



# **MarketGrader Capital**

## **U.S. Risk-Managed Strategies**

**July 2016**

# Introduction to MarketGrader Capital's Risk-Managed Accounts

## **Kaizen Advisory: Risk Management Specialist**

Risk Managed Strategy:  
The Kaizen Dynamic Risk Overlay Index  
(KZTVOL)

## **MarketGrader Capital: Equity Specialist**

Capital Appreciation: MG U.S. 100  
Income Generation: MG Income U.S. 100

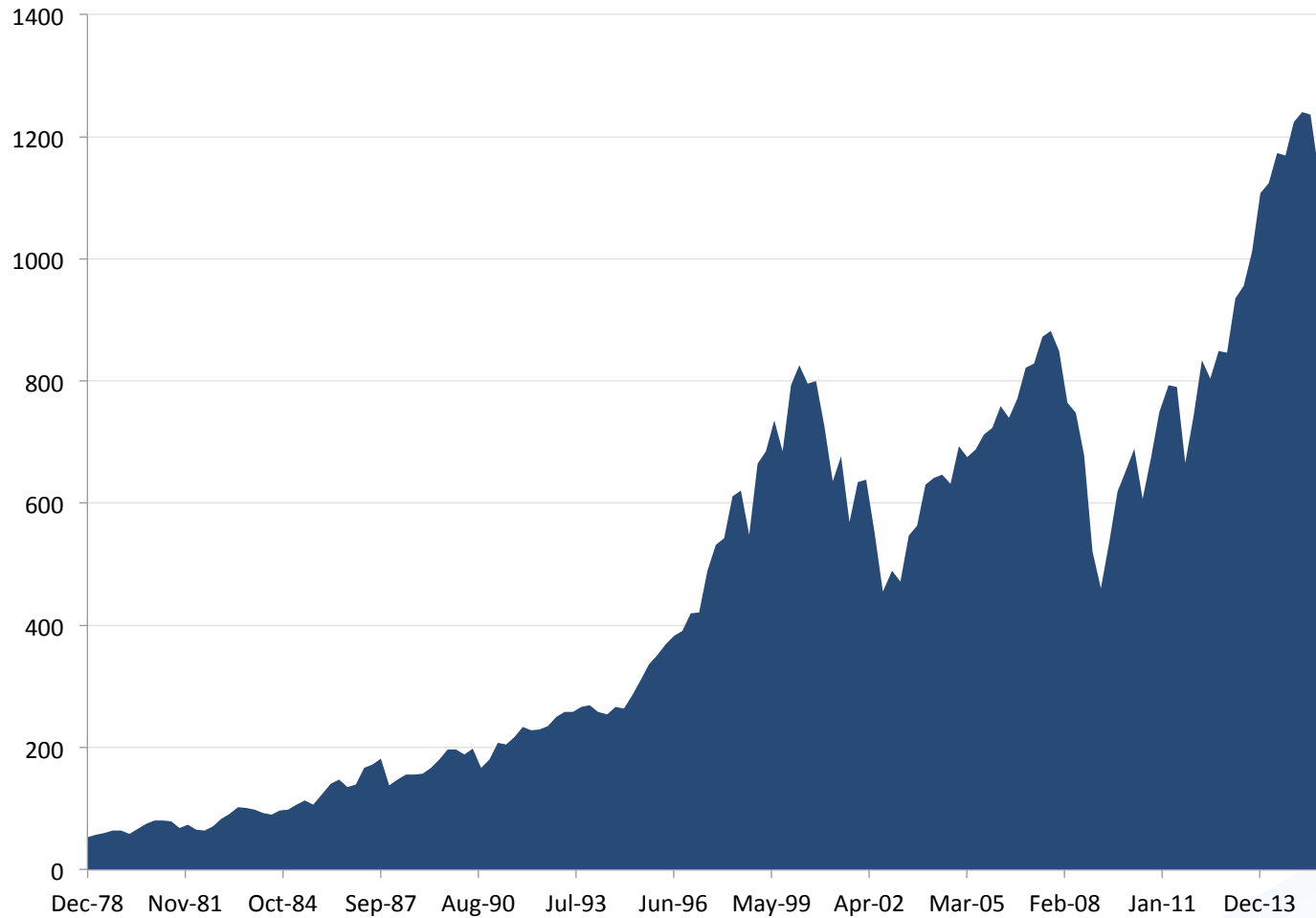
## **Risk Managed Equity Strategies**

Capital Appreciation + Downside Protection = MG U.S. 100 Risk-Managed Index Fund/Strategy

Income Generation + Downside Protection = MG Income U.S. 100 Risk-Managed Index Fund/Strategy

# The Power of Long Term Capital Appreciation

Russell 3000 Price Appreciation 1978-2015



Nominal annualized return of the Russell 3000 (98% of U.S. total market capitalization) since 1978: **8.8%**

\$100 investment on Dec. 31, 1978 = **\$2,228.16** on Dec. 31, 2015

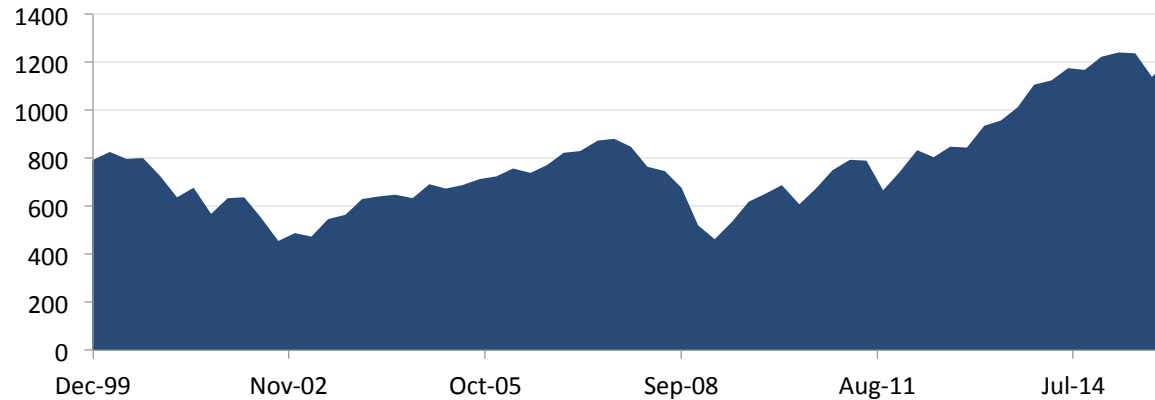
At this rate you would have doubled your money every **8** years

Stock market has successfully fulfilled its dual role in the long run:

- Channel investor savings into private enterprises to fund the growth of the economy
- Provide investors with a rate of return above and beyond the risk-free rate

