

The War Room

Portfolio Construction

Session 8

March 29th

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www.itpm.com

Seminars, Online Education, Trader Mentoring

Modern Portfolio Theory

SYSTEMATIC RISK

These are market risks that cannot be diversified away.

Interest rates, recessions, COVID and wars are examples of systematic risks.

UNSYSTEMATIC RISK

Also known as "specific risk," this risk relates to individual stocks. In more technical terms, it represents the component of a stock's return that is not correlated with general market moves.

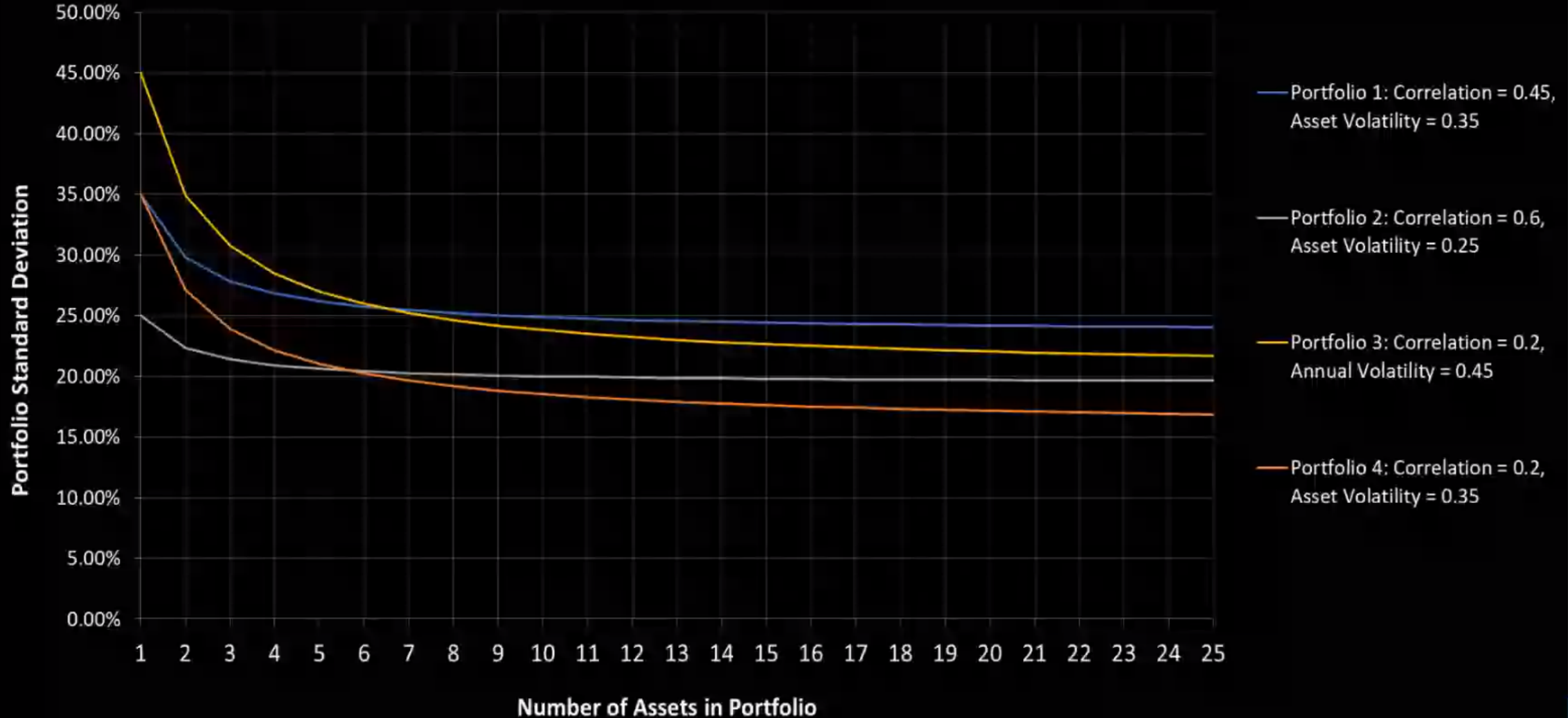
Specific risks can be mitigated through portfolio **DIVERSIFICATION**

Diversification and Risk

Select stocks from

- multiple sectors/industries
- and across the three types of stocks potentially..... cyclical, growth and value
- YOUR FUNDAMENTAL MACRO VIEW WILL LEAD TO YOUR BIAS

Portfolio Standard Deviation (assets equal in weight, volatility and correlation)



Common Pitfalls of Correlation Analysis

Over-diversification can lead to LOWER returns!

