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20th September 2021

What happens if…?

As you may know, we occasionally produce ad-hoc reports whenever we feel that we have something interesting to say (they are all downloadable from our website). We have always preferred to do this rather than write regular but dull features simply to satisfy some random demand for regular "research". That's not to guarantee that our articles are not dull – rather it means that you will only have to suffer them on a less frequent and irregular basis.

"He was dull in a new way, and that made many people think him great."
Dr. Samuel Johnson (of Thomas Gray), 1791

There has been much chatter recently about the US stock market rolling over imminently. As always, it seems as though there are several triggers just waiting to be pulled, including in no particular order;

1. The Fed are seemingly about to start tapering their purchases.
2. Inflation/deflation/stagflation (delete as preferred) is just around the corner.
3. China is cracking down on oversized companies.
4. The second largest property company in China looks likely to implode (Evergrande).
5. The Delta variant continues to spread (especially across US and China) – and there are fears of waning vaccine efficacy after 6 months (on the Alpha, Beta and Gamma variants).
6. The US Debt ceiling is about to be renegotiated higher (yet again).
7. The S&P500 has doubled in just over a year with no pullback greater than 5%.
8. The Shiller P/E ratio has just hit 38+ which is almost a two decade high. On the four previous occasions it has hit 30+, the stock market has "corrected" by 20% or more.
9. The FAANG stocks and MSFT (which are all so dominant in the index – over 20% or some $7t+) may potentially struggle to replicate growth numbers (NB; ongoing chip shortage)
10. We are into September – typically the worst month of the year for stock markets returns

Before I get into the note, let me start with two caveats;

Caveat #1: Betting against the S&P500 has been an expensive game for at least the last twelve years. Since the trough in March 2009, it has risen by over 600% and calling tops has rarely been a winning strategy.

Caveat #2: Notwithstanding the commonly accepted wisdom that diversification reduces risk, too much diversification simply dilutes returns to the point of meaningless. Consequently most of the smarter investors shy away from it. This list of "non-diversifiers" including Warren Buffett, Charlie Munger, Bill Ackman and economist John Maynard Keynes. This philosophy of portfolio concentration can perhaps best be summed up by Jim Rogers;

"Diversification is something that stockbrokers came up with to protect themselves, so they wouldn't get sued for making bad investment choices. Henry Ford never diversified. Bill Gates didn't diversify. The way to get rich is to put your eggs in one basket – but watch that basket very carefully. And make sure you have the right basket."
Jim Rogers

And without question, the right basket to have had for the last 10 years has been the S&P500. Fig.1 below shows the percentage return and drawdown of the S&P500 over the last 20 years;

