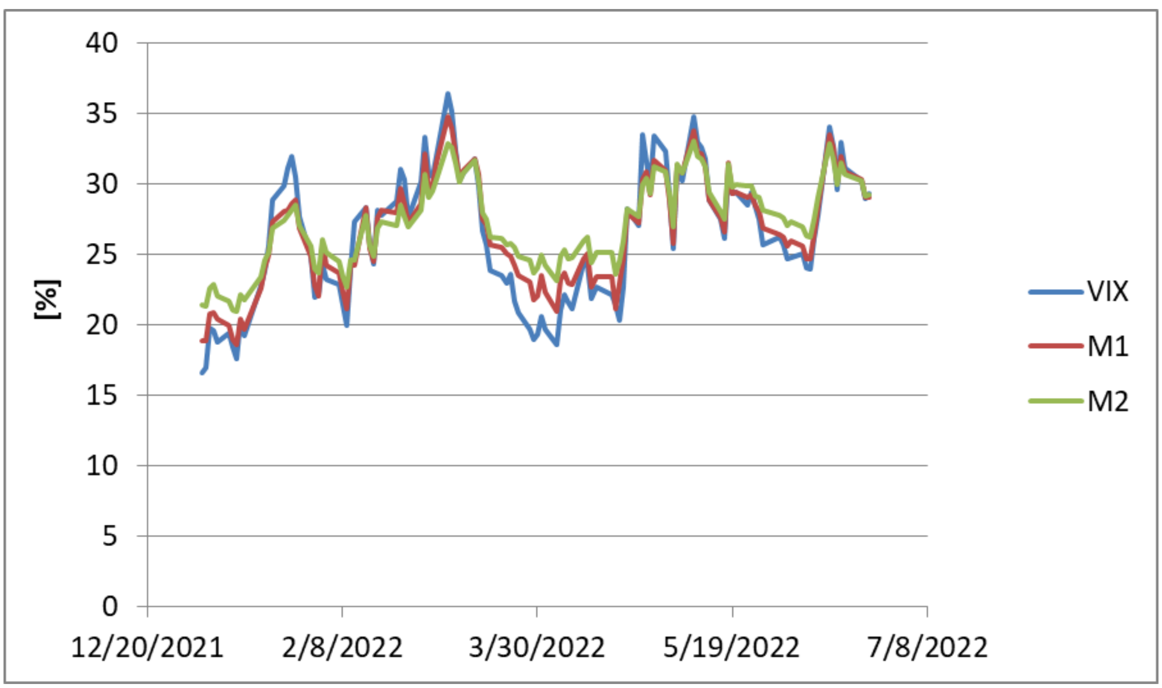
Alpha Growth Capital – June 2022 Newsletter | Mid-Year Review

Good morning,

The first 6 months of 2022 are now officially behind us, it is now time to have a look back and reflect on where we are and what it has been done.

