



# Morpho Advisory

## FAQs

### Who?

Morpho Advisory was born because **investing needed a re-think**. The investing profession needs to transform from being academic theoreticians to being insightful practitioners. It needs to become an industry of substance rather than simply following the forms of espoused theories.

### What?

Investors want to **participate in up markets and avoid down markets**. Less risk, more reward. Simple.

### Why?

Investment professionals should deliver some version of this request on behalf of their customers otherwise, **what value do most fund managers really add**, besides being sellers of convenience, aggregation and reporting? In what other industry is such inconsistency of performance accepted?

### How?

Drawing on our 30 years of experience, a continuous desire to find a better way and a specific “A-ha!” moment, we discovered there are certain determinants that impact risk-asset prices (i.e. corporate bonds & equities), especially for larger movements. Further analysis of **this discovery showed that the impact of these determinants was relatively consistent and made market direction reasonably predictable for most large price moves**. What made the discovery even more remarkable was that we went back over 60 years of data and found that the relationship held.

### And?

Investment returns are significantly improved by not participating in down markets. But wait! There's more. The amount of volatility (an approximation of “risk”) investment portfolio returns experience is also reduced by avoiding down markets. When higher returns are combined with lower risk - well, that's every fund manager's dream: **Improved risk-adjusted and absolute return**. All this as a result of real-world insights rather than conventional ‘industry best practice’ academic portfolio theory.

### What else?

We know from experience that all fund managers experience doubt when making big portfolio decisions. This is due to financial markets being noisy places that often have a widely known consensus of opinion that results in a strong trending market. It is very difficult in this environment to go against the crowd, and uncomfortably so if you get the timing wrong. Because of this **we adapted our research to make our portfolio decisions systematic** - taking the emotional element out of execution. We describe this as:

*Quantitatively Derived, Systematically Applied*



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## Has the strategy been historically optimised?

**We have neither back-fitted data, fudged the numbers nor taken any discretionary action.** We don't like to deceive ourselves let alone deceive others:

- We made an observation;
- We constructed a way by which we could capture that observation and relate it to risk-asset prices;
- We applied that methodology to a large time-series across several asset classes;
- Our insight was validated;
- We developed it, adding new elements from subsequent observations and insights;
- We tested it using real-world prices allowing for fees and transaction slippage;
- It worked. It worked very well. It worked globally, across a wide range of asset classes.

While unquantifiable, **we believe our methodology will continue to perform well for the foreseeable future.** This view is based on our proprietary insights plus behavioural and complexity economics.

## Why haven't the 'big guys' discovered this?

We don't know. It seems obvious to us now that we've discovered it but we weren't thinking along these lines before and we missed it for many years also. Having worked in big organisations we know that **employees typically can't keep up with what's being asked of them let alone have time for thinking freely, creative research or investigating things purely out of curiosity.**

## What is the essence of the strategy?

**It is a binary Risk-On/Risk-Off strategy.** When the signal indicates 'risk-on' funds go into risk-assets. During 'risk-off' periods positioning alters accordingly. Developed as Long-Only the initial design was a dynamic Asset Allocation process. However, the strategy can also be employed as an Overlay, Absolute Return (including 'short' positions) and as a means of Uncorrelated Alpha for diversification.

## Is leverage involved?

Use of leverage is definitely possible but **the strategy was developed as unlevered** for core portfolios.

## Are there liquidity constraints?

**Liquidity is determined by the underlying risk-assets or funds** utilised. At best, the strategy can use the S&P 500 and U.S. Treasuries, making it an extremely liquid strategy for very large multi-billion dollar portfolios.

## What markets will it work in?

**We developed our process using U.S. markets** due to accessibility of data and the high correlation of global markets to the U.S. and its hegemony. Evidence confirms viability across global markets.



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## How is this strategy best employed?

**The strategy was designed to be used in core portfolios for asset allocation over the long-term** with risk-on/risk-off periods often being medium-term in length. Signal periods can be as short as only a few months but can potentially be several years in length. However, the application of our strategy is flexible and can be used within individual asset class portfolios, as a component of an Alternatives portfolio or as a portfolio risk-positioning overlay.

## How does this strategy differ from a typical 60:40 portfolio?

The strategy can be employed across asset classes and used for tilting but the efficacy will be diluted. **It works best during ‘risk-on’ by being 100% invested further out on the risk spectrum to increase returns and reduce volatility**, which sounds counterintuitive – not unlike a Formula 1 car, which needs to maintain a high speed in corners to sustain grip (by utilising down-force produced by the wings).

If you ‘tilt’ the strategy along its time axis, during the 20 years since November 1998, the strategy was in risk-assets 54% of the time and sovereign bonds the other 46%. So, statistically similar to 60:40.

## How closely does the strategy track an index?

Index-tracking is not a consideration of the strategy. If tracking error is a vitally important consideration then this may not be the strategy for you. However, **each component asset class (i.e. risk-asset or sovereign bond) will track an index but only when you are in that class of asset**. The strategy is essentially a systematic Tactical Asset Allocation process. The strategy was designed as an alternative to traditional Modern Portfolio Theory static portfolio “diversification” allocations that lack the ability to identify market risk.

## What is the correlation to a 60:40 portfolio?

Depending on the method of application for which our strategies are used, correlation to market over the last 20 years range from **0.5 for simple asset allocation, to between 0.2 to -0.2 for various absolute return and uncorrelated alpha applications**.

We have gone back to first principles in relation to investment portfolio design and **focused on risk and return in real-world, practical application terms**. We have intentionally chosen not to follow the increasingly abstract and academic path of the investing industry. Importantly, **our strategy methodology is a diversification away from the industry standard of economic view-based ‘tilting’ of asset allocations +/-5% here or there**. This strategy is designed as an alternative, in-whole or in-part, to standard 60/40 portfolios.

## What does it look like?

**We can’t divulge the mechanics of the strategy for proprietary reasons** (it is not a ‘black box’) but we can illustrate the strategy characteristics and performance relative to passive asset class investments.