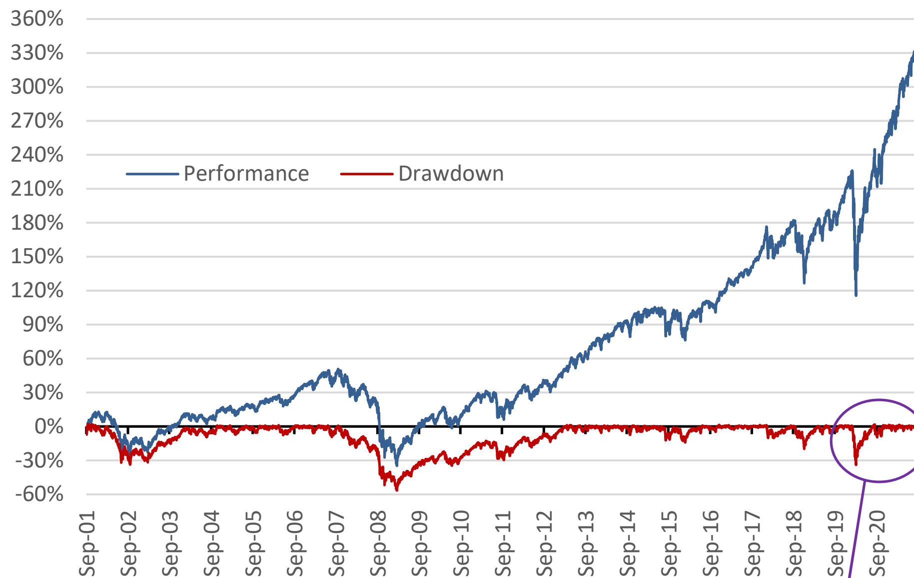

Fig.1: S&P500 Performance and Drawdown from 18th Sep 2001 to COB 17th Sep 2021

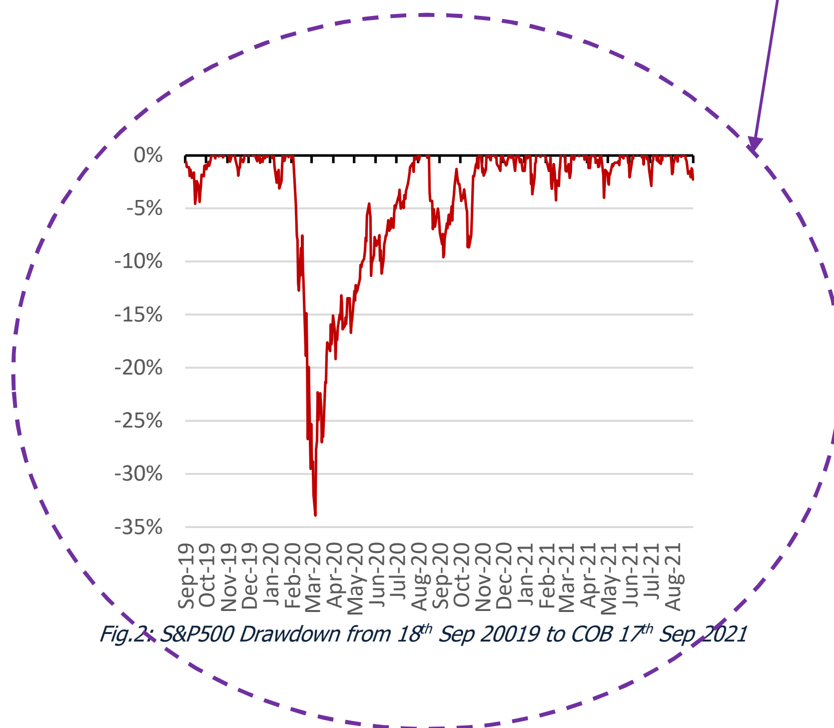

Fig.2: S&P500 Drawdown from 18th Sep 20019 to COB 17th Sep 2021

The human brain is generally pretty good at forgetting bad things and it is a truth universally acknowledged that the GFC in 2008/09 was a "bad thing". It is never mentioned today in this world of ever rising prices, but it might be prudent to remind ourselves that the GFC not only saw a drawdown of 50%+, but that it took **4 years** to recover those losses.

The inset window (Fig.2 above) clearly shows the COVID-inspired wobble last Spring, but also confirms that the 100% gain seen so far in 2021 has been achieved with a maximum drawdown of ~4%.

"And though you think the world is at your feet, it can rise up and tread on you"

Ian McEwan, Atonement

This complacency is further strengthened when market participants see volatility falling. Fig.3 below shows the rolling 5-day percentage change over the last 20 years;