- Continually adding low-correlation ideas to your portfolio for the sake of diversification often leads to lower returns – even on a risk adjusted basis! The portfolio must still be made up of high-quality, high-conviction ideas

Correlation is not Causation

- Just because two variables are related does not mean there is a cause-and-effect relationship between them
- If there is not a cause-and-effect relationship between the two variables, then without understanding the cause factor for the correlation – there is uncertainty of its continuation
- Classic example: Bonds vs Stocks

11 Major Sectors

Sector	Type
Real Estate	Cyclical
Healthcare	Value/Defensive
Financials	Cyclical
Utilities	Value/Defensive
Consumer Staples	Value/Defensive
Consumer Discretionary	Cyclical
Communication Services	Cyclical
Technology	Growth
Materials	Cyclicals
Energy	Value/Cyclical

There is no checklist

There is never a “model” portfolio. Every portfolio will have a different risk profile... an expression of a view with an acceptance of risk.

ITPM will NOT provide a checklist that will state how many strategies should be in

- each sector/industry
- what make up of value, growth and cyclicals there should be
- or what ratio of Calls to Puts there should be

Bottom Up v Top Down

- Bottom Up - Lock yourself away and don't come out until you have found your best ideas based on pure fundamental analysis.
- Top Down - Macro based analysis leading to sector preferences and then identifying the best in class stocks in those sectors.

Its not either /or Both approaches need to work side by side

- Start with best ideas when building your portfolio and across a few industries ideally expressing your MACRO bias
- As the portfolio gets up to 50% invested concentration risk and diversification should guide the completion.

MACRO OVERVIEW EXAMPLE

Take a current MACRO view

Consider a bullish “reflation” view:

- Best Asset classes: Commodities, Equities, Credit, FX
- Worst Asset Classes: Fixed Income, USD
- Best Equity Sectors: Tech, Consumer Discretionary, Industrials, Materials
- Worst Equity Sectors: Low Beta Value, Dividend Yield, Defensives

Calls v Puts

Are these statements even true?

Bullish Bias

7 Calls 3 Puts

Bearish Bias

3 Calls 7 Puts

Balanced

5 Calls 5 Puts

Not necessarily... especially at times of “pivot” or extreme liquidity events

- Scenario 1

During the lockdowns the portfolio went typically “risk off” Buying value and selling growth...
disastrous performance as portfolio has missed the defensive nature of tech during lockdown
(regardless of the call v put make up)

- Scenario 2

Before the vaccine news of late 2020 the portfolio was long growth and short value...
disastrous performance as the portfolio has been structured “short” the vaccine
(regardless of the call v put make up)

- Scenario 3

Imagine being just long growth stocks into the first of potentially many taper tantrums that occurred last week of February

TOO CONCENTRATED A MACRO VIEW

Portfolio Construction Conclusions

- Understand and embrace your Specific Risk and Bias
- We are not trying to replicate the Index or hedge out all risk
- Driven by Fundamental Stock picking consistent with our MACRO view BUT within acceptable risk tolerance.