# Has the relationship between equities and long-term capital appreciation broken down?

## Russell 3000 Price Appreciation Since 2000

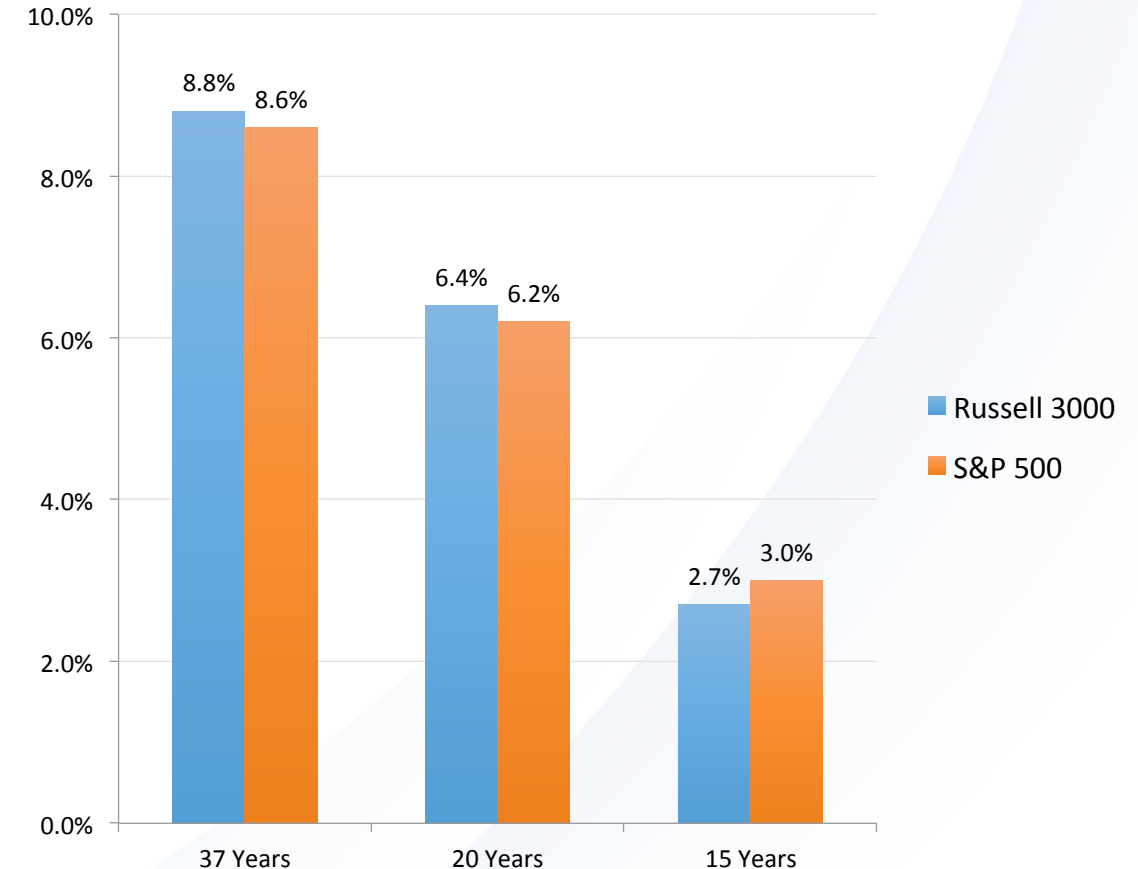


Since the turn of the century the annualized return on equities has been a dismal **2.7%** per year

\$100 investment on Dec. 31, 1999 = **\$152.1603** on Dec. 31, 2015

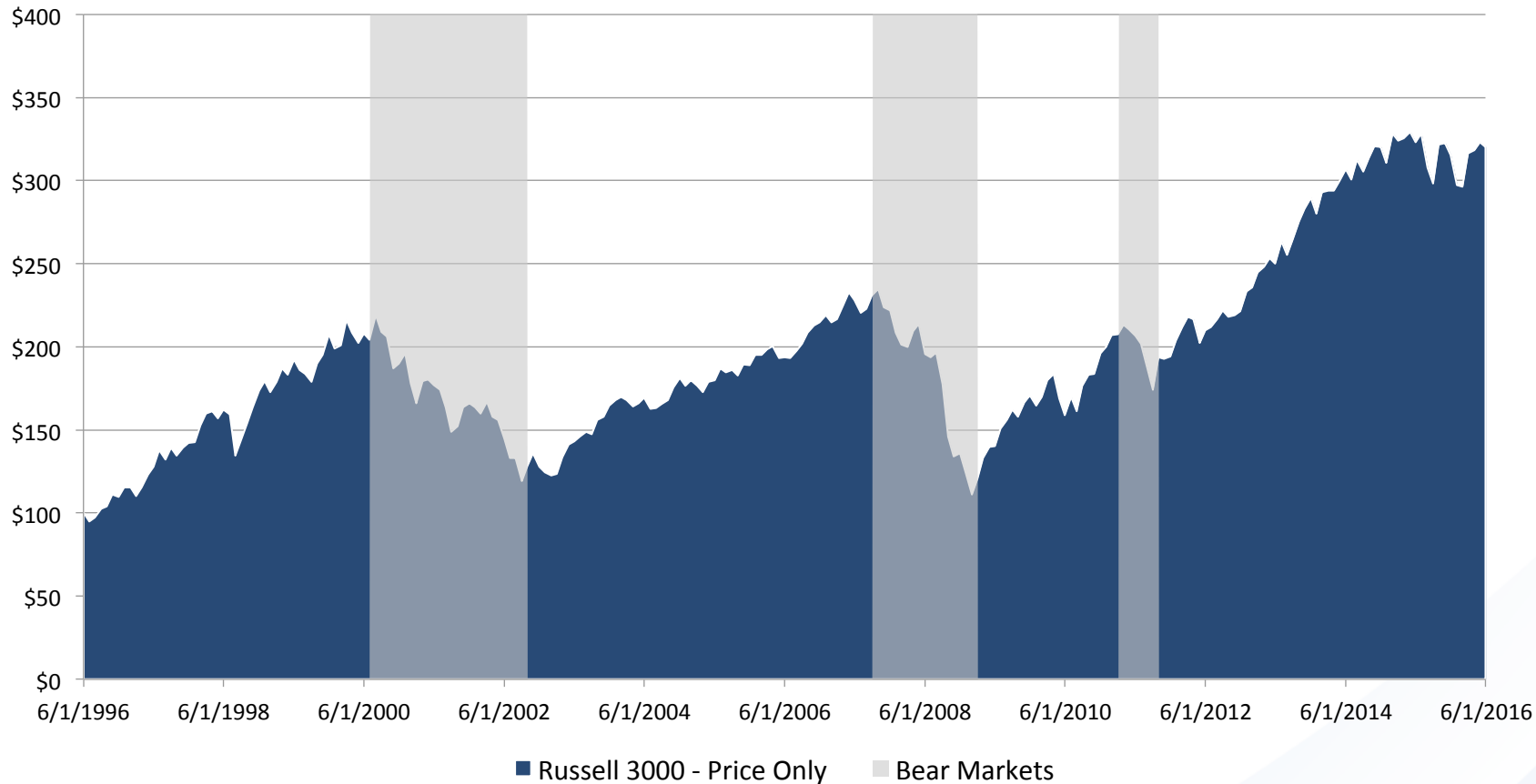
At this rate you would double your money every **27** years

## Nominal Annualized Returns (Price-Only)



# What has happened to equity returns since the turn of the century?

Growth of \$100 Invested in Russell 3000 - 20 Years



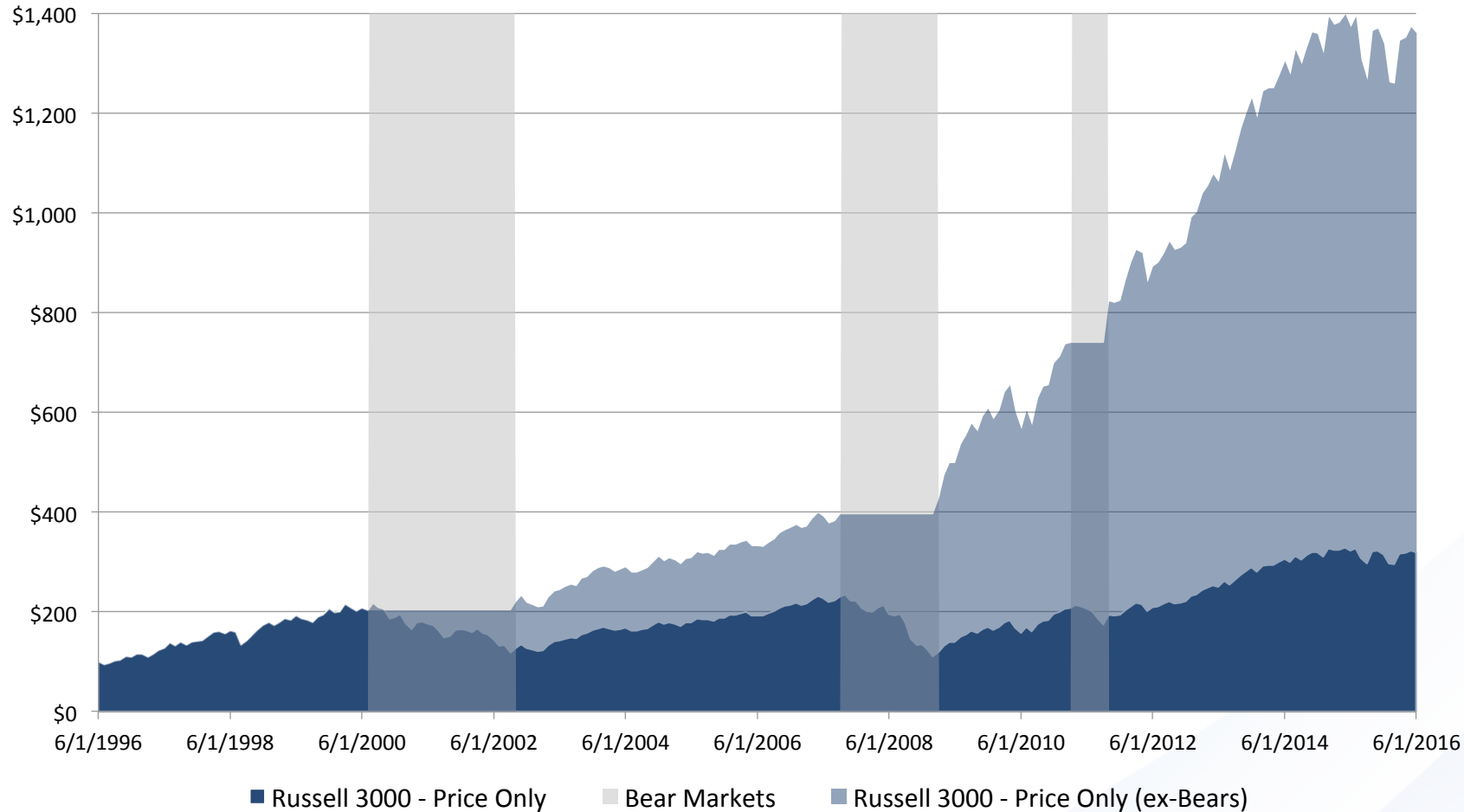
Answer:

Two Bear Markets  
(2000-2002 & 2007-2009)  
and a major systemic event  
(2011)

Market drawdowns are the #1 source of wealth destruction and biggest detriment to high sustained rates of CAGR

# The “Perfect Foresight Portfolio”

Growth of \$100 Invested in Russell 3000 - 20 Years



\$100 investment in Russell 3000 on June 1996:

Buy & hold = **\$320.31**

Perfect foresight portfolio  
sells at market tops and  
buys at market bottoms  
(avoid bear markets and  
systemic event) = **\$1,360.64**

# The 'Perfect Foresight Portfolio' doesn't exist. Is there an alternative?

Perfect foresight portfolio, obviously, does not exist.

## Alternative to perfect foresight portfolio is a sound risk-management strategy

“Risk management” techniques abound but fail to deliver for five fundamental reasons:

1. When price discovery breaks down, correlation of formerly uncorrelated assets negates hedges
2. Focus on market timing is futile
3. Options-based strategies to insure portfolio are too expensive
4. Momentum strategies exit market for prolonged periods of time, missing on capital appreciation
5. Long/Short strategies struggle to find profitable shorts, which backfire, destroying upside of long positions

# In periods of severe market stress there is only one certainty: VOLATILITY

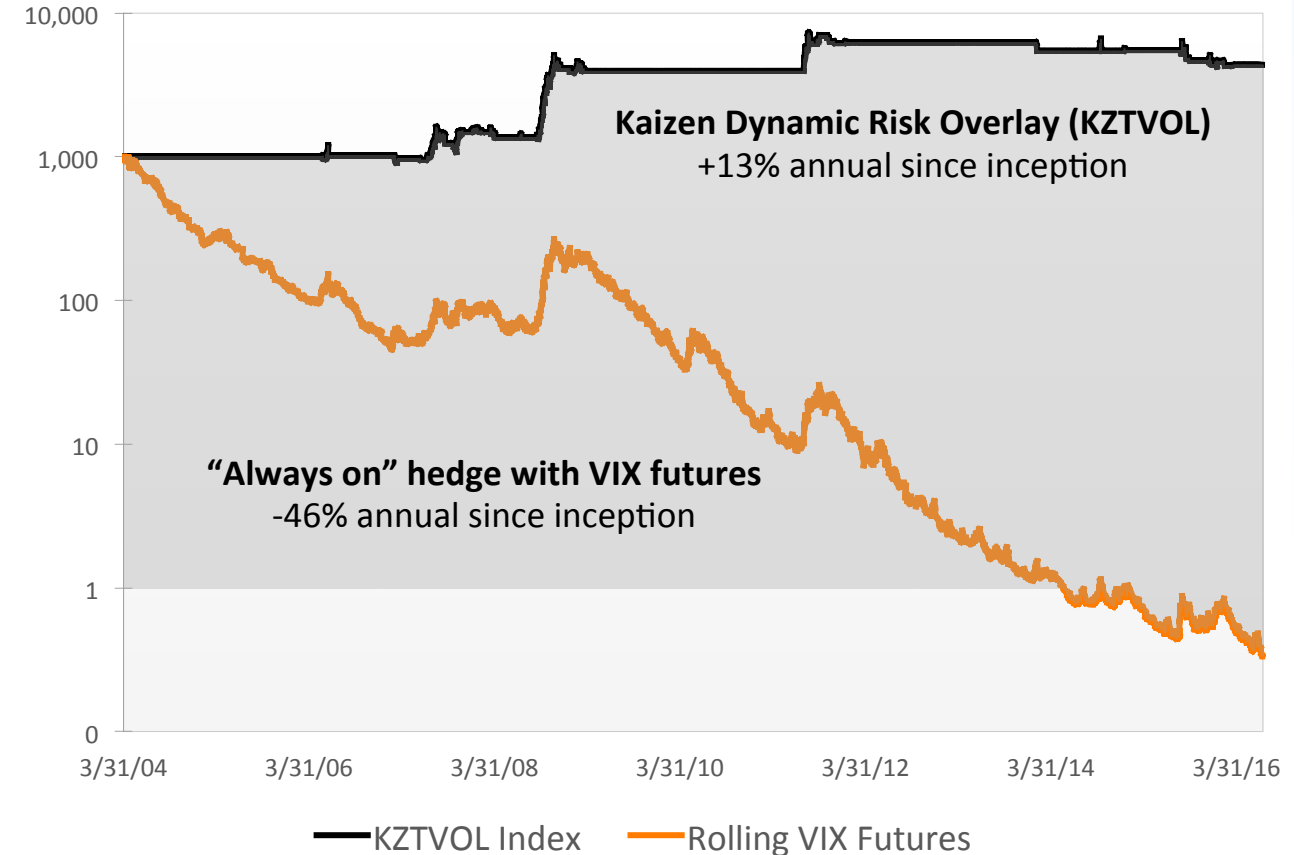
Why not own it as an asset class?

During periods of market stress, when volatility spikes, owning such volatility acts as a catastrophic insurance policy on the underlying portfolio.

Risk Management specialist **Kaizen Advisory** has developed a volatility-based index designed to alert investors during periods of extended market stress:

The **Kaizen Dynamic Risk Overlay Index (NYSE: KZTVOL)**

As a standalone hedge, the index has returned 13% annualized since inception. This is unusual as most hedges are expected to lose money over time.





