
ABR Dynamic Funds – 4Q 2023 Newsletter

Do drawdowns matter if they are eventually recovered?

Introduction

Over the past 25 years, the S&P 500 Index has gained 7.56% annualized, while undergoing 4 bear markets. Should investors ignore these major drawdowns? After all, as the conventional wisdom goes, there were only 4 of them over 25 years, and they did not result in “permanent” losses of capital.

We believe the answer is no because they in fact resulted in permanent losses of capital, even without including possible panic sales at low points.

Although infrequent, these 4 major events were significant drivers of results over time. Consider that removing the 4 drawdowns results in an annualized return of 15.40%, up massively from 7.56% (methodology detailed in the disclosures). To appreciate how large that difference is, \$100 invested over those 25 years with a 7.56% return grows to \$618 while that same \$100 at 15.40% grows to \$3,592. That can be seen as a “permanent” loss of capital of \$2,974 for every \$100 invested over those 25 years.

However, regularly worrying about and anticipating those major drawdowns can also be quite detrimental. If the worry leads to constantly hedging half of the exposure, that same \$100 grows only to \$253 over the full 25 years.

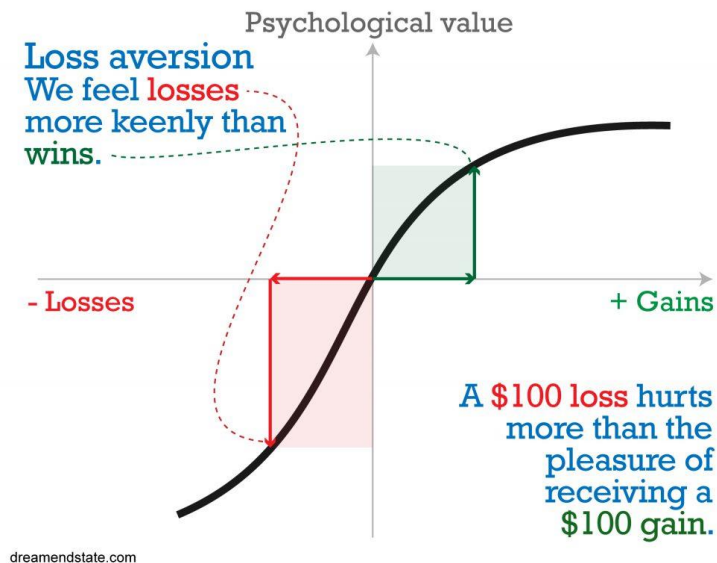
Is there a better approach than ignoring or obsessing over major drawdowns? We think so. Of course, no one can know exactly when a bear market is coming or what shape it will take, but the ABR 75/25 Volatility Strategy has returned +13.7% over its full history since the beginning of VIX futures in 2006, with a lower maximum drawdown than the S&P 500 (see the disclosures for important information, including information regarding hypothetical performance and standardized performance figures).

The point we explore in this note is twofold:

1. The opportunity cost of either accepting major drawdowns or constantly hedging against them may be the biggest driver of suboptimal investment results over time.
2. There are strategies which have provided large positive returns in the historical major drawdowns of the past 25 years, thus potentially preparing investors for them without constantly hedging against them.

Prospect Theory – Opportunity cost is a drag on long-term results

Simply put, prospect theory explains the well-documented human tendency to avoid losses more strongly than to seek gains. In the following graph, the pain from a financial loss (red) is greater than the pleasure from an equal-sized financial gain (green).



What does this mean to investor behavior? When facing the possibility of similarly sized, short-term gains or losses, we prefer to protect our portfolios. Unfortunately, this instinct is financially counterproductive. Over the long term, the cost of the insurance or hedge exceeds the expected payout.

Put another way, on average over time, the S&P 500 has a daily return of about 0.03% with a standard deviation of about 1.20%. Gains and losses of a given magnitude are about equally likely, and Prospect Theory gets in the way of good investing over shorter periods of time. However, give it 25 years, and the S&P 500 has never been down. That places it squarely in the top-right quadrant of the graph (financial gains and psychological happiness). Now, Prospect Theory is no longer interfering with investors' long-term prospects.

On a shorter horizon, given all the legitimate reasons to be concerned on a nearly ongoing basis, Prospect Theory regularly, perhaps even constantly, suggests hedging. But, on a longer horizon, Prospect Theory suggests and every reader knows that remaining fully invested has been better.

This is exactly the problem with collared, hedged, buffered, defined risk, and buy-write strategies. Instead of seeking a solution to the detrimental effects of Prospect Theory, they capitulate to it; constantly hedge roughly half of the equity exposure; and, therefore, generally produce about half of the return without any meaningful diversification value. Prospect Theory makes them easy to sell, while the buyers suffer the compounding opportunity cost over time (with the potential dollar consequences in the introduction).