WAR ROOM

Long Ideas

Momentum vs Turnaround Trades

Jason McDonald

March 29th 2021

TWR Portfolio

LONG IDEAS /CALL STRUCTURES				SHORT IDEAS /PUT STRUCTURES			
TICKER	NAME	SECTOR	PRICE TARGET \$	TICKER	NAME	SECTOR	PRICE TARGET \$
SEM	SELECT MEDICAL	HEALTH CARE	44	COUP	COUPA SOFTWARE	IT - APPLICATION SOFTWARE	170
KLIC	KULICKE & SOFFA	IT - SEMICONDUCTOR EQUIPMENT	65	LYV	LIVE NATION	COMM SERVICES/ENTERTAINMENT	50
HUBB	HUBBELL INC	INDUSTRIAL	240	TPX	TEMPUR SEALY	CONSUMER DISCRETIONARY	50

MOMENTUM vs TURNAROUND

➤ What is momentum trading?

- Momentum trading is the practice of buying and selling assets according to the recent strength of price trends and forward looking **fundamental** growth
- The idea being if there are **solid fundamentals behind a price move** (forward looking) with catalysts and enough force behind the price move, it will continue to move in the same direction

MOMENTUM vs TURNAROUND

➤ What is a turnaround long?

➤ It's a type of value **investing**

➤ Involves taking a position in a stock that has fallen out of favour – most often due to deteriorating fundamentals (sales and earnings) i.e. bad news associated with the company – longer term **investors** are or have been selling and traders are shorting

➤ Profound financial and operational issues are likely to have severely dragged down the company's stock price

MOMENTUM vs TURNAROUND

- As markets generally overshoot a turnaround stock will have a higher intrinsic value than that reflected in the current stock price
- This means that it remains an attractive investment option as its stock price is likely to recover - or “turnaround” - in order to reflect this true value
- Turnarounds are not “classic long trade ideas”
- As traders you are essentially trying to pick the bottom in the fundamentals i.e. the bleeding has stopped and sales and earnings are forecast to turn

MOMENTUM TRADES

- When an asset reaches a higher price, it usually attracts more attention – this pushes the market price even higher
- This continues until large numbers of sellers enter the market – e.g. an unforeseen event causes them to rethink the asset's price
- Once enough sellers are in the market the momentum changes direction

MOMENTUM TRADES

- Momentum traders seek to identify how strong the trend is and open a position to take advantage of the expected price change
- In the background strong fundamentals (expectations) are driving the price higher. Investors and traders are willing to pay higher and higher prices

TESLA MOMENTUM TRADE Q3/Q4 2020

Jason McDonald

DMGitsPhilip published on TradingView.com, March 28, 2021 19:03:53 BST
BATS:TESLA, 1D 618.71 ▼ -21.68 (-3.39%) O:641.87 H:649.82 L:599.88 C:618.71

