MELISSINOS TRADING

PROFITING IN A #TRENDING WORLD

How Michael Melissinos Challenged Conventional Thinking and Designed an Investment Strategy to Follow Global Market Trends.

In March 2008, J.P. Morgan purchased Bear Stearns for $2/share. After 94 years of conducting relatively stable business, Bear was gone. The stock price traded at all-time highs of ~$159/share only 12 months earlier.

Michael Melissinos, a year removed from college, was working as a junior analyst at Bear. Watching the buyout announcement on CNBC in his New York City apartment, he wondered what this meant for his future. At the time, many businesses suspended their hiring as the Financial Crisis was making its way through its first few innings. With little experience, it made the prospect of finding a new job that much more difficult. Up until this point, Michael had been used to being in control of his own destiny. This was his first experience where he realized he was no longer in control.

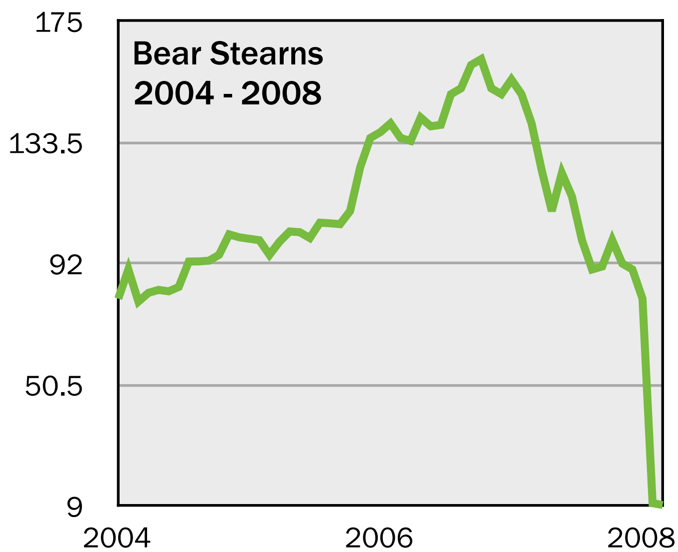
Bear's collapse and the Financial Crisis, in general, transformed Michael's thinking and feelings towards investing. He wanted to rethink the way people approached it. He envisioned a strategy that fit into people's overall health profile. He thought profitable investing should be a healthy endeavor rather than a pursuit of pain and stress. Given his lack of experience, he decided to research how and why people invested the way they did. "Why did most investors only invest in stocks and bonds? How did they decide how much to invest? How did they decide when to exit their investments? Was there an exit plan? If not, why not?"

Michael, like many others, had always been taught to buy stocks, bonds and real-estate and hold them forever. This was based on the assumption that these markets would always go up over time. Maybe they always would, but obviously Bear-like events happened and needed to be planned for. "How did the traditional approach handle these events? Holding on and hoping for markets to eventually recoup losses? What if it took years? This seemed like a demoralizing strategy. What if losses were never recouped? What was the plan then?" It became evident there was no plan. It was same ole, same ole – buy and hold no matter what.

Michael, now 29 years old, founded Melissinos Trading three years after Bear's collapse. Looking back, 2008 taught him that the traditional approach was poor at preparing people for crisis as well as taking advantage of up and downtrends outside of stocks, bonds and real-estate.

He realized he could design a better approach by researching historical price movements of all markets, profiting from their trends while protecting capital during unpredictable crisis scenarios. This type of thinking directly challenged the traditional socially-accepted approach.

Obviously, every market moves. Movement is a function of investor sentiment and underlying fundamentals. The greater the discrepancy between the two, the larger the move. This helped explain the Bear collapse and Financial Crisis. When companies and countries spent beyond their means they were forced to take losses. Investors eventually became aware of this and adjusted their positions to find the right market price. Living through both events helped Michael see the opportunity in helping people prepare for these sorts of price dislocations.