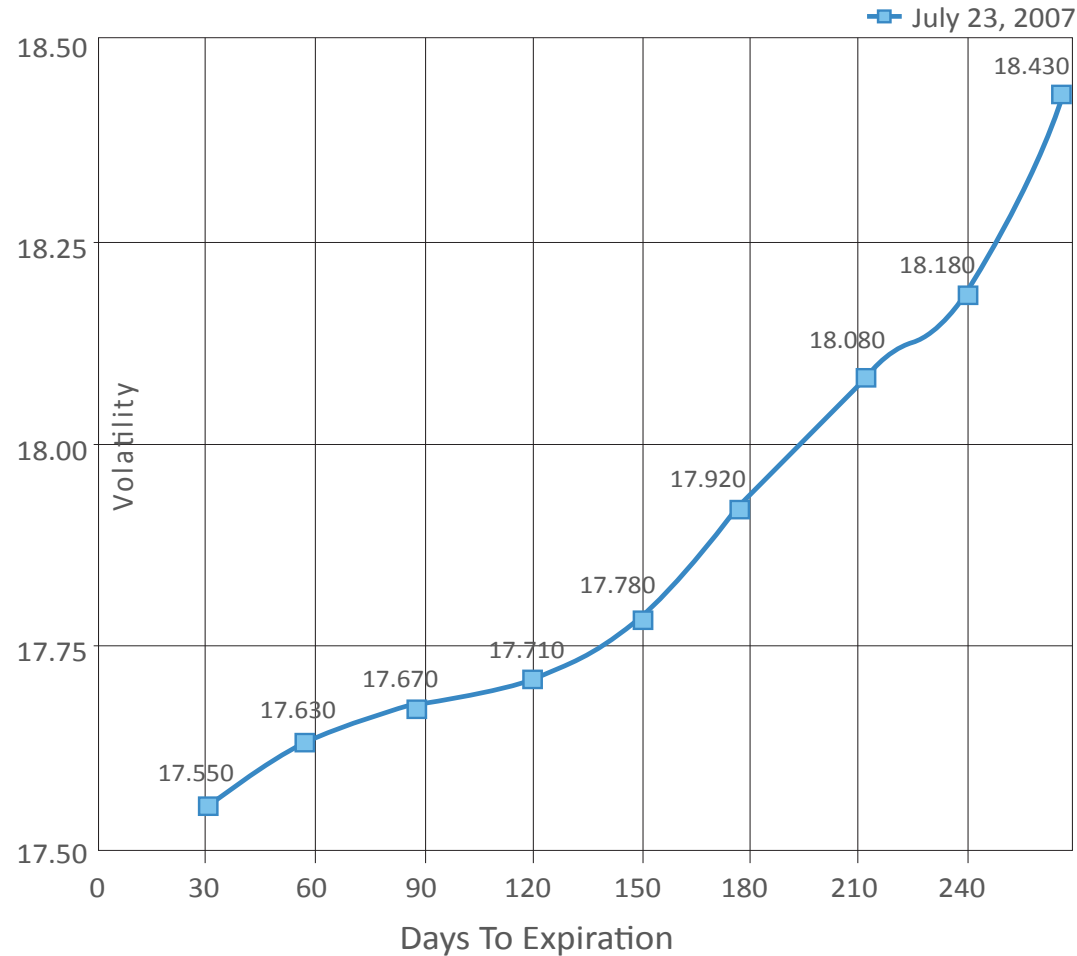
## KZTVOL Attributes

- Developed based on observations of common characteristics of VIX relationships during past bear markets
- Warning signal (hedge) has only been “turned on” 8.9% of trading days since inception (2004), or 20.6 days per year. Not a trading strategy but a portfolio insurance hedge.
- KZTVOL is constantly monitoring price and relationship changes in the volatility space.
- KZTVOL is proprietary, purely quantitative and entirely rules-based. Index is based on a combination of these elements:
  - VIX Futures Term Structure (contango or backwardation)
  - Momentum in Volatility Prices
  - Persistence of Volatility

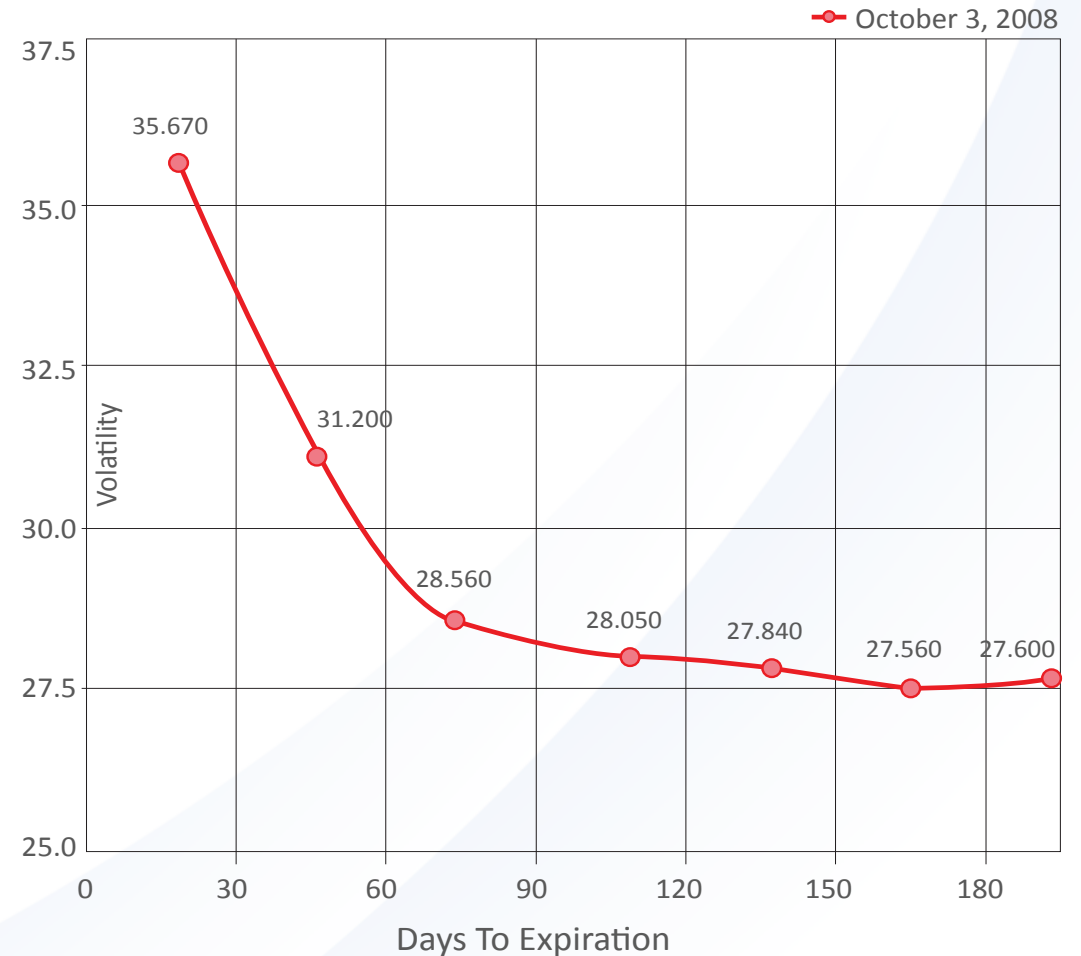
# KZTVOL Mechanics

## VIX Futures Historical Prices During Different Market Conditions (Examples)

### Normal Market: Contango

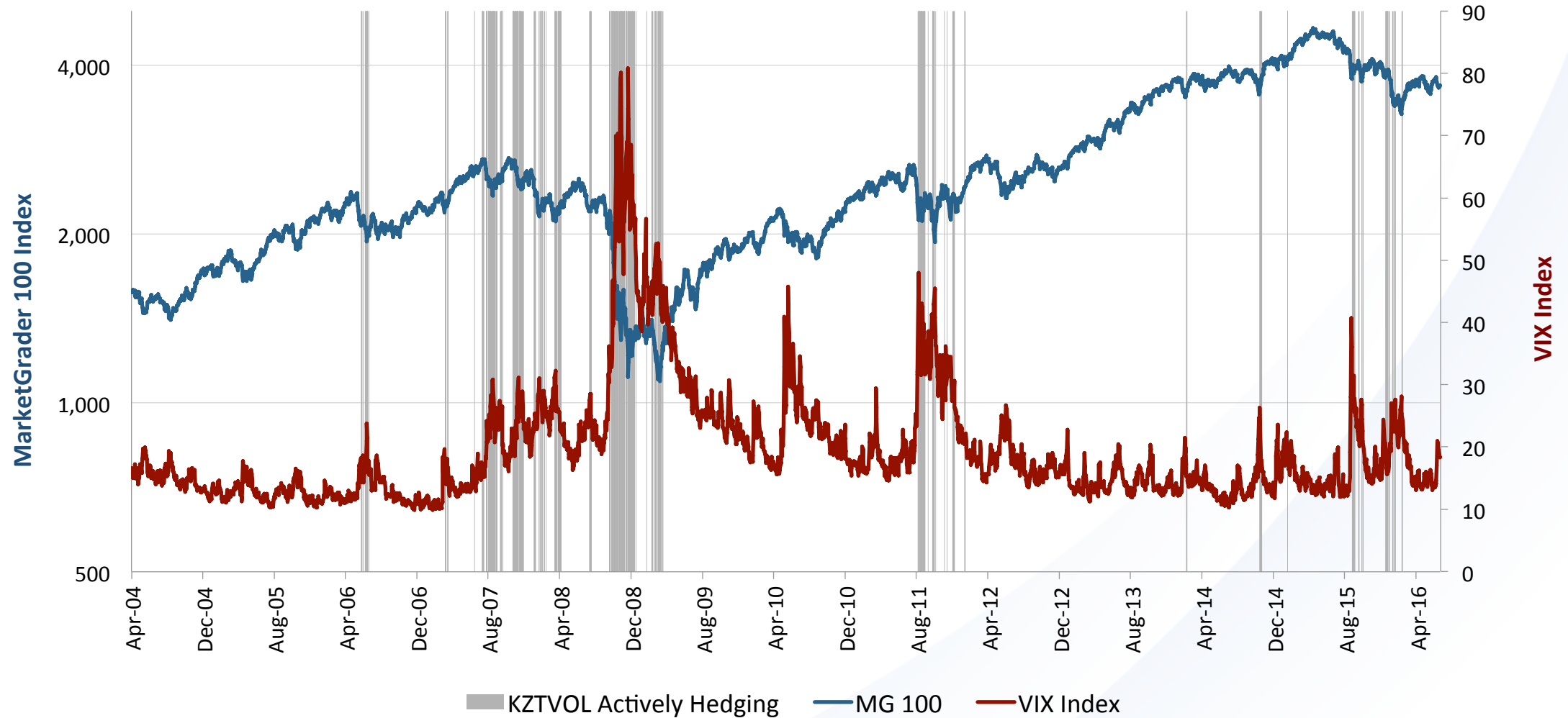


### Stressed Market: Backwardation



# When is the KZTVOL protection on?

## KZTVOL Daily Active Hedge 2004 - 2016



## What does KZTVOL hedge?

KZTVOL as a stand-alone investment/asset isn't very useful because it stays out of the market during prolonged periods of subdued volatility.

