How We Work with Investors:

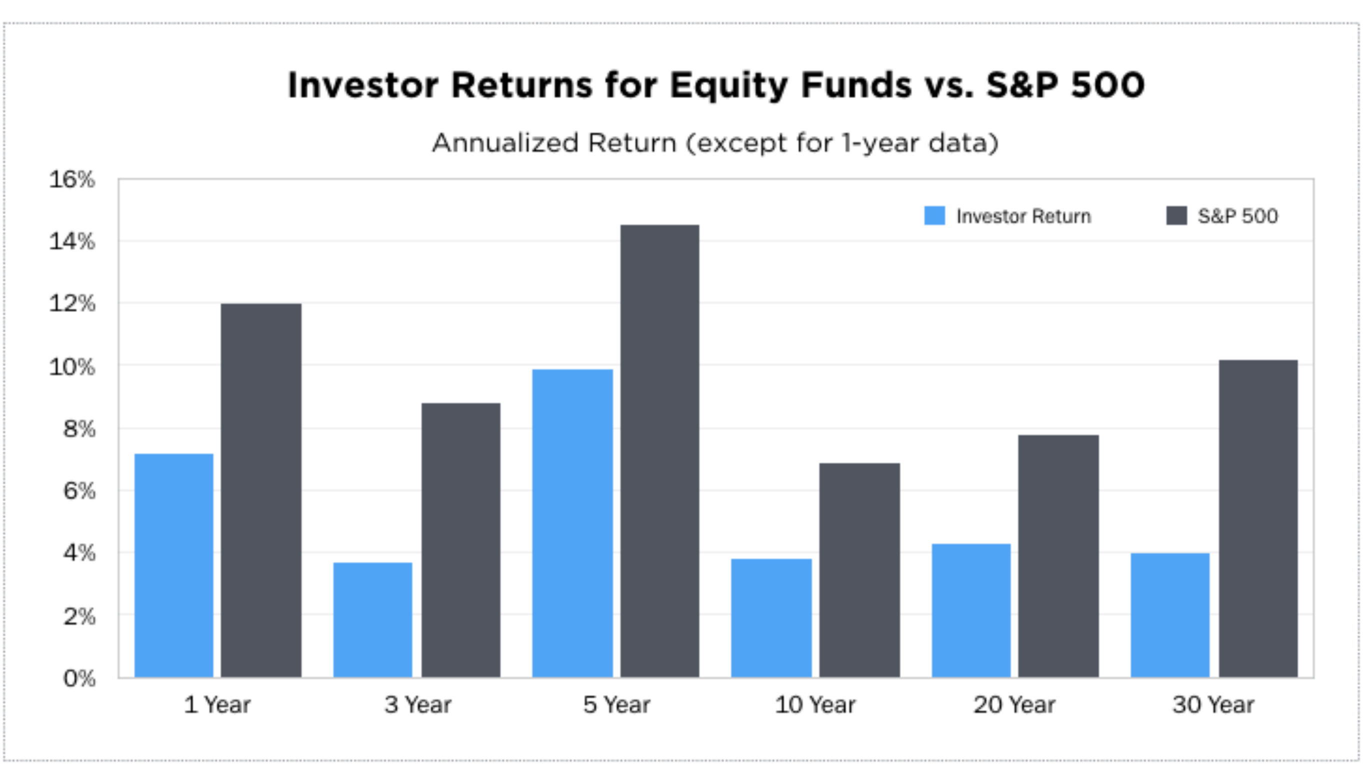
Shifting the Focus from Chasing Short-Term Returns to Long-Term Discipline

Introduction

I believe the traditional investment management model does not work.

The reason? Severe investor underperformance over time.

Over the last ten years, the average investor underperforms the S&P 500 by about 90%. That, to me, represents a colossal failure of the way investors and managers work together. Discipline plays the biggest role in underperformance too, not fees.



Source: dalbar.com

Fund managers and investors entangle themselves in drama that promotes chasing after short-term returns. Managers, out of fear their clients will leave if they don't make money every quarter or year, chase hot stocks and markets.

With such focus on short-term results, pressure mounts and as a result both parties have trouble staying disciplined. Managers must focus on developing a strategy and sticking to it. Clients must focus on making sure the manager is following his or her system perfectly.

In the following pages, I explain the current investment management model, it's flows and how I design a process that shifts the focus from short-term returns to long-term discipline.

The Traditional Investment Management Model

1. An investor places funds with a manager either directly or through a platform.
2. After an investment is made, the manager and investor rarely communicate so they do not build and maintain rapport or trust.
3. In losing streaks, the investor expresses frustration and demands the manager start making money or else. The manager, now feeling the pressure, abandons his or her system and chases after short-term returns.