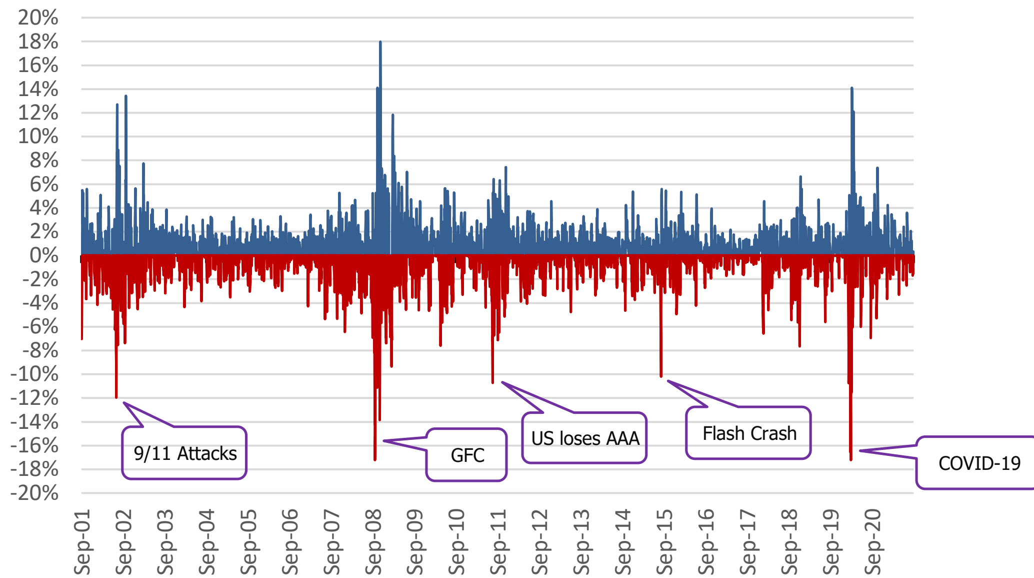

Fig.3: S&P500 Rolling 5-Day Performance from 18th Sep 2001 to COB 17th Sep 2021

Fig.4 below shows the absolute 5-day price action (20day average) over the last 2 years and shows the market remaining remarkably stable with average 5-day price action coming in at around 1% so far this year. Fig.5 shows the VIX and confirms market volatility bumping around in the 15-20% range. Admittedly that's not back at the extraordinarily low pre-Covid 10-15% levels – but its still fairly cheap.

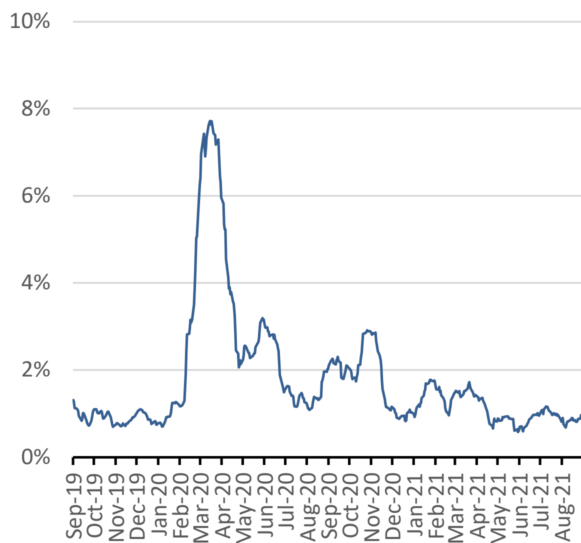

Fig.4: S&P500 Absolute Rolling 5-Day Performance

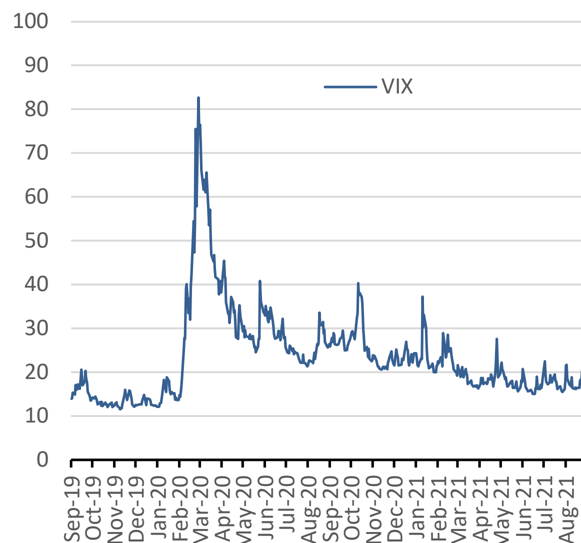

Fig.5: S&P500 VIX

Of course, just because the stock market may be vulnerable to a substantial sell-off, that doesn't mean it's going to happen…and not necessarily any time soon.

> "Bull markets are born on pessimism, grow on scepticism,
> mature on optimism and die on euphoria."
> *Sir John Templeton*

Given todays' hand-wringing about the potential for a correction, one could hardly classify the current investment mood as euphoric. Indeed the mood could arguably be termed sceptic which would seem to indicate that the index has further to run on the upside.

But what if it doesn't?

Crashes, almost by definition, come unexpectedly and are usually very quick and painful. That's why they're called crashes! Compounding the potential headache for investment managers is the fact that, as we have seen in the last 3 major plunges (2011,2015,2020), a stock market crash typically leads to crashes across asset classes – including those alleged "safe-havens" (eg gold).

Perhaps this is no surprise given that the financial world has changed beyond all recognition in the last 10 years or so. With no trading floors, no specialists, no market-makers, minimal conversations and everything driven by algorithms and micro-seconds, these increasingly inter-connected markets can move lightning fast. And a less experienced retail trader base drives and contributes to a panic and a "sell everything" mentality.