It needs an underlying risk asset that is always invested as the driver of long-term capital appreciation.

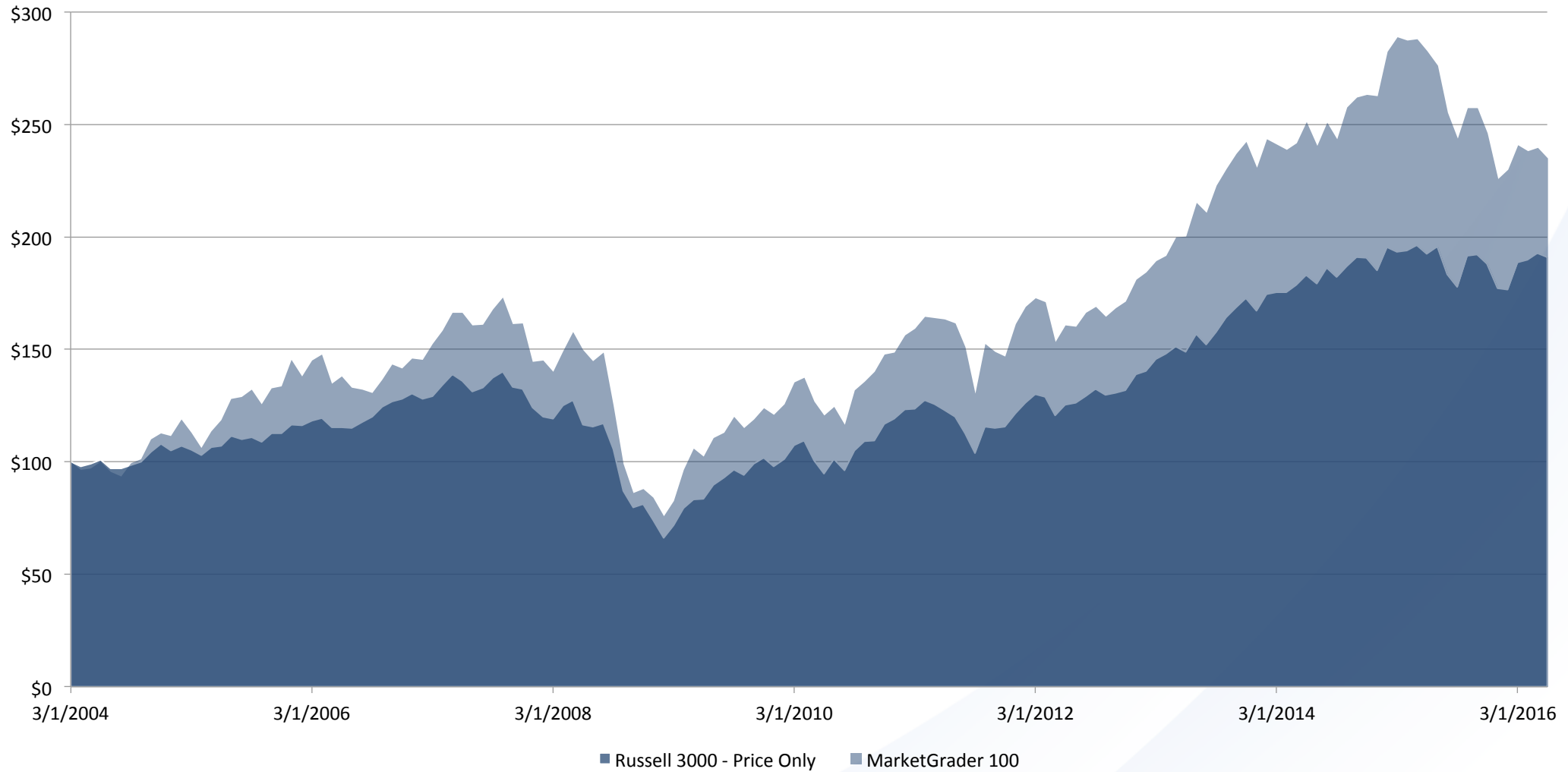
GARP-based long-term oriented approach of MarketGrader Indexes is ideally suited to combine with KZTVOL.

MarketGrader Index + KZTVOL offer a substitute to the “perfect foresight portfolio”.



# Why MarketGrader 100?: Long-Term Capital Appreciation Through GARP

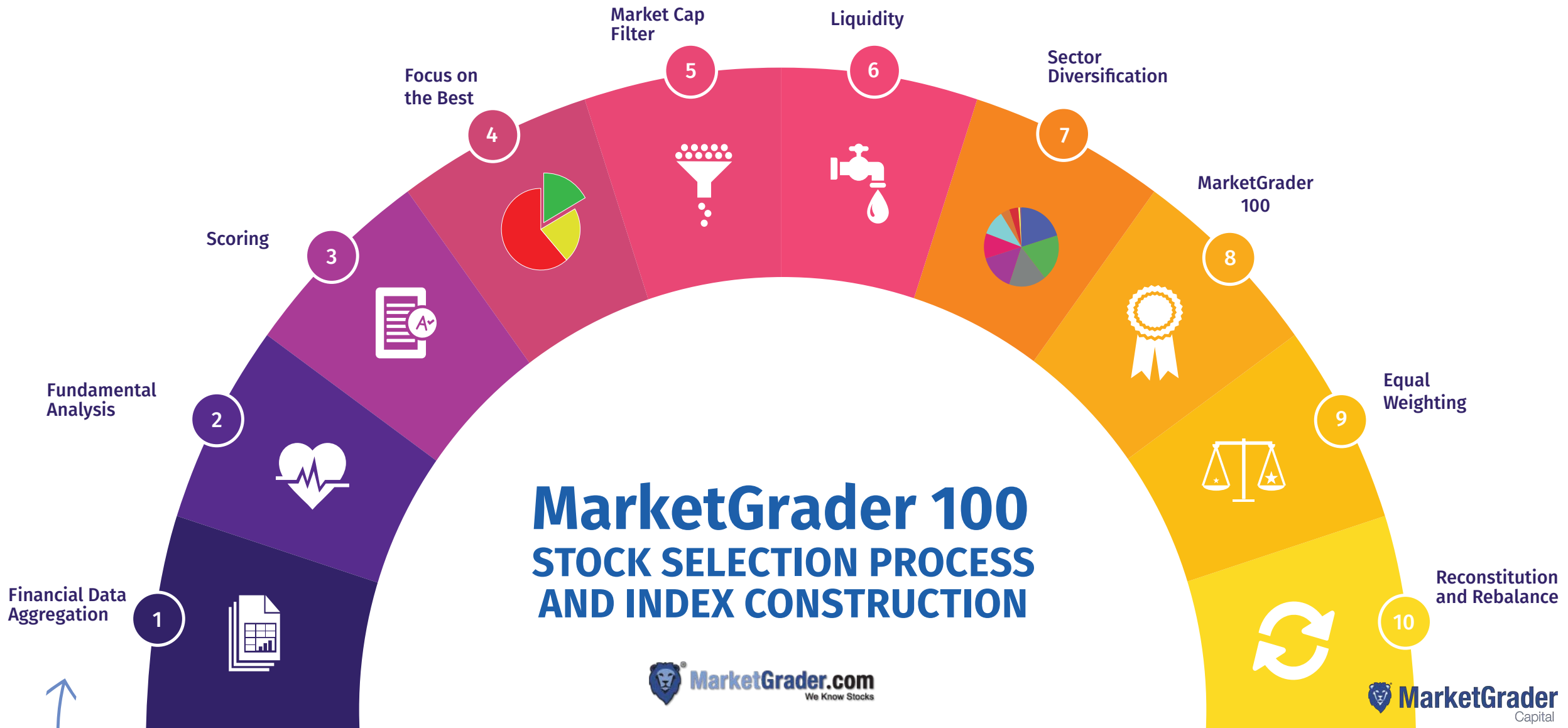
Growth of \$100 Invested in 2004



# The MarketGrader 100 Index – A Measure of Capital Appreciation

- MarketGrader analyzes daily the financial statements of 4,800 U.S. companies, rating them based on company fundamentals.
- The company's investment philosophy is centered on the belief that consistent creators of *economic value* (earnings) are the best creators of long-term shareholder value.
- We focus on identifying companies with superior earnings growth that you can purchase at a reasonable price. Our goal is to own those companies.
- The **MarketGrader 100**, our flagship core index, is a U.S. equity index that tracks the performance of the market's most attractive stocks.
- It selects the **top 2%** of all public companies in the U.S. based on the quality of their fundamentals. The next Apple or Nike is probably a member of the index.
- Its objective is to provide a benchmark for investors seeking capital appreciation through exposure to U.S. equities.
- It was first published in 2003 and is calculated by NYSE (MGONE).