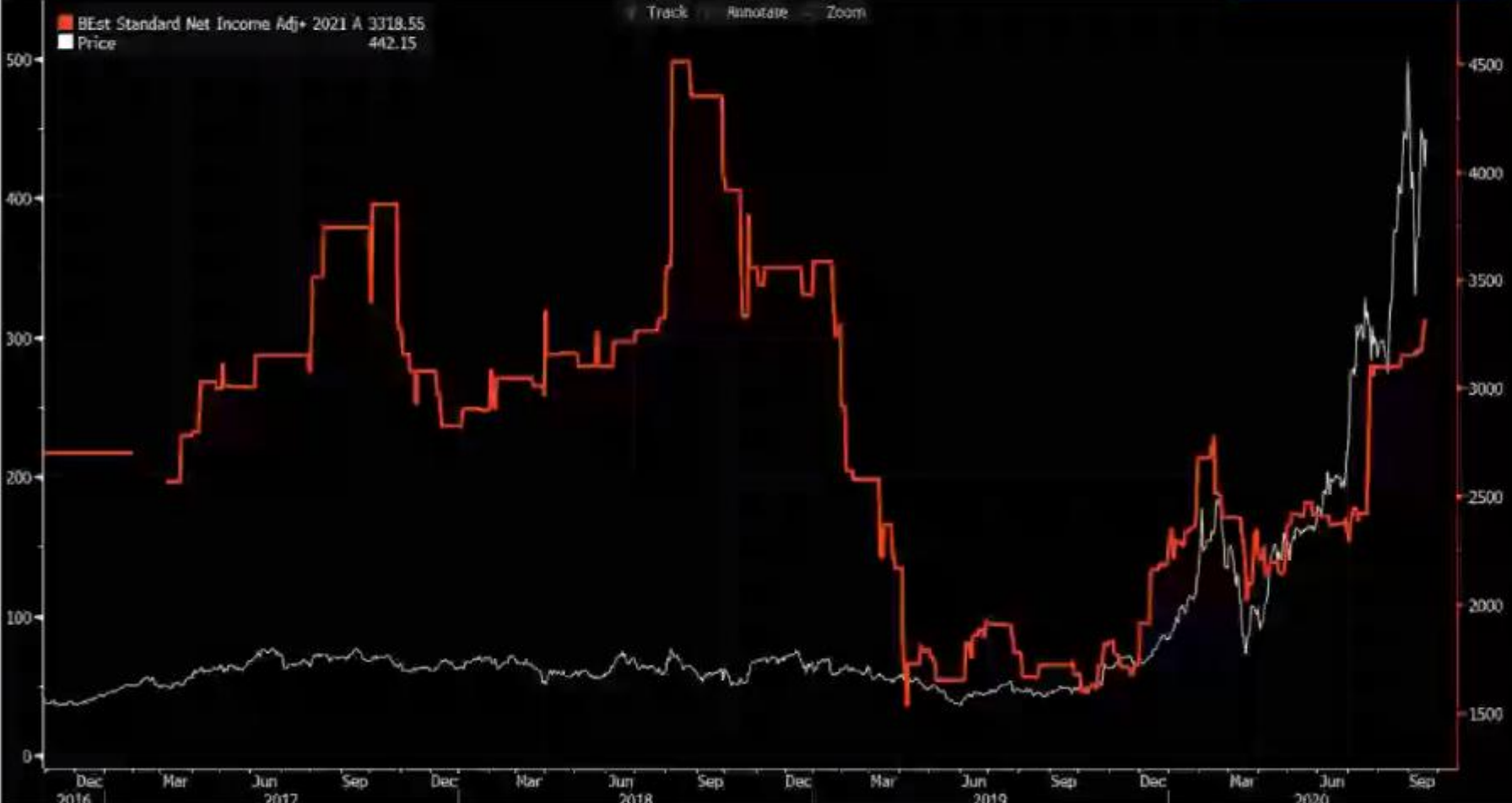


TSLA US \$ C 442.15 +18.72 Q441.02 / 441.61Q 23x19
 On 18 Sep d Vol 86,406,819 O 447.94P H 451.00X L 428.80D Val 38.092B