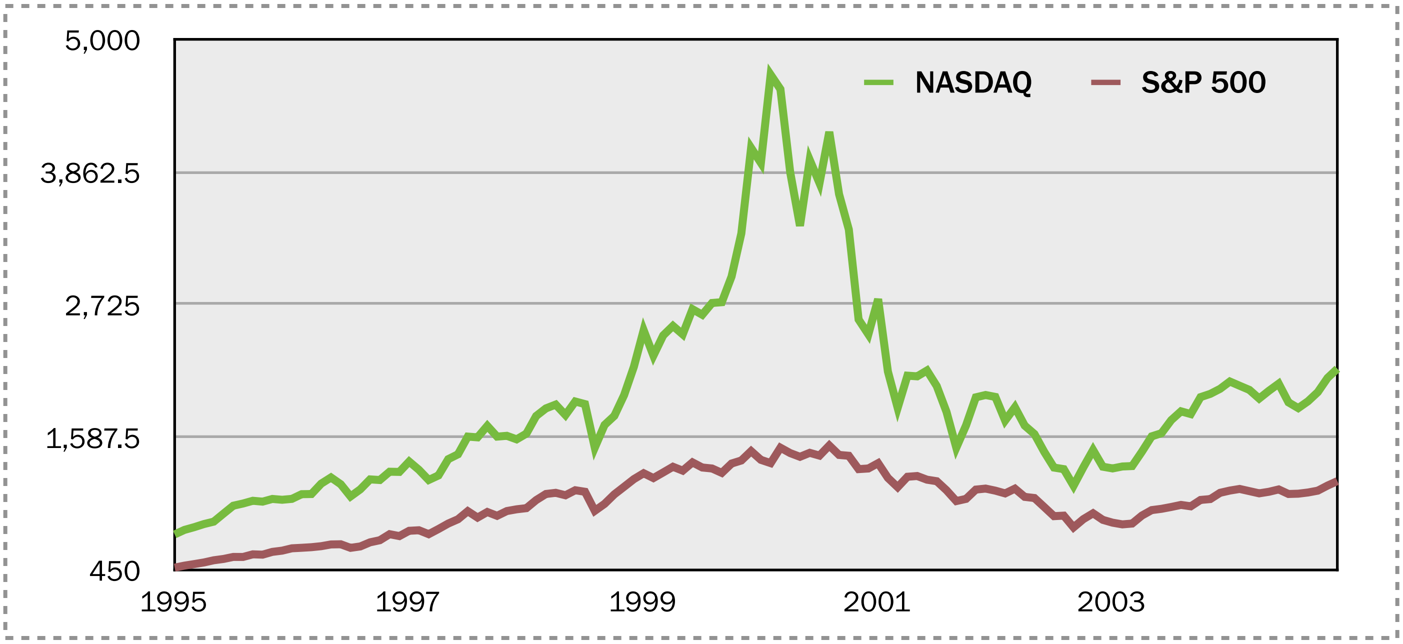
The foundation of Michael's investment strategy, Eupatrid (Greek for "well-born"), is designed to follow market trends in all asset classes. The strategy was and is active. It buys strength and sells weakness, while attempting to stay on the sidelines during sideways trends. It views each market as simply a wave to surf and is agnostic to the direction each market moves. It is a pure opportunistic strategy. Eupatrid was originally created for Michael and his family's assets. By investing under this new philosophy, they could protect themselves from sudden shifts in market trends, while opening the door to profit from trends in markets they did not have exposure to (currencies, commodities, foreign stocks and bonds). Today, Eupatrid continues to evolve and improve the way it helps people prepare for ever-changing marketing conditions. This article tells the story of how Eupatrid came into existence. It describes how Michael's lengthy research process laid the foundation for a simple and robust investment philosophy.

EARLY RESEARCH

Michael founded Melissinos Trading in 2011 in his parents' New Jersey home. At the time, he worked at a proprietary trading firm in New York. However, most of his days were spent conducting research into building Eupatrid.

Ever since his days at Bear, he had been consumed by fundamental data. Wall Street research is based on assessing the fundamentals of a given stock. Michael knew that stock prices were influenced by both the fundamentals and investor sentiment, so he was always puzzled why so many people only focused on the fundamental aspect. Perhaps it allowed them to live in the non-existent future by predicting it instead of facing the facts of today. Eventually, he found it much more effective to focus only on the market price instead of fundamentals. Fundamental data, by itself, was a major distraction. Even fully understanding the fundamental story, the price still needed to move favorably in order to record a profit anyway. Focusing only on price eliminated distractions and biases that could impede in following trends.

Throughout history, some of the best trends occurred without fundamental support. One of the best examples of this was the dot-com bubble. "Who could've imagined that stock prices of companies with zero earnings could multiply by, in some cases, thousands of times? Relying only on fundamentals likely kept people from participating in the NASDAQ uptrend, instead waiting for the inevitable downtrend. Even if they predicted right, they still would have missed out on possibly a once in a lifetime trend. A price-focused investor likely would have done well from both sides of the trend whereas a fundamentalist probably missed out."