# MarketGrader 100 Stock Selection Process & Index Construction



# How do we find GARP?

## Anika Therapeutics, Inc. (ANIK)

### Overall Grade & Rating

83.4 ● BUY

24

Fundamental indicators in 4 categories:

- Growth
- Value
- Profitability
- Cash Flow

- Growth**
- Market Growth Long Term (1)
  - Market Growth Short Term (2)
  - EPS Weighted Growth (3)
  - Growth Potential (4)
  - Earnings Impact (5)
  - Earnings Surprise (6)

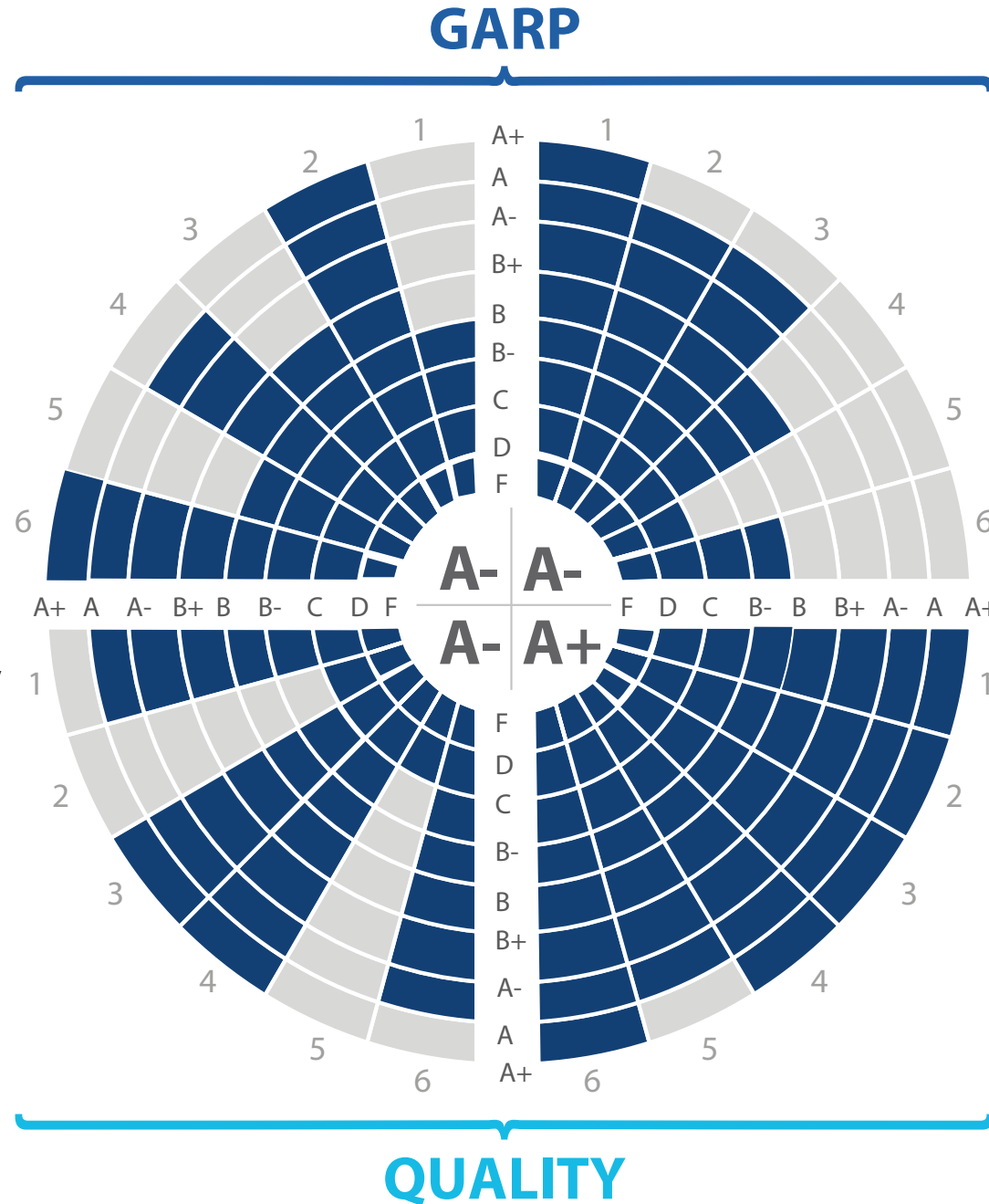
- Profitability**
- Asset Utilization (1)
  - Capital Utilization (2)
  - Operating Margins (3)
  - Relative Margin (4)
  - Return On Equity (5)
  - Gross Profitability (6)

### Value (At a Reasonable Price)

- (1) Capital Structure
- (2) PE Analysis
- (3) Price To Book Ratio
- (4) Price To Cash Flow Ratio
- (5) Price To Sales Ratio
- (6) Market Value

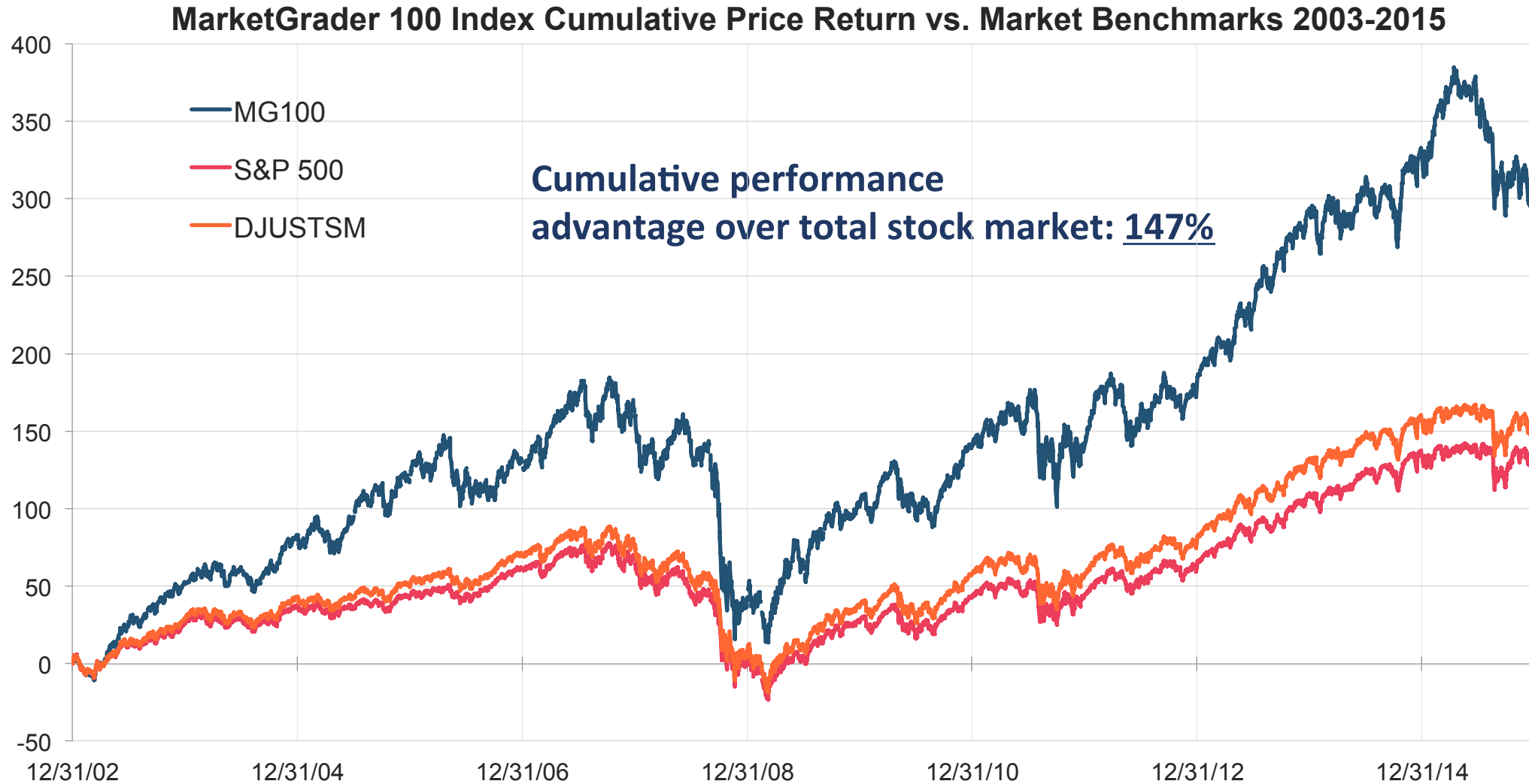
### Cash Flow

- (1) Cash Flow Growth
- (2) EBITDA Margin
- (3) Debt To Cash Flow Ratio
- (4) Interest Coverage Ratio
- (5) Economic Value Added
- (6) Working Capital Ratio