TSLA US Equity Settings Earnings Estimates Graph

Tesla Inc Estimate Type General Product Measure Net Income Adj

1M 3M 6M 1Y 5Y Max Graph Options



Type Revision
 Currency USD

Include Price

Estimate Periods
 2021 Annual

1) Add More Periods

Estimate Sources

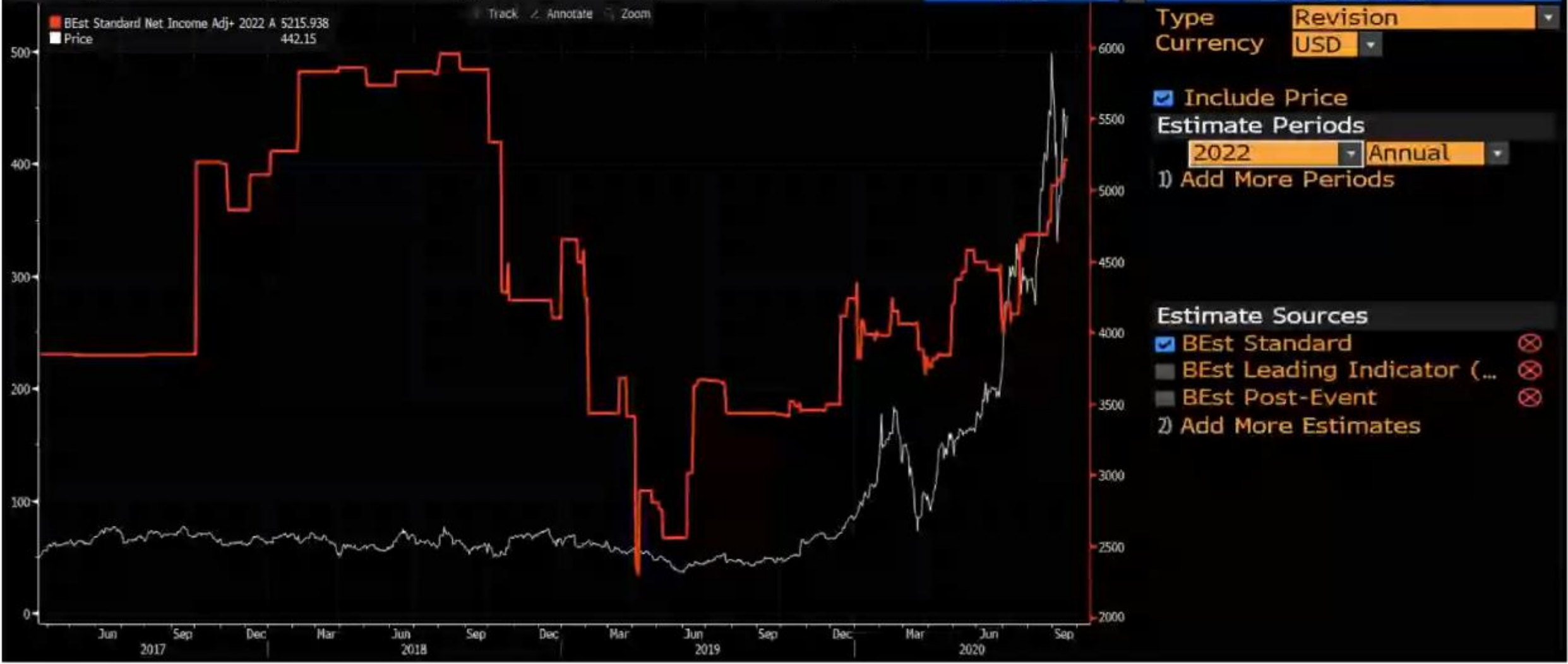
- BEst Standard
- BEst Leading Indicator (...)
- BEst Post-Event

2) Add More Estimates

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TSLA US Equity Settings Earnings Estimates Graph

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MOMENTUM TRADES

- The position is closed when the trend starts to lose its strength
- A momentum trader doesn't necessarily try to find the top and bottom but focuses on the main body of the price move
- The aim: to exploit market sentiment/herding - tendency for traders to follow the majority

MOMENTUM TRADES

- Trading momentum is based on the following key factors:
- Fundamentally positive outliers
- Volatility - traders' bread and butter! Volatility is the degree of change in an asset's price – if a market is highly volatile, it means that there are big price swings. Momentum traders seek out volatile markets to take advantage of short-term rises/falls in an asset's value
- Time frame - duration of a trade can depend on how long the trend maintains its strength. Suitable for traders using 1-3 month time horizons.
If volatility is sufficient can also employ shorter time frames e.g.
April/May/June 2020

TURNAROUND LONGS

- Turnaround “trades” are a form of **value** investing - picking stocks based on their intrinsic values
- Should a company’s value (measured via a range of methods – P/BV, P/E, asset-based) be considered worth more than the current share price the company is likely to be deemed “undervalued” – perhaps ripe for a recovery?
- Such stocks are sought by value **investors** - Warren Buffett, Bill Ackmann etc.
- Key word here is **investor** Also note “undervalued”/“cheap”

TURNAROUND LONGS

- **What makes a turnaround candidate?**
- Company has suffered a consistent decline in their financial performance, resulting in loss of investor confidence/collapse in share price
- Trades at a heavy discount, eventually becomes ignored/forgotten by the “mainstream” investment community

TURNAROUND LONGS

- **Turnaround measures:**
- Prevent further deterioration by implementing cost cutting programmes
- Sell non-core assets/divestments
- Change of management team