It Has Critical Design Flaws

1. The investor does not gain knowledge of the manager's system - namely, how or why it works.
2. The investor has no way of making sure the manager is sticking to his or her system.
3. This relationship discourages honesty, accountability and support. The manager does not have to explain their system - leaving them to do whatever they want as long as they produce consistent short-term performance.

Most investing relationships are built on control and threats rather than rapport and trust.

The investor controls the manager by threatening to withdraw money if he does not produce consistent short-term performance. The manager medicates the investor's feelings of frustration, fear, sadness, etc via guilt trips, making predictions about the markets, etc.

My Solution to Improve Results

1. **Manager Responsibility:** To fully explain the strategy's philosophy, how his strategy works, when it performs well and poorly and what kind of returns and volatility to expect.
2. **Investor Responsibility:** Determine whether the investment suits their risk tolerance and then commit to supporting the manager to follow his system.

When both parties work this way, the relationship naturally shifts from controlling to supportive.

A New Investment Management Model:

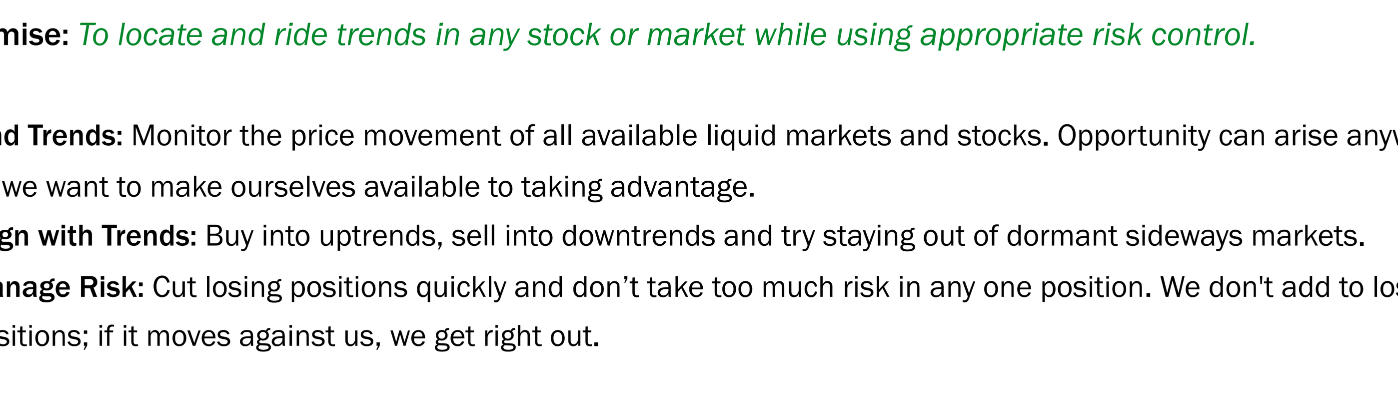
How We Work with Investors at Melissinos Trading

Long-term investing success derives from having both a good strategy and a supportive relationship between me and my investors.

Like a healthy diet, it only works if we follow it.

It's my job to design a strategy that works and can follow consistently. It's also my job to fully explain how the strategy works, present the data proving it works and lay out it's performance and volatility behavior so investors can get a handle on what to expect.

Without a complete explanation of how it works and performance expectations, I believe investors will wind up chasing good returns up and bad returns down and, as a result, hurting their returns - just like equity investors have been doing vs. the S&P 500 over the last 30 years.



Our Investing Strategy

The Premise: *To locate and ride trends in any stock or market while using appropriate risk control.*

- **Find Trends:** Monitor the price movement of all available liquid markets and stocks. Opportunity can arise anywhere, so we want to make ourselves available to taking advantage.
- **Align with Trends:** Buy into uptrends, sell into downtrends and try staying out of dormant sideways markets.
- **Manage Risk:** Cut losing positions quickly and don't take too much risk in any one position. We don't add to losing positions; if it moves against us, we get right out.

The Design: *Invest in the strongest trends; pick spots to buy / sell and adjust position sizes.*