Michael found many instances of massive trends in all different markets throughout historical data. When removing the names of the markets from the data, it was nearly impossible to tell any two apart. The one thing all markets have in common is people. He concluded that since all markets are driven by human emotion, that all could be traded the same exact way. The stock market was driven by the same greed, fear, hope and pride that Crude Oil or any other market was. Historically, most people only positioned themselves to benefit from uptrends in stocks, bonds and real-estate. But research showed there was tremendous opportunity in following trends, both up *and* down, in *all* markets not just the traditional ones. This kind of thinking laid the groundwork for constructing Eupatrid.

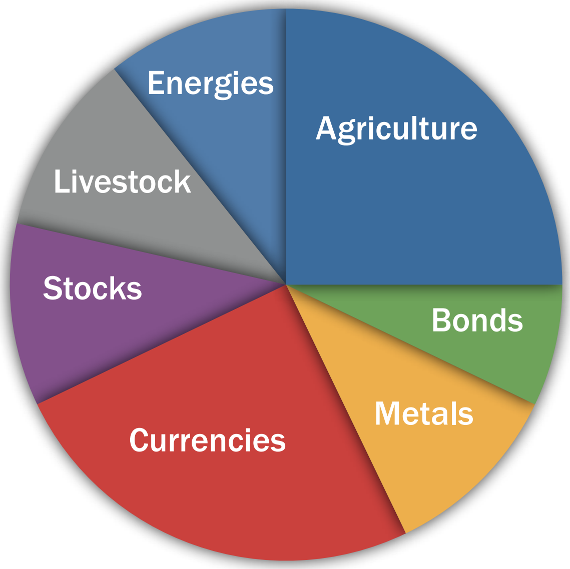
THE NEED FOR DIVERSIFICATION

The first problem Michael aimed to solve was fixing his and his family's asset allocation. Like many other folks, their portfolios consisted of traditional markets. This mix of highly correlated assets typically performed well during economic growth, but suffered tremendously during recessions and depressions – especially deflationary ones like the Great Depression. It also missed out on trends in other asset classes such as commodities, currencies and foreign stocks and bonds. Their portfolios were essentially putting a massive bet on one particular scenario, economic growth, to happen forever.

One of the main goals of Eupatrid was to weather changing market conditions without predicting them. Markets are always in the process of rising, falling and congesting. Without being able to predict how people were going to react to the fundamental data affecting markets, it would be impossible to predict trends with any consistency. Michael found a far better approach was to expose a portfolio to as many markets as possible and react to their movement. This way, if some markets, but other markets were trending well, the portfolio could take advantage. The new portfolio then became dependent on up and down trends across a diverse basket instead of only up-trends in a concentrated basket.

The new portfolio contained markets in 7 different sectors (graph below). This mix put Michael's family in a much more favorable position by: 1) not relying too heavily on one or two sectors to provide returns and 2) allowing them to profit from trends in markets they didn't have access to before. It gave them exposure to markets such as Crude Oil, Wheat, British Pound, etc that moved for all different reasons. Holding a portfolio of markets driven by as many different reasons as possible was a major advantage over the traditional method.

The keys for most investors are diversifying their portfolios and adapting to market trends. Too often, investors miss out on big opportunities in non-traditional markets and hold on to their losing positions for far too long. Big winning positions eventually became losers and small losers became debilitating losses crippling their portfolio. The trick is to figure out which markets to monitor, when to hold them and when to fold them in a way that is simple and robust.



BALANCING AND RISK-ADJUSTING POSITIONS

After building a diversified portfolio of markets to monitor, the next step was figuring out how much capital to allocate to each trade. Michael knew it was important to make all bets similar so as to avoid favoritism towards any one particular trade or sector. This thinking is akin to how professional blackjack players view each hand. They assess the odds after each card is dealt, bet more when the odds are in their favor, less or not at all when they are out of favor.

Knowing he could not predict which "hand" (i.e. trade) would be dealt next, betting the same percentage on each trade was the only logical choice. This way, when viewing each trade in terms of return per unit of risk, all positions became more or less the same. Each position would be allowed to equally contribute to the portfolio's overall performance. Bias towards any one specific trade would decrease the portfolio's balance and long-term edge. Position sizing became a function of the bet fraction (a fixed percentage of portfolio equity) and the market's volatility. Bigger positions could be taken when volatility was low and smaller when volatility was high.

