfolio risks were at normal levels, including diversified VaR and stress risks. General market volatility and overall correlations remained very low. The portfolios were generally long US, EU and Australian equities, short US and EU bonds, long energy and short the USD. Managers had started reducing positions across the board in the wake of declining trends in the last few days of January.

On Friday Feb 2nd, stock markets tumbled amid an accelerated bond sell-off after strong wage growth data heightened speculations that the Fed would raise interest rates more aggressively than expected. The S&P suffered the biggest daily fall since September 2016; the dollar found some support from the rise in yields, but commodities priced in USD suffered hefty losses.

FIGURE 1 - MAIN EQUITY INDICES

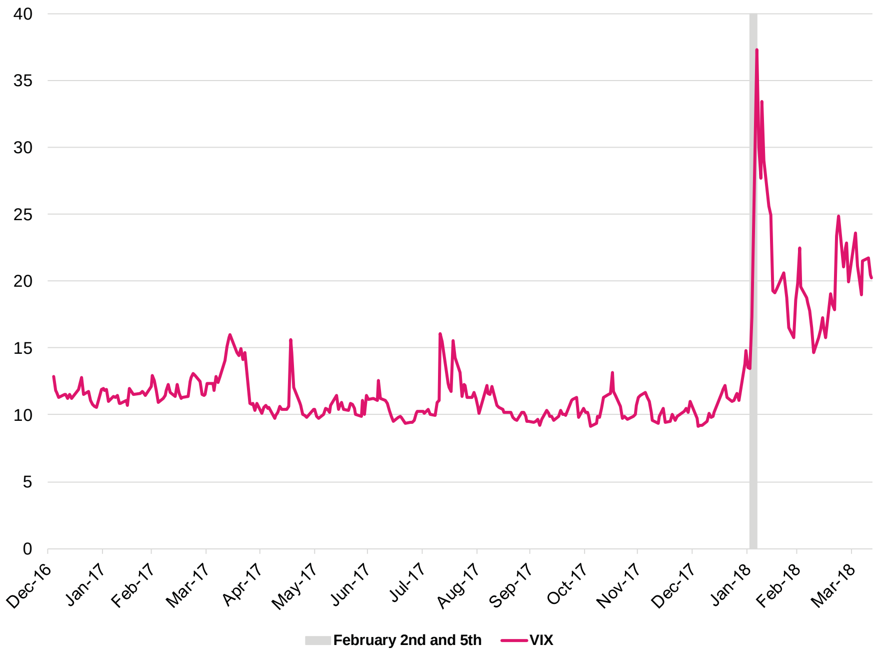
Source: Bloomberg



The VIX volatility index leapt to 37.3, well-above its long-term average of 20; levels last seen in August 2015. Consequently, a series of inverse VIX ETFs such as XIV and SVXY, betting on falling volatility, collapsed and were liquidated after suffering devastating losses.