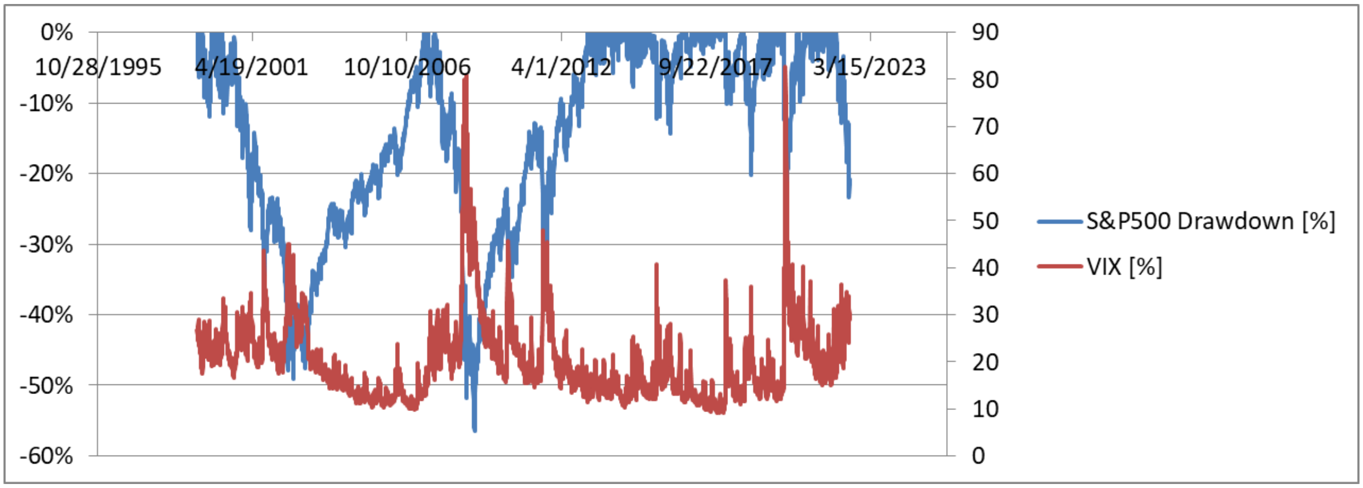
2022 has been characterized by a decline in equities. Year to date the S&P500 has lost 20.58%. According to the definition, the US equity market is now in a bear market. According to many, this is nearly unprecedented and a very rare event. Personally the large decline was not the part that got my attention the most but rather the behavior of the market volatility. Below I have plotted the VIX and the first two months (M1 and M2) of the VIX futures term structure. Usually with large pull backs, M1 and M2 are far below the VIX while the VIX could shoot up well above 40%. In such context, long volatility and tail risk event strategies are triggered and some profits could be made. 2022 was not the case and this has puzzled me a lot.

I have asked myself why. It took me several weeks to figure this out. After doing lot of data mining, I reached the conclusion that the VIX would have reacted only if the current situation would have been unexpected and/or the decline would have started to inflict pain in the investor's portfolio.



This can be visually observed in this second chart. For instance during the Dotcom bubble, the VIX was within 30% even when the market pull back 20-30%. It was not until the 50% decline that the VIX reached 45%.

The question now is: what was learned so that if history would repeat itself we would avoid some of the pain experienced in 2022? This question will be answered in a short while, scroll down if impatient.



When it comes to NEXT-alpha, Year to Date, the strategy has delivered -13.99%. It is definitely the worst start of the year in its 4.5 years of history. If on one hand this is disappointing on the other hand the strategy was designed not to exceed a maximum drawdown of 15% (give it or take it because this is not an exact science). On a side note, 15% was chosen because, in my experience, investors, in the heat of the moment (myself included), have a threshold pain of 10-15% prior starting acting. Investing in NEXT-alpha would not have resulted in all the intra-month volatility that for instance equities have experienced. The ride would have been smoother.

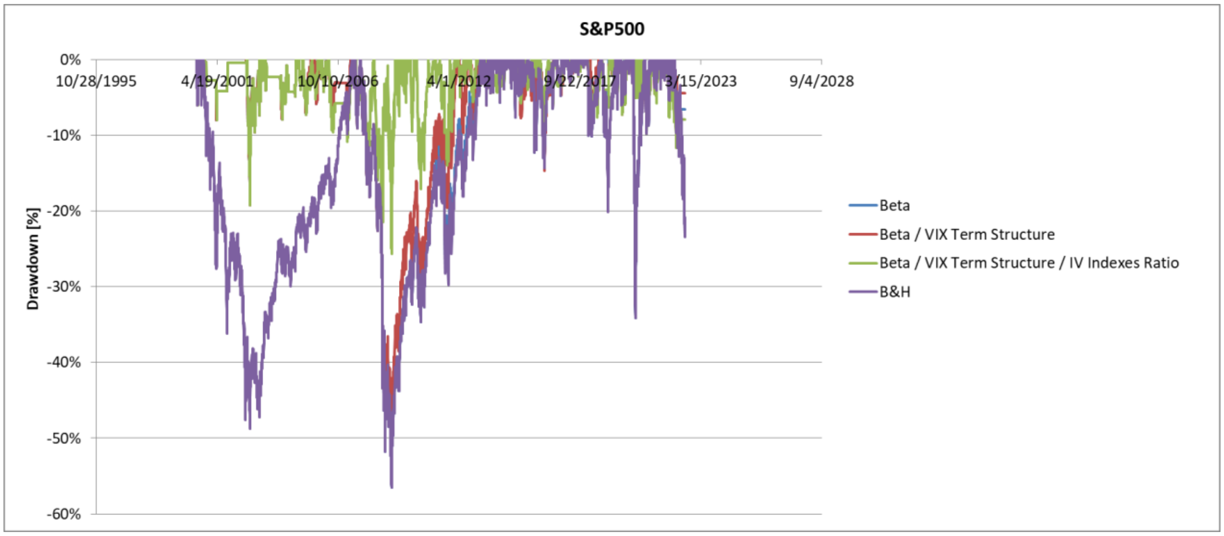
The signals we have in place allow the strategy to behave better than the market. Oversimplifying, when the S&P500 would go back to all the time high, NEXT-alpha should reach new highs. Again oversimplifying, with the current numbers, when the S&P500 would be at 0% then NEXT-alpha would be at +6.59% (-13.99% - (-20.58%)).