The idea of sizing positions based on volatility seemed to be a foreign idea throughout the investment community. By doing this, high-volatility and low-volatility markets could be adjusted to impact the portfolio similarly. Traditionally speaking, most people simply over-allocated to stocks and bonds without hesitation. During volatility shocks, their passive portfolios were typically 1) over-allocated in the wrong areas, and 2) on the wrong side of the trends (because they always held on). Understanding that volatility shocks were a normal characteristic of markets, it made sense to prepare for this.

BALANCING TRENDS AND WHIPSAWS

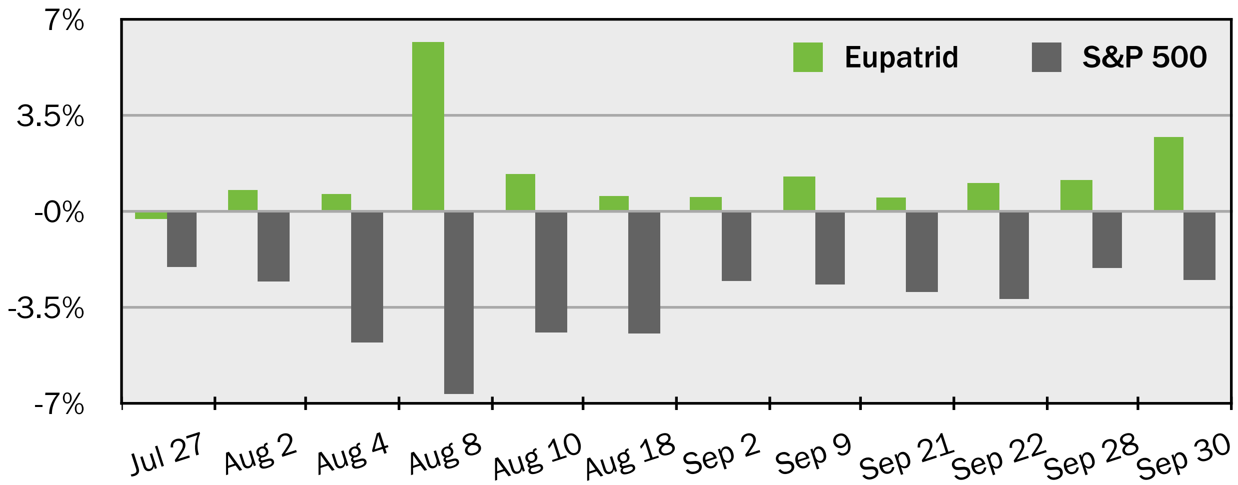
Throughout the research process, Michael's early discoveries of investing in a diverse set of markets, aligning with trends, recognizing human psychology as the driver and risk adjusting positions became the core philosophy of Eupatrid. Confidence grew through substantial back-testing particularly through periods of market bubbles and crashes. But, before capital could be committed, Michael needed to understand his own risk tolerance. Was following a system that aimed for 30% returns with maximum drawdowns of 65% something that he and his potential clients could tolerate? Probably not. Michael tested various bet-sizing amounts in order to find an appropriate risk level.

Markets oscillate between trending and whipsaw periods (sideways congestion). Each phase can last much longer than people expect. Markets are not bound by the laws of physics, so transitions aren't always smooth. It was crucial to design a system that could weather whipsaw periods so it could make it to the next set of trends.

Michael used technology to collect and process historical data. From this, he developed rules to decide when to enter and exit markets. These rules were designed to be robust and timeless in nature. They could be applied to every market in the portfolio. Using Microsoft Excel and other coding languages such as C# and Python, Michael saw how altering the time frame of the rules affected portfolio returns. He found that the best performing portfolio utilized *long-term* signals. This made sense given that the biggest trends typically played out over multiple months and years rather than days or weeks. This was evident in major economic shifts, such as transitioning from bull to bear markets. It also held true during extreme isolated shocks like bubbles and panics. These shifts did not happen overnight, but over many months and years.

Adapting to change is basic to survival. Eupatrid is designed to survive change of all shapes and sizes. This philosophy weathered every stress scenario during the testing period (~100 years). The 1920's German hyperinflation, the Great Depression, 1970's inflation, 1980's dis-inflation, 1987 Black Monday crash, 1991 Kuwait Invasion, 1998 LTCM collapse, 2000 Dot-Com crash and 2008 Financial Crisis were all scenarios that Eupatrid took advantage of. After Melissinos Trading launched, there was one surprise event where Eupatrid performed well – the August 2011 downgrade of U.S. Debt. It was favorably positioned taking advantage of the uptrend in bonds and gold, and downtrend in stocks.