FIGURE 2 - VIX Q1 2018

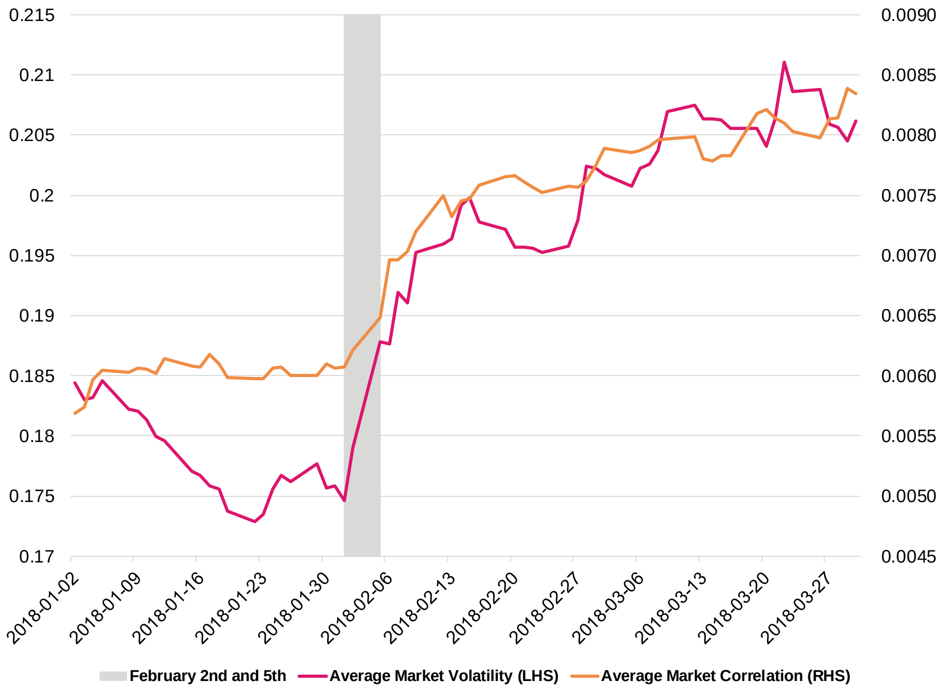
Source: Bloomberg



On Monday, February 5th, the reversal continued resulting in further losses across all sectors but still dominated by equity losses. During the sell-off, we also saw a noticeable increase in volatility and overall correlations. This increase continued during the rest of February and into March.

FIGURE 3 - MARKET VOLATILITY & CORRELATIONS

20-day market volatility and correlation.
Source: Bloomberg, RPM



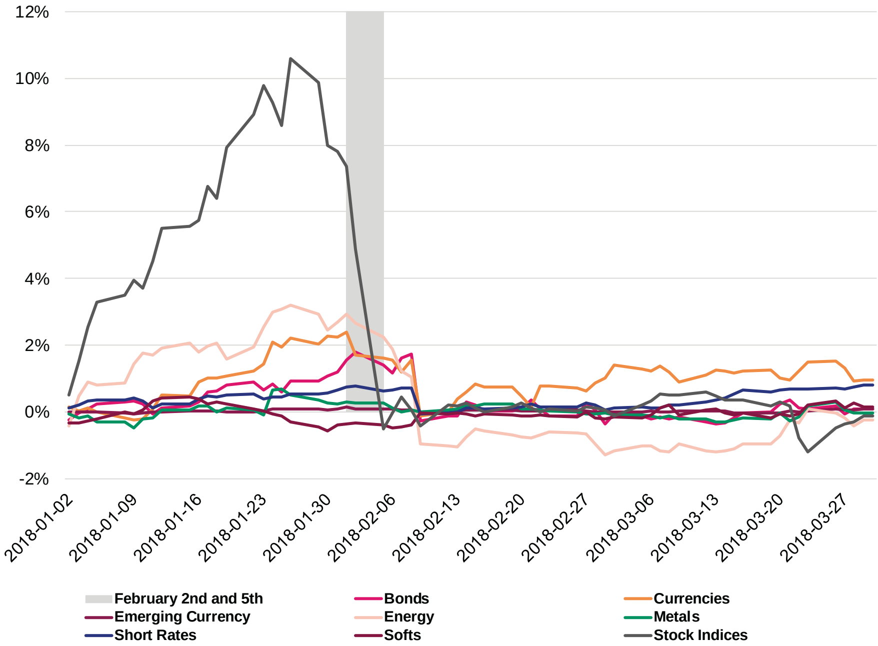
WHERE DID IT HURT AND HOW DID CTAs REACT?

The build-up of general trends, and equity trends in particular, followed by a sudden reversal of basically all those trends is the worst possible scenario, especially for trend followers.

Looking at sector performance, during the sell-off, the majority of losses came from equities, but all sectors were negative over the course of these two days.

FIGURE 4 - SECTOR CONTRIBUTION

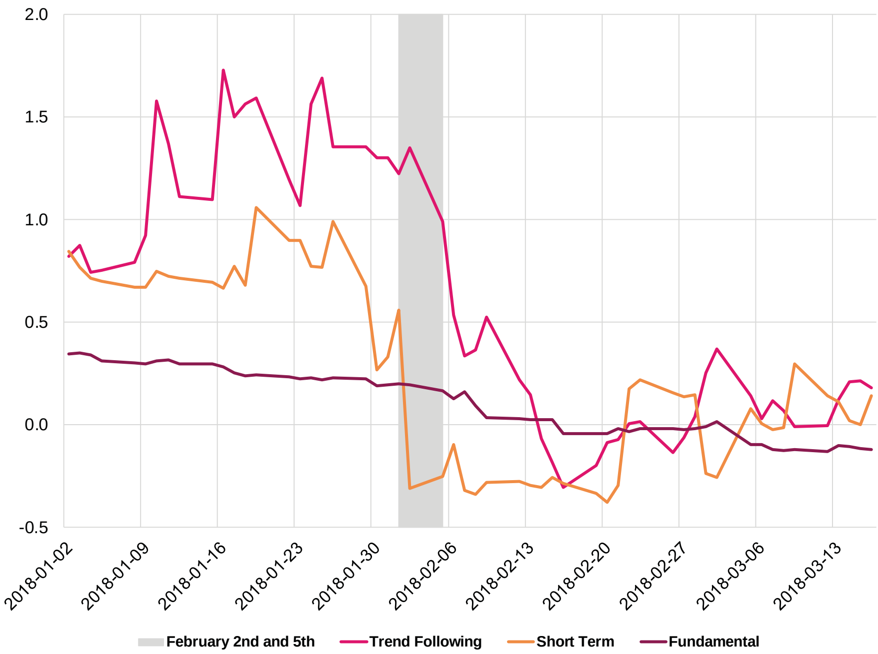
Sector contribution in RPM Evolving CTA Fund.
Source: RPM