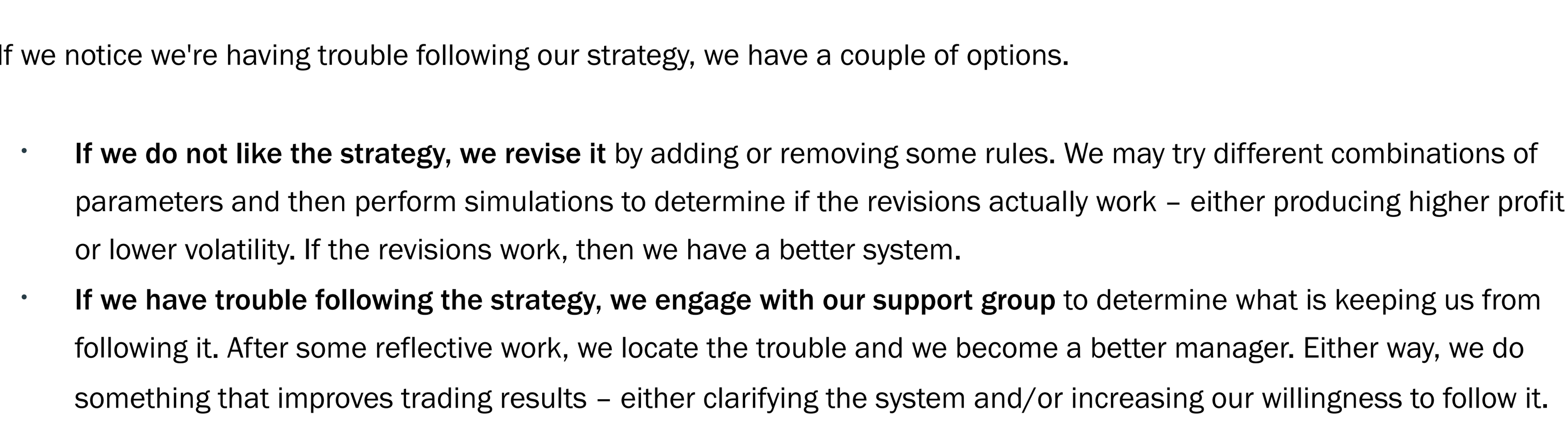
- **Market Selection:** Construct a diverse portfolio of markets and stocks to maximize the odds of catching many different trends.
- **Tactics:** Use simple quantitative techniques to get in and out of our investments.
- **Position Sizing:** Limit the amount of risk taken in any position, sector and the portfolio overall. The risk we take depends on each position's trend strength, volatility and correlation to our other positions.

Simulation: *Backtest to determine robustness and understand performance behavior.*

- **Code the strategy and backtest it** over historical data to see if it works and understand how it performs over time.
- **Optimize it** to fit our personal risk tolerance.
- **Stress-test the strategy to determine robustness.** A good strategy has minimal sensitivity to minor changes in it's parameters. We trade the most robust strategy we can create.
- **Objective of the Strategy:** We strive to build a strategy with a high annual rate of return and low volatility; and one that performs better than simple index funds on a risk-adjusted basis.

Execution: *Follow the rules without question.*

- **Daily Rules:** After we build our strategy, we follow the rules every day without question; virtually no discretion.
- **A Robot Assistant:** A computer promotes organization, speed and accuracy to ensure we don't make lazy mistakes.



Iterations and Tweaks

If we notice we're having trouble following our strategy, we have a couple of options.

- **If we do not like the strategy, we revise it** by adding or removing some rules. We may try different combinations of parameters and then perform simulations to determine if the revisions actually work – either producing higher profit or lower volatility. If the revisions work, then we have a better system.
- **If we have trouble following the strategy, we engage with our support group** to determine what is keeping us from following it. After some reflective work, we locate the trouble and we become a better manager. Either way, we do something that improves trading results – either clarifying the system and/or increasing our willingness to follow it.

Accountability

We provide investors with a monthly performance recap highlighting current positions, PnL and open risk.

Upon request, we provide additional details on entry and exit prices and dates. These reports provide transparency and show investors that we are following the system.

A Shift in Focus Occurs Naturally

Investors who understand and believe in the strategy naturally shift their focus to long-term discipline instead of chasing short-term performance.

We, the manager, can focus on strategy development and consistent execution.

This new model promotes teamwork and reduces short-term performance-related stress. It gives investors a way to make sure we are sticking to the strategy and allows us to focus 100% on improving the strategy.

Satisfaction Comes From Discipline

As a systematic manager, we develop a peaceful detachment from the day-to-day fluctuations in performance. After exhaustive backtesting and stress-testing, we develop confidence in our strategy, so we lose the desire to outguess it.

Our satisfaction derives from sticking with the system, no matter what - even during losing streaks.

Conclusion

There are many ways to work with investors, but this is my way. I prefer having relationships where we can both be candid and open about our thoughts and feelings. In my experience, produces better investing performance and an overall better work environment.

Most people have constant discussions about the investing strategy - what's the "secret", how to improve it and how to get rid of the losing streaks.

People think if you have a good strategy, you automatically win. No, it takes discipline and trust.

I think my way is more holistic and considers not only the strategy, but also how to ensure discipline so we can maximize performance for investors over the long run.

Thanks for reading.

Michael Melissinos
CEO

Would you like to discuss working together?

Schedule a call here or send me an email at the address below.

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