It's not even just retail traders. As we have highlighted in previous reports, professional/smart money traders in their mid-late thirties with over 10 years market experience under their belt have NEVER seen central banks raise interest rates and NEVER experienced a bear market.

"The most aggravating thing about the younger generation is that I no longer belong to it"
Albert Einstein

So what does an investment manager do that might reduce his exposure to a sizeable downward lurch in the S&P500? Investing in other asset classes will likely prove no diversifier if the worst comes to pass. Buying puts might work given that volatility is relatively cheap (see Fig.5) but you really need to get your timing spot on. One key option might be to invest in our Jaguar AEGIR strategy (JAs).

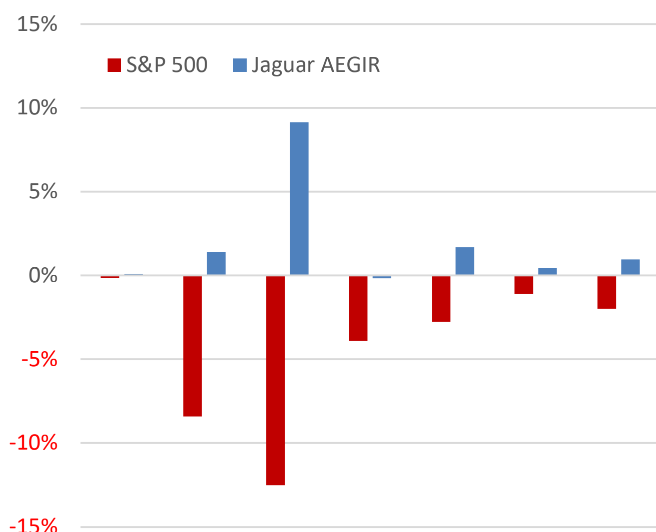

Fig.6: Jaguar AEGIR Performance in S&P Down Months (Sep18-Sep21)

Fig.6 (left) shows the performance of the JAs in the 7 down months that the S&P500 has had in the last 2 years (24 months from Oct 2019 to Sep 2021).

The S&P500 had a cumulative monthly loss of 30.9% over the period while the JAs was up a cumulative 13.6% - it was up in 6 of those 7 months.

The outperformance holds over both 3 years and 5 years as well, as follows;

3yrs; S&P = -55.4% / JAS = +13.6%
(JAs up in 8 of 11 S&P down months)

5yrs; S&P = -64.4% / JAS = +15.3%
(JAs up in 11 of 16 S&P down months)

Our strategy began back in January 2012, and as you can see from the table below and Fig.7, it has pretty much kept pace with the S&P500 since then (returns to CoB 17th September 2021);

	JAs	S&P500		JAs	S&P500
Inception to date	209.94%	255.56%	Ave 12 month RoR	11.45%	13.51%
Annual Comp. RoR	12.30%	13.89%	Best 12 month RoR	86.14%	53.69%
Best Month	15.62%	12.68%	Worrst 12month RoR	-2.14%	-8.81%
Worst Month	-5.90%	-12.51%	Max Draw	-6.31%	-20.00%
Ave Up Month	1.78%	2.98%	Std Deviation	9.07%	13.04%
Ave Down Month	-1.02%	-3.10%	Sharpe Ratio (0%)	1.33	1.07
% Up months	72%	70%	Correlation	-0.11	