Looking at positioning, we see that shorter term managers reacted by reducing the equity positions intraday on Feb 2nd and ended the day with an aggregated short equity position, whereas trend following managers kept the positions stable on the first sell-off day. As the sell-off continued on Feb 5th, trend following managers now started reducing equity positions accordingly and most of the long equity positions were basically flat by mid-February. Longer term trend followers were naturally slower than the shorter term strategies.

FIGURE 5 - EQUITY EXPOSURE

Equity exposure RPM Evolving CTA Fund
Source: RPM



If we look at the position taking in equities in particular, the pattern in Figure 5 is in line with the findings in the previous RPM Educational #4, where we noted that CTAs are usually long equities going into an equity crisis but are able to turn positions in 10 to 15 days. If anything, they were actually somewhat quicker this time around. If this will be perceived as slamming the barn door shut just after the horse had bolted, or as a prudent preparation for a bigger drop, only the future will tell...

During the rest of February and most of March, positions remained relatively stable. Volatility picked up somewhat and market correlations also increased steadily. From the bottoming-out of the reversal in the second week of February until end of March, the CTA industry was basically flat.

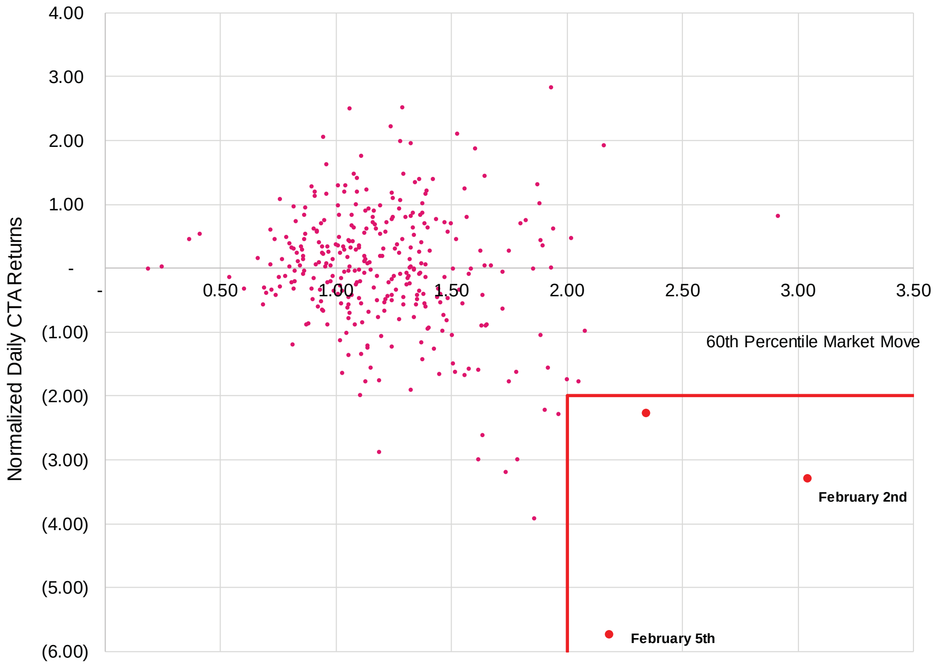
GIVEN THE MARKETS, WAS THE RESULT WITHIN EXPECTATIONS?

Both Feb 2nd and Feb 5th were so called Coordinated Market Sell-Offs[1], meaning that CTAs posted losses greater than a 2-standard deviation move, while more than 20% of the major futures markets had a daily move larger than two standard deviations.