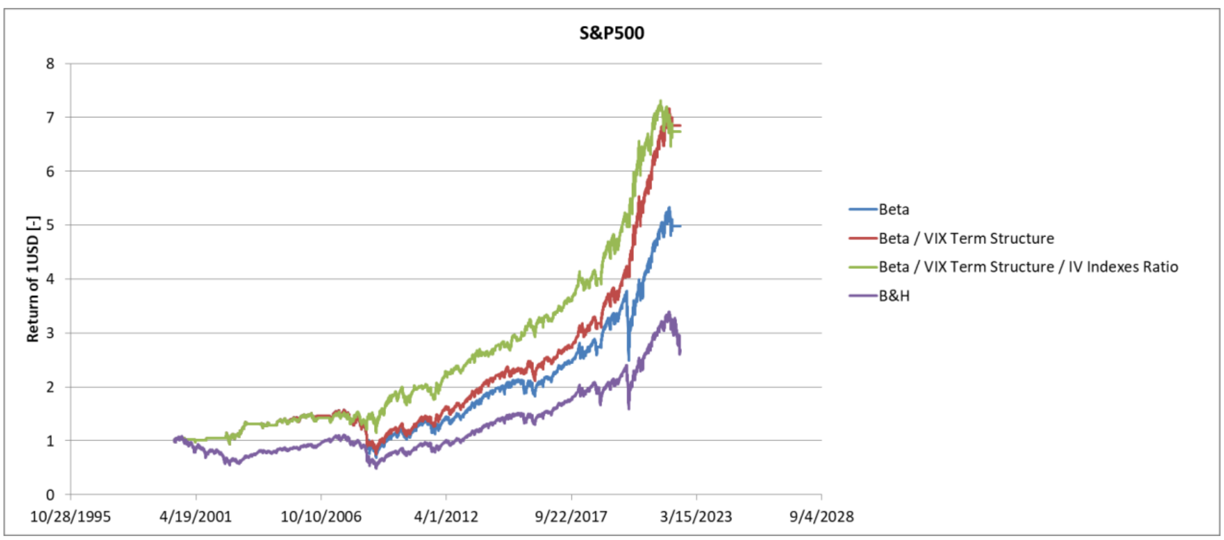
Is this a reason to be complacent? No.

This is because I strive to do things better over time by analyzing what has happened and trying to figure out whether this could have been avoided in the future.

First. It might not be unlikely that we might experience a 1970's 2.0. In this context it is now a couple of months that I have allocated 7.5% of the portfolio to trading Iron Condors with different underlying (equities, metals, softs, agriculture,…). The allocation might increase depending on the market conditions. Iron Condors could allow to profit in periods of high volatility independently on where the equity market goes.

Second. On top of my usual volatility matrixes, I have developed a couple of complementary indicators to guide me whether to trade or not the equity part of the NEXT-alpha strategy. The two indicators look at the beta and Implied Volatility ratio of the three main US indexes. The first one would have helped in 2022 and during the Dotcom bubble while the second during the 2007-2009 Financial Crisis. They are now implemented as per end of June 2022. The panic indicator (VIX term structure shape) is always an integral part of numbers to look at. Below I have plotted a chart showing how these three indicators would have helped to reduce the drawdown of the S&P500 while boosting its returns.