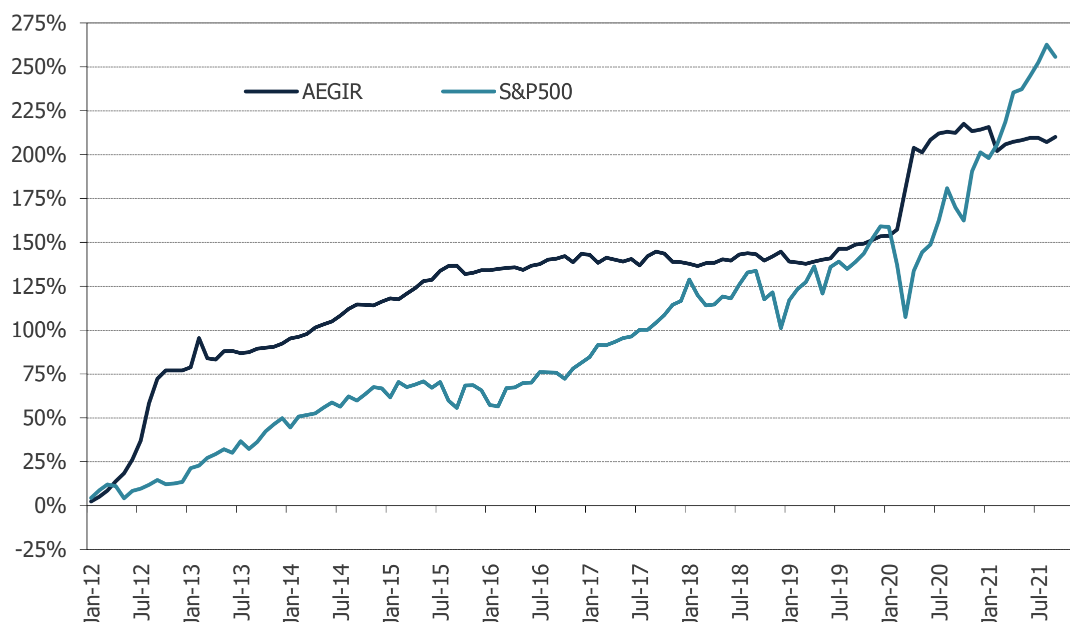

Fig.7: Jaguar AEGIR Strategy Performance vs S&P 500 Performance since inception (1st Jan 2012-17th Sep 2021)

The table below shows the performance of our JAs and the S&P500 together with various split allocations;

	JAs	S&P500	10/90	25/75	40/60
Inception to date	209.94%	255.56%	251.00%	244.15%	237.31%
Annual Comp. RoR	12.30%	13.89%	13.74%	13.51%	13.28%
Best Month	15.62%	12.68%	12.18%	11.29%	10.57%
Worst Month	-5.90%	-12.51%	-10.18%	-6.76%	-4.85%
Ave Up Month	1.78%	2.98%	2.67%	2.29%	2.03%
Ave Down Month	-1.02%	-3.10%	-2.78%	-2.21%	-1.58%
% Up months	72%	70%	72%	74%	74%
Ave 12 month RoR	11.45%	13.51%	11.42%	11.34%	11.35%
Best 12 month RoR	86.14%	53.69%	30.40%	35.58%	41.64%
Worst 12month RoR	-2.14%	-8.81%	-6.17%	-4.53%	-3.04%
Max Draw	-6.31%	-20.00%	-16.98%	-12.43%	-8.00%
Std Deviation	9.07%	13.04%	11.56%	9.55%	8.09%
Sharpe Ratio (0%)	1.33	1.07	1.18	1.39	1.60

You can see that by switching just 10% of an S&P500 portfolio to JAs would have reduced the maximum drawdown by over 3%, increased the %age of up months by 2% and reduced annualised volatility by 1.5%. The Sharpe ratio is consequently increased by 10% - and all for a 15bp/pa cost.

By allocating 40% to JAs, the maximum drawdown would have more than halved from 20% to just 8%, with volatility dropping from just over 13% to just over 8%. The Sharpe ratio would have improved by 50% from 1.07 to 1.60 and all for just 60bps/pa cost.

At this stage I should include the "past performance is no guarantee of future performance" line – and further disclaimers can be found at the end of this note – but I think the case for a small allocation from S&P500 to our Jaguar AEGIR strategy is quite compelling.

"The four most expensive words in the English language are; 'This time it's different'"
Sir John Templeton

We would be pleased to talk to you in more detail about our strategy.
Kind regards
Jaguar Investments

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An investment in the strategy is speculative and involves a high degree of risk. The strategy's performance can be volatile and there can be no assurance that the strategy will achieve its investment objectives. While an investment in the strategy may result in profits, it may also result in losses – investors may lose all or a substantial amount of their investment. The strategy may employ leverage which can magnify gains or losses. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE PERFORMANCE. Performance figures and related statistical data for the AEGIR strategy is derived from a composite of the actual monthly trading returns of all managed accounts in the period beginning 1st January 2012 and ending on 17th September 2021. All performance returns and related statistical data are net of all management and performance fees.

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