THE FACTOR REPORT

March 16, 2022

<u>The Nature of Asset Volatility: A Case Study of Actual Factor Prop Account Trades</u>

The following is from the March 6, 2022 Factor weekend update. <u>Please read this first</u>.

> *The composite risk of an entire portfolio or grouping of trades can be measured in two ways:*
> - *Initial risk at the time of entering trades*
> - *Current risk using revised protective stop levels*
>
> *Even though I might have moved stops to BE (or even a locked-in profit) on trades, I still consider composite <u>initial</u> risk because it better reflects how much asset volatility would be experienced if a trend reversal occurs in my portfolio.*
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> *As a general rule I limit my composite initial risk on a portfolio of highly correlated positions to 200 BPs max. At the present time my composite initial BP risk on metals and mineral positions is greater than 300 BPs. This means that a broad reversal in these positions would not be fun. <u>I cannot remember the last time I had as many highly correlated positions</u> [emphasis added].*
>
> *Accordingly, I will actively seek opportunities to bleed off the risk of reversals in metal-related assets. I became a bit too much enthusiastic this past week in this asset class. Drawdowns exceeding 3% (sequential closed trade basis) or 5-6% (marked-to-market basis) are the max limits of my comfort zone.*

Presenting trading scenarios in conceptual or philosophical form is one thing – presenting actual trading realities always makes for a clearer case study.

I knew I had an oversized position when I wrote the Mar 6 Factor weekend update, as explained above. There are at least three ways to measure the asset volatility of a highly correlated portfolio (two are mentioned in the Mar 6 narrative).

1. The composite of the <u>initial risks</u> in a highly correlated portfolio – in this case, my composite BP risk was minus 333 BPs.
2. The composite current risk using revised protective levels (typically less than #1 above) – at liquidation my composite portfolio produced a profit of plus 200 BPs
3. The drawdown or "give-back" from daily closing price highs (or daily closing price lows in the case of a short portfolio) – based on closing price highs I had a composite unrealized profit of plus 900 BPs. Remember, unrealized profits do NOT below to us

	#1. Initial BO Risk	#2. P/L per $1MM AUM	#3. Max Closing Profit per $1MM AUM
GCM22	29	$ 7,256	$ 16,000
SIK22	29	$ 990	$ 9,500
SIK22	32	$ 1,386	$ 13,300
HGK22	27	$ (2,792)	$ 3,900
SIK22	26	$ 1,344	$ 13,440
SIVR	35	$ 1,514	$ 4,865
SIVR	35	$ 3,500	$ 8,575
SCCO	35	$ 703	$ 8,312
SCCO	35	$ 8,153	$ 8,153
FCX	25	$ (1,787)	$ 1,607
FCX	25	$ (378)	$ 1,607
	333	$ 19,889	$ 89,259

The table below to the right shows the three dimensions of the asset volatility of my recent metals/mining futures/stock portfolio. The composite initial risk of the portfolio (#1) was 333 BPs. Yet, as alluded to on Mar 6, the potential “pain-level” asset volatility was much higher. In fact, I identified this pain level at 500-600 basis points (marked-to-market basis).

In fact, at the peak of each trade I had an unrealized profit in the Factor Prop Account of $133,888 (900 basis points). I exited the entire portfolio with a composite profit of 300 basis points, or 600 basis points below peak unrealized profit levels. In other words, I gave up 2/3rds of my max unrealized profits (profits that do NOT belong to me).

In hindsight I can find two faults with my recent journey into metals and mining.

1. I should have had a GTC limit order to exit Gold near the 2021 high. Had I been carrying a 100% long position instead of a 50% position I would have for sure jettisoned half. Instead, I got greedy. This critique is a nit-pick.
2. I had way too big of a position in highly correlated markets. Normally, I impose a max risk on highly correlated positions at 150-200 BPs. I had double this initial risk.

Two lessons I would like to share with Factor Members are as follows:

- Do not be deceived by the composite initial BP risk of a correlated portfolio. In fact, the “give-back” should a reversal occur could be 2X or 3X or even more of your composite initial risk – and this is true even with active and aggressive trade management protocol.

- A composite initial BP risk of 150-200 for a highly correlated portfolio is a good risk management policy

It should be pointed out that it would be IMPOSSIBLE for me to keep a maximum composite initial risk to 200 if I just traded U.S. stocks because of the “all-one-market” nature of stocks. I am glad I am a futures/forex trader.

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