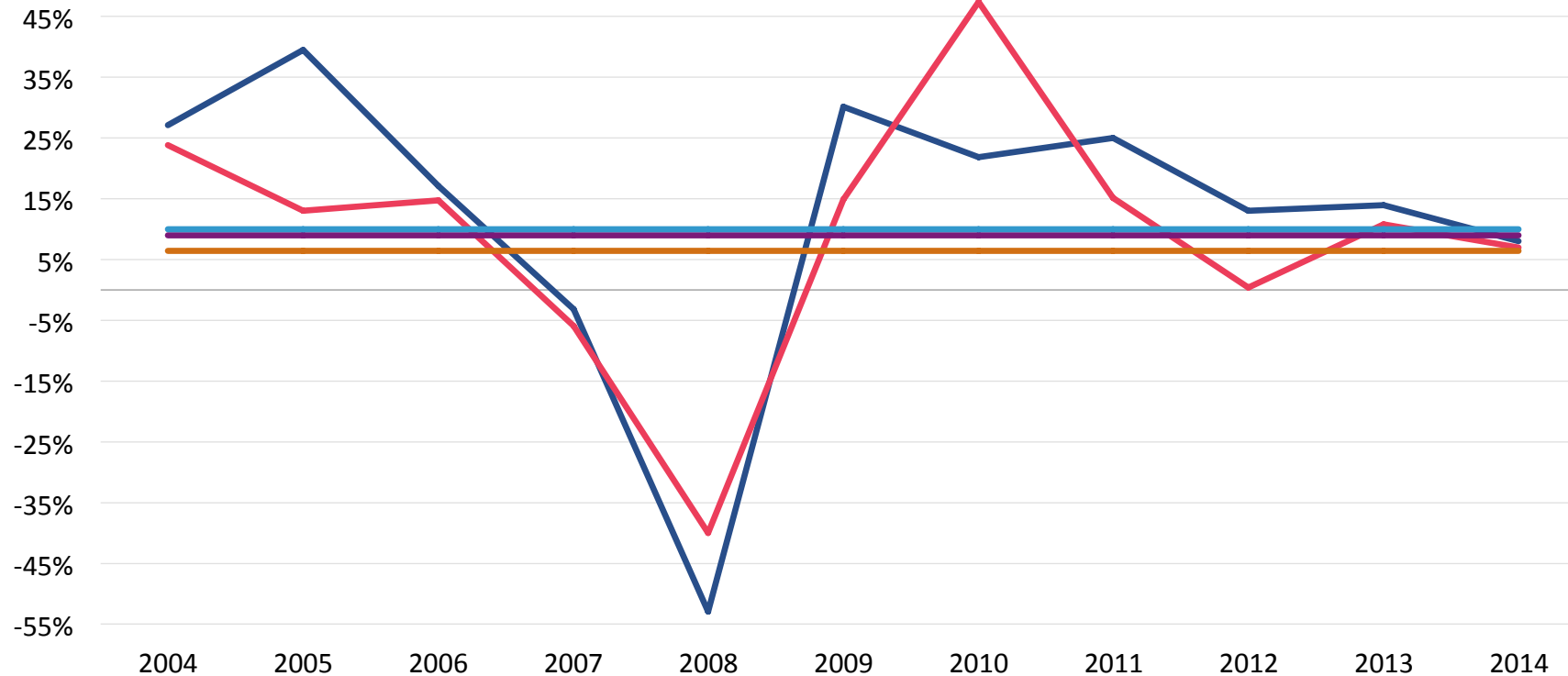
# The MarketGrader 100 Index – A Measure of Capital Appreciation



