

market notes: Fire and/or Ice?

In Q3 2021 we wrote *Regime Change Resilience*.

This market note: **Fire and/or Ice**, follows up one year later, looking back at what we said... and then thinking through how best to prepare for what might be next.

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In our paper, *Regime Change Resilience*, we questioned some of the assumptions embedded in most institutional portfolios. We suggested that investors had a false sense of stability – and that expectation of stability was deeply embedded in many portfolios. Investors had become accustomed to persistent macro forces, like accommodative policy and globalization. They weren't concerned about volatility or inflation. They are now.

We were most concerned about the assumed negative correlation between stocks and bonds. We believed this relationship was at risk – and that it could break down at the worst time. We labelled such price relationships as “transitory diversifiers,” or ones that we believed were the by-product of the macro environment, and subject to change if the regime were to shift.

At the same time – to help investors better understand their risks and options, we suggested investors more directly target “structural diversifiers,” i.e., investment strategies that could be more resilient in the face of regime shifts. We especially suggested that investors consider long volatility and trend following.

From Jan 2000 – Dec 2021, the realized daily correlation between the S&P 500 and the U.S. Aggregate Bond Index was -0.3. In 2022 YTD, the same realized correlation has been +0.2.¹ This positive correlation is reminiscent of the stable positive relationship observed between stocks and bonds from the 1960s through the late 1990s.

Unfortunately for investors, this positive relationship has surfaced while both stocks and bonds have drawn down significantly. 60/40 portfolios are down about -19.1%² YTD, using Bloomberg's 60/40 as an example (ticker BMA6040). The return has been difficult, and the path has been meaningfully more volatile relative to history.

Many of the trends that have taken us here seem embedded for now. Investors, looking for an end to the market turbulence, might consider the words of Robert Frost.

In his 1920 “Fire and Ice”, the first line states: “*Some say the world will end in fire, Some say in ice...*”

So, what do you think is next in store for markets?

Will it be *Fire?* – a panicked, reflexive, and liquidity driven market crisis in which major indices gap down successively (i.e., GFC, COVID-crisis, etc.)

Or do you think it will be *Ice?* – a continuation of large swings in macro assets, with an overall decline in traditional risk assets (as we have seen in 2022 YTD)

It may well be neither. However, if it is Fire, Ice, or both, we will be ready with Risk Responders. This strategy was built on the back of our *Regime Change Resilience* paper and it is a favorite among our most forward-thinking clients.

¹ Source: Bloomberg. One River. Daily returns through 09/23/2022

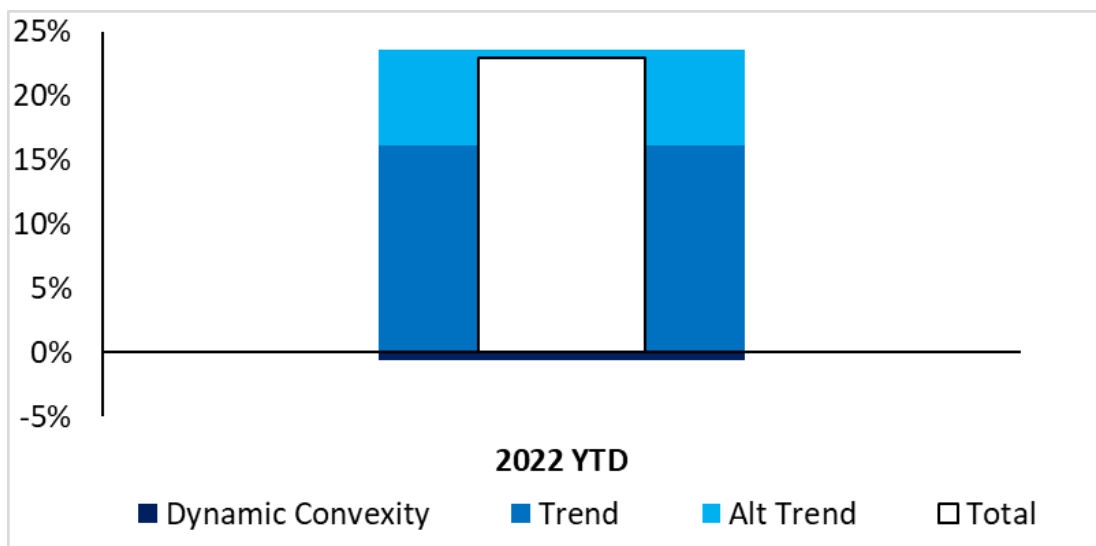
² Source: Bloomberg. Through 09/23/2022.