Overcoming Loss Aversion – Thrive in major drawdowns without constantly hedging against them

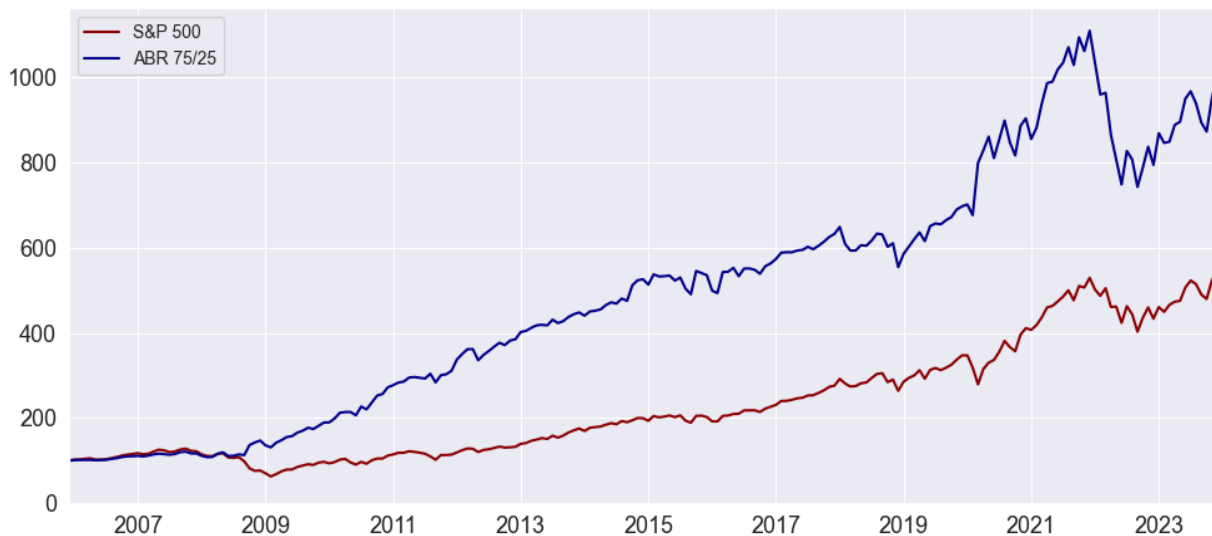
How can investors overcome loss aversion, and the accompanying urge to constantly hedge, in order to remain fully invested while also preparing to potentially thrive in major drawdowns? To answer this question, we first broadly group the 4 bear markets of the last 25 years into two categories:

1. The first type we call a “grind down.” These include the end of the tech bubble and the rising interest rates of 2022. They were characterized by greater than 6 months from the high point in the S&P 500 to the subsequent low point, without the VIX Index ever reaching extreme levels.
2. The second type we call a “crash.” These include the GFC and Covid, both of which brought VIX peaks above 80, although there’s nothing special about that number.

In order to remain invested, overcome loss aversion and perhaps even thrive in major drawdowns, we think it may help investors to use alternative investments that are specifically designed to produce gains in these two types of large drawdowns. Furthermore, there are even strategies that seek increased exposure to these alternatives, depending on market conditions, while reducing exposure to them in strong bull markets for stocks and bonds (reach out to us to learn more about them):

1. Conventional trend-following managed futures strategies are generally well suited to deal with a “grind down.” The Credit Suisse Managed Futures Liquid Index, as a benchmark example, returned +33.22% in the collapse of the tech bubble and +29.63% in the grind down in 2022, and it gained 5.84% annualized over the full 25 years.
2. Volatility trend-following strategies may be well suited to deal with a “crash.” The ABR 75/25 Volatility Strategy gained 20.88% in October 2008 (GFC – pre-inception performance) and 18.13% in March 2020 (Covid – live performance), and it gained 13.66% over its full history since 2006 (the beginning of VIX futures).

Performance: 2006 - Dec 2023



	Return	St Dev	Sharpe	Down Dev	Beta	Alpha	Treynor	Sortino	MAR	Max DD
S&P 500	9.9%	15.5%	0.54	11.5%	1.00	0.000	0.08	0.73	0.19	51%
ABR 75/25	13.7%	14.6%	0.83	9.0%	0.54	0.076	0.22	1.35	0.41	33%

(Includes pre-inception performance before February 2017. See below for important information.)

Conclusion

Humans naturally tend to believe very recent past and current concerns are more likely than they really are to prevail over time. We also tend to overreact to whatever has our attention in the moment. These tendencies may be useful in some situations, such as life-or-death threats warranting fight-or-flight responses. However, when combined with the loss aversion behind Prospect Theory and the opportunistic marketing of permanently hedged option overlay strategies, these tendencies are truly sub-optimal for long-term investors. We think it makes more sense to seek a way to thrive in the major downturns. The difference may be enormous, as explored in the introduction.

To learn more about the ABR 75/25 Volatility Strategy, please reach out to us at info@abrfunds.com.