Sources: Bloomberg, MarketGrader.com

# How did MG 100 achieve such returns relative to the broad stock market?

## MG 100 and S&P 500 Year-over-Year Earnings Growth Last Decade



MG 100 EPS  
Growth  
(Annualized): **9.0%**

MG 100 EPS  
Growth (with  
acquired  
companies): **10.0%**

S&P 500 EPS  
Growth  
(Annualized): **6.4%**

— MG 100 Earnings Growth

— S&P 500 Earnings Growth

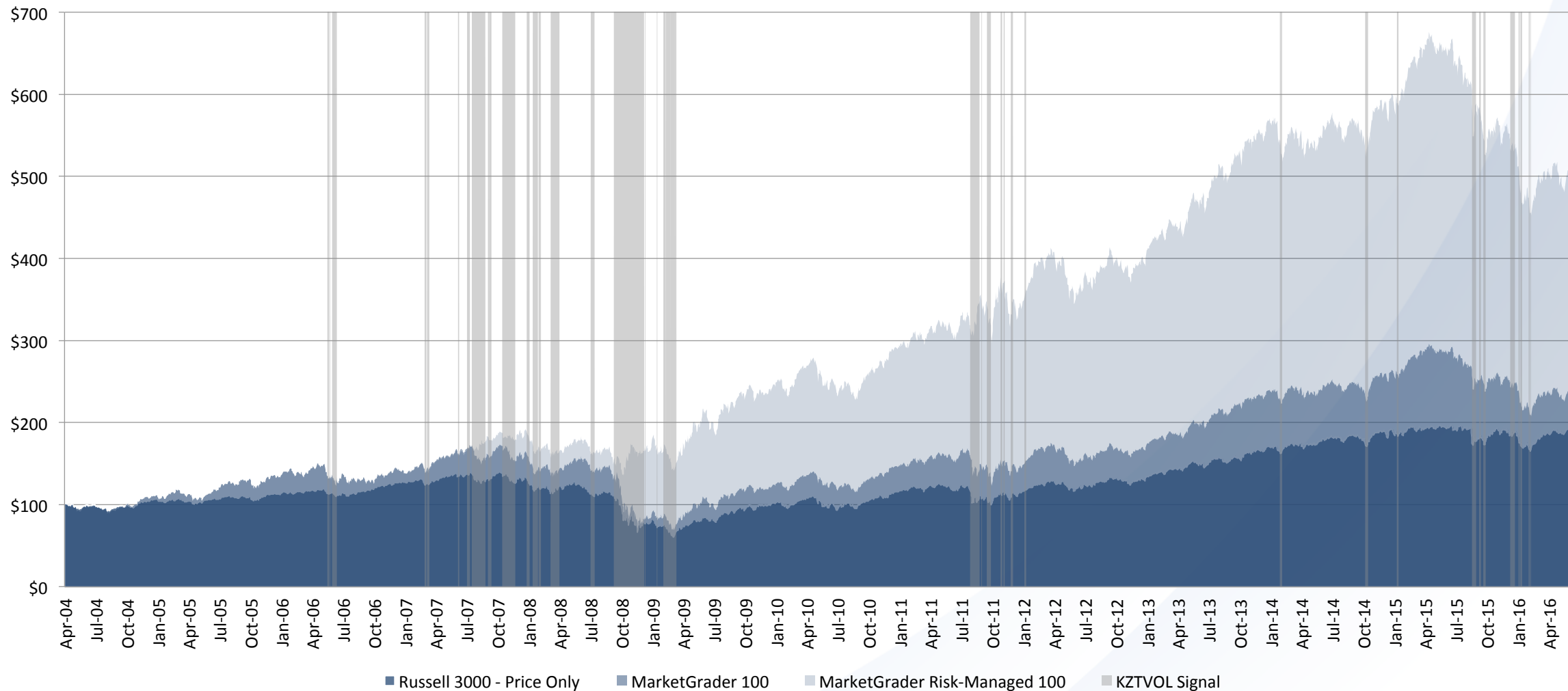
— MG 100 Annualized EPS Growth

— S&P 500 Annualized EPS Growth

— MG 100 Annualized EPS Growth + Acquisitions

# MarketGrader Risk-Managed 100: Has it worked?

Growth of \$100 Invested in 2004



# MarketGrader Risk-Managed 100: Has it worked?

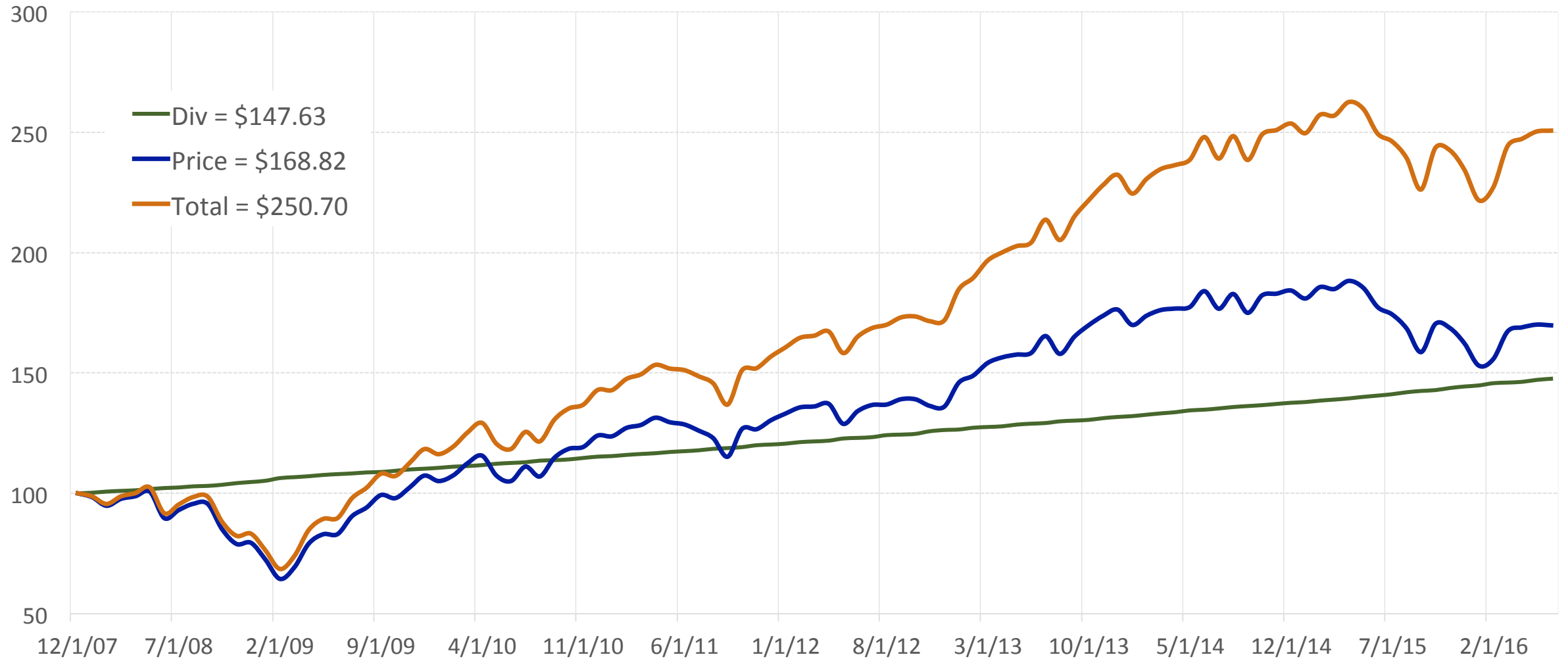
	Growth of \$100 since 3/31/04*	Annualized Return
<b>Russell 3000 Index (price-only)</b>	\$190.92	5.4%
<b>MarketGrader 100 Index (price-only)</b>	\$234.98	7.2%
<b>Perfect Foresight Portfolio (Russell 3000 ex-Bear Markets)</b>	\$472.85	13.4%
<b>MarketGrader Risk-Managed 100 (KZTMGO)</b>	\$500.52	14.0%

## Key Differentiators

- Profits from hedge are reinvested into MG100 at depressed prices (e.g. Mar 2009), so there is a higher exposure to the rebound.
- Occasionally, hedge and index can be profitable in the same year (e.g. 2011).
- Foresight portfolio hedge is cash = 0 return, while KZTVOL has positive annual return.

# The Income Risk-Managed Option: MG Income U.S. 100 Index

Growth of \$100 12/31/2007 – 06/30/2016



Source: MarketGrader Research.

# MarketGrader Risk-Managed 100 Separate Accounts

How is the MarketGrader Risk-Managed 100 Account operated?

- Account is always fully invested in the MarketGrader 100 Index
- Account is rebalanced in line with MG100, twice a year (Feb & Aug)
- Benchmark is the MarketGrader Risk Managed 100 Index (NYSE: KZTMGO), which combines MGONE & KZTMGO
- When KZTVOL signal comes “on” MGC borrows up to 15% (Reg. T Margin) of portfolio value (MG100) to use as collateral for VIX futures contracts. No more than 15% of portfolio market value as margin is used to secure a 30% exposure to volatility.
- Composition of MG100 remains intact while hedge is on.
- A portion of the hedge is rolled forward daily to maintain protection when signal is “on” while potentially taking small profits.
- Exit signal is typically led by relationship between VIX curve (1-month vol) and VXV curve (3-month vol), which tends to normalize before the VIX futures curve.
- Any capital gain in volatility is used to buy more of underlying portfolio.

## About Us

**MarketGrader Capital, LLC**, a Registered Investment Advisor based in Coral Gables, Florida, operates as the investment management arm of MarketGrader.com Corp. The company is the exclusive licensee of all global MarketGrader Indexes, including the Barron's 400 Index. It is dedicated to managing a family of value-added investment products based on MarketGrader's intellectual property, including exchange traded funds (ETFs), mutual funds and separately managed accounts. It acts as exclusive licensor of MarketGrader's indexes in the case of investment funds and as investment advisor in the case of institutional separately managed accounts.

**Kaizen Advisory, LLC**, an Illinois limited liability company formed in May 2014 and registered with the SEC as an investment advisor, is a risk-management specialist with approximately \$138 million in assets under management. The company designed and developed the proprietary Kaizen Risk Overlay Index (NYSE: KZTVOL) as a risk management index designed to protect risk assets from significant market drawdowns.

### Contact Information

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# Biographies

## **Brady Lipp** – Managing Director, MarketGrader Capital

- Over 30 years of experience in the investment management industry.
- Held key leadership roles at Strong Capital Management (Institutional Team), Warburg Pincus Asset Management (Partner/Managing Director, Institutional Services Group) and Credit Suisse Asset Management (Managing Director, Global Post Venture Capital Investment Team).
- Established critical strategic relationships generating billions in AUM growth across multiple distribution channels.

## **David Lucterhand** – Managing Director, MarketGrader Capital

- Over 40 years of experience in capital markets
- Former principal and chief executive of LL Chandos & Co. merchant bankers, broker-dealer and registered investment adviser and member of the Chicago Board of Trade and Chicago Board Options Exchange.
- Advised the governments of Russia, Kazakhstan, Ukraine and Moldova in the development of their capital markets and design of new financial instruments as executive agent for the United States Agency for International Development (USAID).

## **Xiaolian Wang**- Managing Director, MarketGrader Capital

- Over 12 years experience in the investment management business
- Former China Director at Armored Wolf, a global macro asset manager with \$700 million in AUM global macro fund founded by former Pimco executive.
- Former Vice President at Investcorp, a global fund of funds with over \$5 billion in AUM, responsible for hedge fund manager sourcing and monitoring and due diligence on fixed income strategies and global macro strategies.
- Former Portfolio Manager at Macquarie Allegiance Capital, where she managed \$450 million



# Biographies

## **Francis Gupta, Ph.D.** – Senior Advisor

- 18 years of experience in the institutional investment management business.
- In-depth experience in creating and managing intellectual assets.
- Former Director of Product Research & Design at Dow Jones Indexes (DJI); created the research group at DJI.
- Formerly on the asset management's Strategic Advisory teams of Credit Suisse and J.P. Morgan.
- Co-authored "The Legacy of Modern Portfolio Theory" paper with Frank Fabozzi and Harry Markowitz (*The Journal of Investing*, Fall 2002). Has been published in *The Journal of Portfolio Management*, *Journal of Indexes*, *Journal of Indexes Europe*, *Journal of Retirement Planning*.

## **Michael Thompson, CFA** – Chief Investment Officer, Kaizen Advisory

- 17 years of experience in the investment management industry.
- Former portfolio manager at William Blair & Co. and Northern Trust Company.
- Expert in derivatives modeling and management; co-developer of the Kaizen Dynamic Risk Overlay Index (NYSE: KZTVOL).
- Former principal at Advocate Asset Management and Typhon Capital Management.
- BS in Economics, University of Illinois at Urbana/Champaign. Member of the CFA Society of Chicago.

## **Matt Thompson, CFA** – Director of Research, Kaizen Advisory

- 15 years of experience in securities and futures management.
- Served in business development and financial modeling roles for Chicago-based start-up derivatives exchange.
- co-developer of the Kaizen Dynamic Risk Overlay Index (NYSE: KZTVOL).
- Former principal at Advocate Asset Management and Typhon Capital Management.
- BS in Economics, University of Illinois at Urbana/Champaign. Member of the CFA Society of Chicago.