TURNAROUND LONGS

- **Turnaround measures:**
- Change the entire focus of the business
- Extreme example: filing for bankruptcy to alleviate some of the debt burden
- E.g. many US coal companies filed for bankruptcy to eliminate much of the debt they accrued when coal prices were at all-time highs

TURNAROUND LONGS

- Investing in turnaround stocks = a risky strategy, see Warren Buffett/Tesco
- Company may continue on an inexorable decline – long-term mgmt. issues, product marketing problems, cyclical or secular decline, even legal action
- Repairing balance sheet is only one measure required for the stock to rebound
- Investing in turnaround stocks inevitably involves being a contrarian

TURNAROUND LONGS

- Traders and investors feel reassured that they are making the right decision when others do the same – see momentum trades!
- With a turnaround situation, initially at least, the majority ignore the “true value” and focus on news surrounding the company’s fall from grace
- Investing against the consensus view generally requires a degree of independence/discipline/balls of steel!/potentially deep pockets

CONCLUSIONS:

1. Momentum strategies are very much **TRADING** strategies
2. Turnarounds **can** be trading situations **IF** a catalyst(s) is identified & timing is **cute**. However = usually long-term investments (deep value)
3. Momentum trades by definition become consensus trades
4. Turnarounds are anti-consensus - timing the turn is tricky

Airline KPI's

- **ASKs** – available seat kilometres
- **RPKs** – revenue passenger kilometres
- **Load factor percent** or Passenger load factor is passenger kilometres RPK expressed as a percentage of available seat kilometres ASK
- **RPK Yield** is the average revenue collected per passenger kilometre
- **Cost per ASK** is a measure obtained by dividing total operating costs by total ASKs.

Airline KPI's

Annual 2020 financial results

(59.7)%
operating
revenues, y/y

(34.2)%
available seat
miles, y/y

(38.6)%
RASM, y/y

\$(3.5)B
net loss¹

\$(6.22)
loss per
diluted share¹

28.1%
non-fuel
CASM^{1,2}, y/y

\$0
Profitsharing

52.4%
load factor

\$14.3B
liquidity³

Bank KPI's – Wells Fargo

Income statement (\$mn)	2019A
Net interest income	47,843.0
Operating expenses	53,284
Pre-provision earnings	28,507
Loan loss provisions	2,687
Pre-tax income	24,198
Net income (adj)	17,938

Balance sheet (\$bn)	
Total assets	1,928
Risk-weighted assets	1,246
Non-performing loans (\$mn)	5,346
Allowance for loan losses	10
Loans	952.7
Deposits	1,323
Tier 1 capital	147
Tier 1 common capital	139
Shareholders' equity	167
Tangible common equity	139
Loan/deposit ratio (%)	73.9 ★

Valuation and leverage metrics

P/E (reported) (x)	7.5
P/BV (tangible) (x) ★	0.9
Dividend yield (%)	6.4
P/PPE (x)	4.7
Tier 1 (%)	11.83
Tier 1 Common (%) ★	11.14
Tang assets/tang equity (x)	13.7

Margin and return data

Return on RWAs (%)	1.6
ROA (%)	1.0
ROE (tangible common) (%)	12.2
Fee income/revenue (%)	41.5
Net interest margin (%)	2.7 ★
Cost/income (%)	65.1

Credit quality ratios

Loan loss provs/loans (%)	0.3
NCO ratio (%)	0.3
Coverage ratio (%)	178.7
NPL ratio (%) ★	0.6
Reserves/loans (%)	1.0

Retail KPI's

- Conversion Rate
- Same Store Sales
- Sales per square metre
- Average Inventory
- Same store sales
- Cash Conversion Cycle
- Gross Margin Return on Investment
- Stock Turnover Days
- Sell through rates
- Selling Square Feet
- Gross Square Feet
- Online %
- Return on Invested Capital
- Gross Margin / SG&A Rate
- Net Margin
- Inventory Turnover
- Customer Retention
- Average Sale per Customer

You will find KPI's via presentations, read transcripts, read industry reports