Disclosures:

For the periods ending at the end of 2023, the ABR 75/25 Volatility strategy returned +26.2% for one year, +12.6% for five years, +8.4% for 10 years, and +13.7% over the full history since 2006. These figures are annualized and include pre-inception performance before February 2017.

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The "ABR 75/25" Volatility Strategy is represented by a blend of 75% of the returns of the ABR Dynamic Blend Equity and Volatility Index Powered by Wilshire (ABRVXX) and 25% of the returns of the ABR Enhanced Short Volatility Index Powered by Wilshire (ABRXIV) respectively (collectively, the "ABR Indexes"). Wilshire® is a service mark of Wilshire Associates Incorporated (Wilshire) and has been licensed for use by ABR Dynamic Funds, LLC. The ABR Indexes are not sponsored, endorsed, sold or promoted by Wilshire, and Wilshire makes no representations or warranties with respect to the ABR Indexes. ABR Dynamic Funds, LLC may receive compensation in connection with licensing the ABR Indexes to third parties. The strategy's calculations and performance utilized month-end rebalances back to the stated blend.

The ABR 75/25 Volatility Strategy includes pre-inception performance and is shown net of hypothetical expenses of 2.00% fixed and 20.00% incentive per year. Actual expenses may vary. ABRVXX was launched 30 April 2015, and ABRXIV was launched 31 January 2017, such that performance information before those dates constitutes pre-inception (hypothetical) index performance. The performance history of each Index, both pre-inception (or hypothetical) and post-inception, was derived by application of ABR's algorithmic trading models to market data going back to 2006. Hypothetical performance results have certain inherent limitations. Hypothetical trading programs in general are designed with the benefit of hindsight. Investors cannot invest directly in an index.

Hypothetical performance results have certain inherent limitations. Hypothetical trading programs in general are designed with the benefit of hindsight. HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND RESULTS

SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM. ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR TO ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS.

The inception date of the non-U.S. pooled vehicles that utilizes the ABR 75/25 Volatility Strategy was 22 October 2021. There also exists a U.S. pooled vehicle which utilizes the Strategy and for which various terms, including expenses, vary. For more information on the live-trading performance of various ABR-advised funds and strategies, or the hypothetical performance presented, please contact us. Past performance does not guarantee future results.

The Strategy may acquire or enter into derivatives instruments and transactions. Derivatives are financial instruments that have a value which depends upon, or is derived from, a reference asset, such as one or more underlying securities, pools of securities, options, futures, indexes, or currencies. Derivatives may result in investment exposures that are greater than their cost would suggest; in other words, a small investment in a derivative may have a large impact on the Strategies' performance. The successful use of derivatives generally depends on the ability to predict market movements. There may be an imperfect correlation between a derivative and its reference asset. Certain transactions, such as those involving investing in certain derivatives, may give rise to leverage, causing the Strategy to be more volatile than if it had not been leveraged.

Incorporating a dynamic volatility strategy into a portfolio is designed to help an investor potentially mitigate, and potentially benefit from, volatility in the U.S. stock market. However, all investing involves risk including the possible loss of principal. There can be no assurance such a strategy will achieve a gain or prevent a loss. Volatility assets and strategies may not be suitable for some investors due to their financial circumstances and risk tolerance. A volatility strategy should not be viewed as a complete investment program.

Volatility assets entail their own unique risks that investors should consider when evaluating a volatility strategy. Volatility-based futures can become volatile and difficult to value and can be imperfectly correlated to the underlying asset or index. Due to leverage, the loss on a long futures contract could greatly exceed the initial investment. The loss on a short contract theoretically is unlimited since the appreciation of the shorted asset also theoretically is unlimited. Thus, a small investment in derivatives could have a large potential impact on the performance of a portfolio. Further, a volatility strategy may at times call for high portfolio turnover rates, which increases brokerage costs. High turnover also may generate net short-term capital gains.

The method for the removal of the S&P 500 drawdowns, as discussed in the introduction, was as follows. For the "grind down" drawdowns (the end of the tech bubble and the interest rate increases of 2022), the daily returns of the S&P 500 were zeroed from its high point to the subsequent low point. These dates are 5 September 2000 through 9 October 2002 and 4 January 2022 through 12 October 2022. For the "crash" drawdowns (the GFC and Covid), the daily returns of the S&P 500 were zeroed from the final instance of the VIX Index rising above 25 before its highest point to its highest point. These dates are 12 September 2008 through 20 November 2008 and 24 February 2020 through 16 March 2020. These dates were selected in hindsight, and it is not possible to know the high and low points in the S&P 500 or the VIX in advance. As a result, it is not possible to precisely avoid any particular drawdown. The illustration in the introduction was provided for the purpose of illustrating the full theoretical benefit of avoiding drawdowns, not the realized results of any strategy or investment.

Dynamic Funds for a Dynamic Future



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