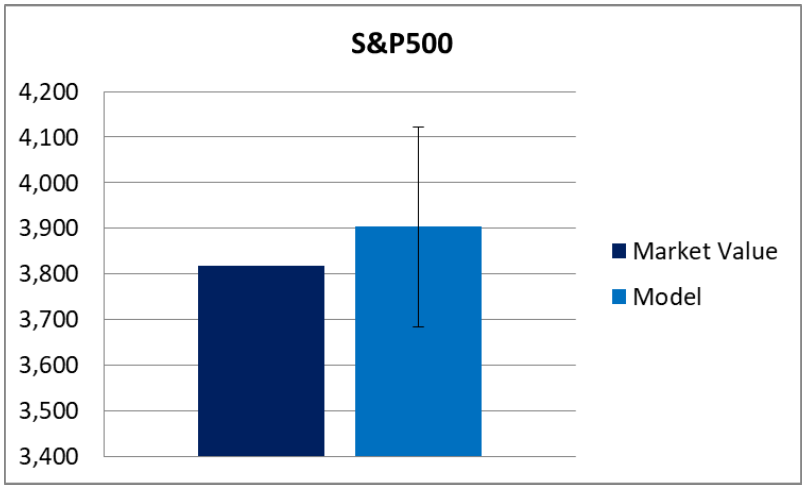
The first half of 2022 has been though for the vast majority of us. In my opinion, we have all to keep in mind that we are here for the long run and the ingredients for the long term success, in my view, are:

1. Have a good risk mitigation in place. "Losses are more costly to a fund than gains are beneficial" - Brent Osachoff.
2. Unemotionally stick to the rules you have set. If the strategy does not behave like in the backtest, halt it and analyze what went wrong.
3. Never take decisions in the heat of the moment or out of frustration. a) if you do not know what to do then do nothing b) the time scale of profit making in the market (months, years) is vastly different from what we humans perceive (minutes, hours, days).

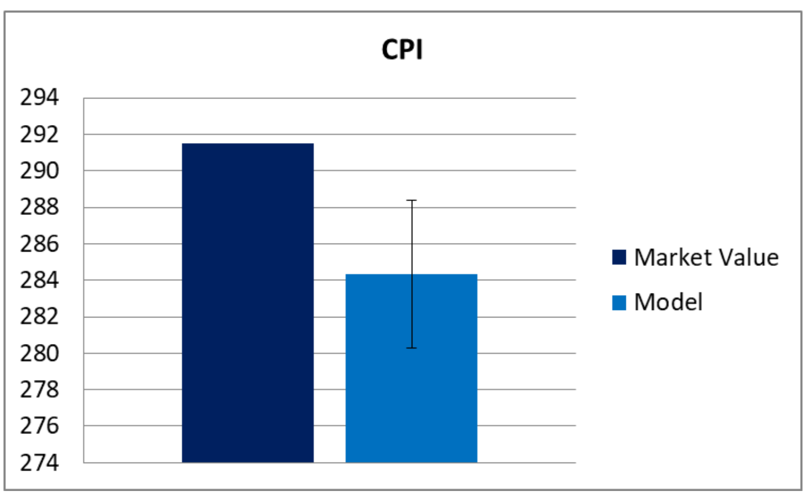
4. Strive for improvement through data driven decision. What has worked in the past might not work in the future: keep improving your investment strategy.
5. Do not get distracted or believe to all the shiny objects you see on social media.

Looking at the macroeconomic situation.

It looks like the S&P500 has reached its fair valuation. Where the market might go from now? In short, I do not know. Despite I can see a couple of directions. In the best case it will move sideways until the inflation story will be over and the GDP will start growing again. In the worst case, it will head lower triggered by some drastic events. As I see it, the most probable could be something related to the nominal bond yield increase by the US Federal Reserve.



Inflation wise, our model suggest that the CPI might be ahead of itself by 2.45%.



It might not be unlikely that in the month of July, on an annualized basis, the CPI will grow less than what it did in June (see magenta line). Real 10 Year Treasury bond yields are still negative. Also in this case, it is not unlikely that the Federal Reserve will not go mild in increasing the T-bond yields. To control the inflation, M2 is now growing at a slower pace. In the month of June, it increases by 0.1054%.