Below is a performance chart showing how Eupatrid performed on the days the S&P 500 fell 2% or more in the months surrounding the U.S. Debt downgrade. Eupatrid outperformed on all but one day.



Past performance are necessarily indicative of future results.

3 YEARS IN THE MAKING: THE EUPATRID COMMODITY PROGRAM

The final Eupatrid trading system was put into action in January 2011. Michael's desire to create a timeless strategy exploiting market trends was now a reality. The personal journey of living through Bear's collapse, the Financial Crisis and challenging traditional thinking helped him develop a strategy he thought would be reliable forever.

Michael knew each market would trend over time. He did not know when or which direction, but that movement was a given. Unlike many investors, he did not assume markets would always rise over time. Even if this was the case, markets still went through periods of decline and congestion. Michael felt that allocating capital during these conditions was grossly inefficient. He thought designing a strategy aligned with nature – with the trends – was the best way to profit in the markets.

After Eupatrid was built, Michael's job was to follow the rules every day without question. Since inception, it has performed in accordance with Michael's expectations. Having expanded his client base from three clients to over two dozen by Fall 2013, Michael had the opportunity to see how little people were aware of alternative approaches like Eupatrid.

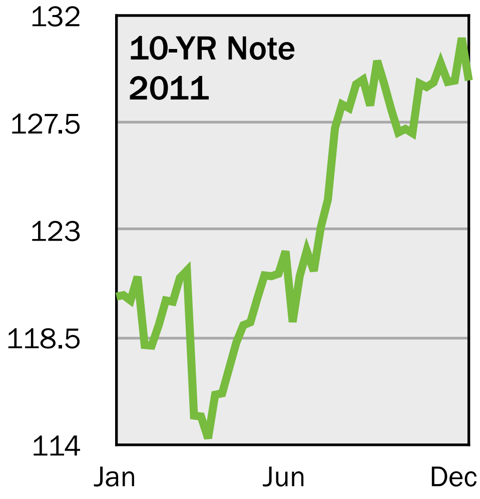
EARLY ADOPTERS

In late Fall 2010, Michael brought the Eupatrid philosophy to his friends and family. Many understood and accepted its general principles without much pushback. After a couple of months of conversations, Michael launched with $300,000 of starting capital.

The first large institutional investor to show interest was a CT-based fund-of-funds. They had been monitoring Eupatrid's performance for months seeing it as a strategy that was "doing what it's supposed to do" during a strong trending period (Gold and Treasuries were the standouts). They were looking for a strategy uncorrelated to their core investments of traditional long-only equities and fixed income. Michael advised them to not chase his recent returns, but instead wait until things cooled down a bit. They agreed and decided to make an investment several months later. They are still invested.

Michael continued advising people to incorporate a trend-following element like Eupatrid into their portfolios. Most people started small, allocating roughly 1-2% of their total portfolio to Eupatrid. As confidence grew, some decided to increase their allocations to 5-10%.

To be clear, there was plenty of resistance to Eupatrid's principles. Since its inception, U.S. stock markets have been in the midst of one of the best bull markets of the last ten years. This makes many people wonder why they even need to diversify. Over many conversations, many people were completely unfamiliar with the notion of investing using a system, while others were uncomfortable with the inherent leverage included in futures markets. Underneath these concerns, many folks had genuinely lost their trust in investing overall often declaring it "rigged" or "fixed". However, Eupatrid slowing gained a dedicated following. Investors grew more comfortable with the idea of investing in futures markets, holding a diversified portfolio instead of a concentrated one all the while viewing recent stock market gains as something that was temporary rather than a given.



A COMMON-SENSE APPROACH

Today, Eupatrid manages assets for over two dozen clients. Eupatrid was created out of Michael's desire to prepare for uncertainty. In investing as in life, one can make three observations: 1) everything moves; 2) movement is driven by human emotions and 3) no one can predict what will move, when it will move or which direction it will move. The basic premise of Eupatrid is very simple. It 1) monitors movement of many different markets; 2) aligns itself with that movement; 3) holds positions that work and discards ones that don't and 4) never attempts to predict anything.

Investing without a well-researched plan is like sailing without a compass. The compass tells the navigator where he is and what direction he's going. Without knowing these two critical pieces of information, the odds of survival are slim. Eupatrid simplifies investing by organizing a pre-determined set of rules to follow every day. There is never any confusion about whether or not the rules should be followed. People need a plan that prepares them for uncertainty. Michael believes Eupatrid fulfills that need.