FIGURE 6 - RETURNS VS MARKET MOVE

Normalized Daily CTA returns versus 80th Percentile Normalized Market Move, Jan-17 to Mar-18

Source: RPM, Bloomberg



As seen in Figure 6, in the period from January 2017 until March 2018, we have seen in total three such days. However, in our history we have never seen two such days back-to-back. We saw a very similar period in late February 2007, with markets and CTA returns recovering in a couple of weeks but which in hindsight served as a pre-amble for the Great Financial Crisis.

We see further that during all the worst days for CTAs in this period (a loss corresponding to a 2-standard deviation move or greater) the 80 Percentile Market Move is greater than 1 (meaning that 80% or more of the major futures markets have a daily move greater than 1 standard deviation).

In general, the daily win/loss ratio (number of profitable positions versus losing positions) has great explanatory power for CTA portfolio returns. This means that it is not outsized moves in any single market that explain returns, it is rather how many of the bets they get right (or wrong).

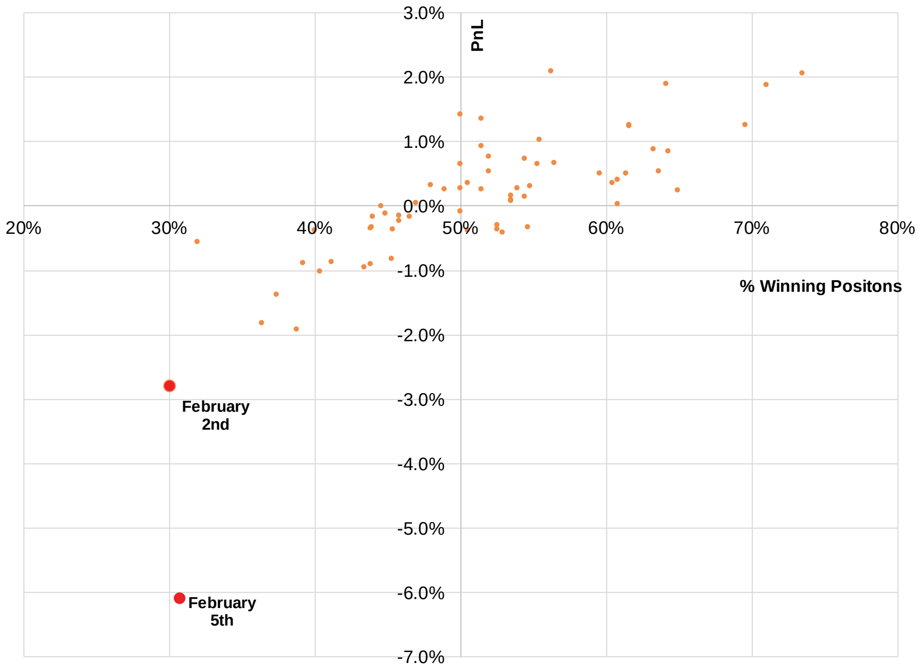
1.RPM's CoMaSe indicator (Coordinated Market Sell-off Indicator) is used to determine when the risk of a sell-off is higher than usual (using a combination of proprietary position data from the underlying CTAs as well as macro and market data such as speculative capital in the market and macroeconomic activity). In January, this indicator reached levels not seen since early 2017 and was one of the inputs in RPM's decision to decrease risk going into February.

In January, the RPM Evolving Fund was up on 16 out of 21 trading days. The average win/loss ratio for these days was 60/40. On both sell-off days, February 2nd and February 5th, the ratio was 30/70 meaning that 70% of the positions had negative performance. On February 5th, losses were dominated by equities. There are exception on the upside as well, for example during Brexit when the win/loss ratio was 50/50 but the CTA industry has excellent performance due to profits in currencies and fixed income.

FIGURE 7 - WIN/LOSS RATIO VS PNL

PnL versus Win/Loss Ratio
RPM Evolving CTA Fund
Jan-18 to Mar-18.

Source: RPM



FINAL WORDS
Whether the events in early February and the subsequent period was just a correction or signaling a bear market scenario is too early to tell. However, to quote the conclusion from the RPM Educational #4:

"…when you invest in CTAs you don't buy into a market view or position. You buy into the CTAs' innate ability to react and adapt to market events in a systematic, disciplined, and relatively unconstrained way. These abilities are particularly important in periods when markets are driven by fear and emotions. Such a period will come again, sooner or later…"

We are more than happy to receive feedback, questions, comments and to engage in further discussions regarding CTAs in general. Please reach out to us on:

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