Risk Responders is a systematic multi-strategy fund that combines a long-volatility sub-strategy (to protect against a market crisis - Fire) with two multi-asset trend-following sub-strategies (to protect against both prolonged market declines and correlation breakdowns - Ice).

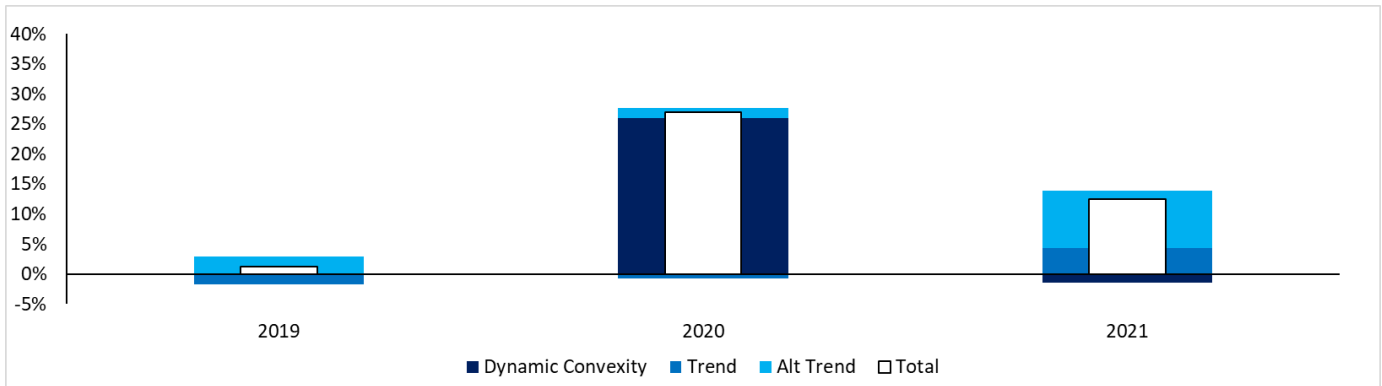
The fund, by virtue of the underlying strategies, endogenously allocates risk between these sub-strategies, such that the portfolio behaves like a levered trend-following strategy in a non-crisis period, and like a long-volatility strategy during a market crisis.

We have seen the strategy fulfil its portfolio role year-to-date. The prolonged and pronounced macro headwinds for traditional portfolios (e.g., the 60/40 portfolio), have provided a forceful tailwind to trend-following strategies. Accordingly, the Risk Responders strategy has delivered an estimated +23.0%³ YTD 2022. Exhibit 1 shows the total return and attribution by sub-strategy both 2022 YTD and going back annually to the strategy inception:

Exhibit 1: Risk Responders Return Attribution, 2022 YTD (Top) and Annual Live Pro-Forma Since November 2019 (Bottom)²



³ Source: One River. Estimated gross performance for the Risk Responders strategy as of end of day 09/23/2022. The Risk Responders Cayman fund went live on March 15, 2022. The performance prior to that launch date represents a pro-forma combination of live Dynamic Convexity, Trend, and Alternative Markets Trend returns as implemented in the live Risk Responders strategy. The Risk Responders Strategy was researched in 2021, with final allocations decided in September 2021.



What’s in store for markets and Risk Responders next? The short answer is that no one knows. The correct response, we believe, is to diversify your portfolio in preparation for whatever comes next.

As noted, perhaps neither *fire* nor *ice* lie ahead, and global markets will begin to thaw out and course correct from here. In that case, the traditional market exposures that have recently come under such immense pressures will likely provide attractive return outcomes. However, if either or both of those risks do manifest from here, we expect that Risk Responders will live up to its name.

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