MONEY MANAGER INTERVIEW

Fund's Active Hedging Strategy Protects Capital During Downturns

JORDAN L. KAHN, ACM FUNDS

JORDAN L. KAHN, CFA, is President and Chief Investment Officer at ACM Funds. Mr. Kahn has 25 years of experience in the investment industry serving as a senior portfolio manager, equity research analyst, and investment consultant. Before forming ACM, Jordan founded his own RIA called KAM Advisors. Prior, Mr. Kahn was a Managing Partner with Beverly Investment Advisors, and before that a senior portfolio manager for Summit Wealth Management (formerly Berger & Associates). Prior to that, Mr. Kahn ran a technology-focused fund at Kahn Asset Management. He has also worked as the Assistant Director of Equity Research at Feldman Securities Group in Chicago. Prior to Feldman Securities Group, Mr. Kahn was an investment analyst at The Chicago Trust Company. Mr. Kahn began his career with the consulting firm Hewitt Associates. He received his Master of Science degree in Financial Markets and Trading from the Stuart School of Business at the Illinois Institute of Technology. His studies included derivative strategies in corporate finance, trading strategies involving options and futures, and Value-at-Risk (VAR) management. A Chartered Financial Analyst, Mr. Kahn graduated cum laude in Economics with a concentration in Finance from the University of Colorado.

SECTOR — GENERAL INVESTING

(AHT577) TWST: Briefly describe the fund that you'd like to talk about today and include assets under management and what type of investor the fund is for.

Mr. Kahn: I am going to be talking about the ACM Dynamic Opportunity Fund. It is a hedged equity strategy that we run as a mutual fund. Our assets under management are about $180 million. The fund is primarily designed to help investors participate in the upside that comes from the equity markets, while not having all of the downside risk due to our active hedging strategy.

TWST: Can you explain what you mean by active hedging strategy?

Mr. Kahn: I certainly will, but just as an overview, basically, we use a strategy where we short index ETFs against our portfolio of stocks to adjust our exposure to the market during market downturns. While most mutual funds are 100% long, even during market corrections, we try to decrease our exposure and protect capital during downturns for our clients.

TWST: Just to be clear, this is not a fund of funds or composed of ETFs, is it?

Mr. Kahn: No, it's not a fund of funds, nor is it a fund of ETFs. On the long side, we run an individual stock portfolio, just like a lot of other mutual funds do. We are trying to pick our best ideas. On the long side, we have on average between 30-50 stocks in the portfolio that we like, but what I was alluding to is that, when markets start to experience downturns, we adjust our exposure to the market. So instead of being 100% long during market downturns, we begin to layer in hedges by shorting the index ETFs for things like the SPY and the QQQ, etc. We will short those against our long exposure to adjust our overall net long positioning.

We have a hedge model that we run every day. Let's say at the end of the day that it tells us that we should take our exposure to the market down to 80%. If we're 100% long in stocks, we would short 20% worth of those ETFs that I mentioned, and it might be a combination of SPY for the S&P or QQQ for the NASDAQ, or maybe even something like IWM for small cap, but we would short 20% worth of those indexes so that we'd be 100% long in stocks, 20% short on our ETF, and that would net our exposure to that 80% that I mentioned that our hedge model may be indicating on any given day.

TWST: Timing is so important in investing. At what point are you recognizing the downturn and making these changes in the management? Are you already in the downturn when this happens or are you doing that when you are predicting it's about to happen?

Mr. Kahn: That is a really, really good question. What trips up most long/short managers is the timing of when to implement those hedges. Just to give you a little bit of background. I had my own RIA for a number of years. When the SEC loosened the restrictions and allowed mutual fund managers to use hedging strategies and short stocks, I tried a lot of these various funds that were coming out for my clients.

There was always one problem or another with shorting, meaning that one manager would do a good job hedging against the downturn, but then they wouldn't get back in for the next upturn. Another manager may have done a very good job capitalizing an upside, but when a correction started, they didn't think it was going to be a big correction. So they didn't hedge, and so there was always kind of that frustration. That is what we call a "manager bias." How does the manager feel about the market and what are they trying to predict going forward?

So when we started this fund, we specifically wanted to take that manager bias out of the equation. What we developed was a quantitative model: our dynamic hedge model. It looks at several of the major indexes — things like the S&P 500, the NASDAQ, the small cap index — and on each one of those indexes, we overlay a series of moving averages. So we'll use both short-term, intermediate-term as well as longer-term moving averages. When each one of those indices starts to break below those respective moving averages, that's what tells us when to start initiating our hedges. So it's not really up to me how I feel when I get out of bed in the morning about the market, rather, it's really listening to our models and not second-guessing them.

So to your point about whether it might be a shallow or a severe correction, we're not really trying to predict that ahead of time. Sometimes our models, and those indices I mentioned, will only come down and breach their shorter-term moving averages before they right themselves and start going back to the upside. In those cases, our hedges usually only get implemented in a moderate fashion. The portfolio doesn't get completely hedged. But in severe downturns, when those indices that I mentioned start breaking through all of the moving averages in our model, that's when the portfolio can get fully hedged. In deep corrections, our exposure can go all the way down to 0%. So like last March 2020, we were fully hedged all the way down to zero.

That is another big differentiator for our strategy. Our long exposure to the market can go anywhere from being 100% long, when we're trying to fully participate in the uptrend, all the way down to 0% when we're fully hedged. That is a big differentiating factor, because most long/short funds, if you look at their exposure, they usually have these set ranges where they want to be maybe 50% to 80% long, and have 20% to 30% in shorts all the time. They never are really fully long during the uptrend, nor are they fully hedged in the downturn.

TWST: The nature of the way the model is looking at the market is sensing so is it automatically making adjustments? To what extent is there automation built into the management of this fund? And does it have some predictive ability in terms of the nature of the correction that it wants to make given the prediction it might make about the downturn?

Mr. Kahn: It doesn't have predictability. It's just monitoring these things on a daily basis and watching how the corrections unfold. Sometimes it may be a certain segment of the market. Sometimes maybe small caps are correcting, but large caps aren't. In that sense, our models would pick up on that. When we start to initiate our hedges, maybe we would start with a small-cap hedge like the IWM, but we wouldn't add a large-cap hedge like the SPY there, because that's not being picked up in our models. So that's one nuance that you were alluding to.

The other thing is: It doesn't happen automatically. On a daily basis, me and my team —I have two other managers on the Fund that help out — we look at our hedge models on a daily basis and we talk every day so that we can discuss and figure out what the hedge model is saying and what adjustments we need to make by the market close to bring us more in line with that model. Our exposure is adjusted, basically, on a daily basis if needed.

TWST: Your latest fund sheet that I'm looking at, issued August 31, says the fund holds 48 holdings. Is that about typical?

Mr. Kahn: We averaged about 30 to 50 names, so the fact that the market has been in an uptrend for the better part of a year now, that's why we're probably at the upper end of that range. In corrections and downturns, sometimes it gets trimmed back towards the lower end. It just depends on market conditions.

TWST: Can you speak a little bit about the holdings that you have? How are they selected?

Mr. Kahn: I spent some time talking about how our hedge strategy is a differentiating factor for the fund. We believe that we also have a differentiating factor in terms of our security

Highlights

Jordan L. Kahn discusses the ACM Dynamic Opportunity Fund, which uses a hedging strategy to reduce downside risk while still allowing investors to participate in the upside of the equity markets. He explains that they use a dynamic hedge model that looks at several major indices and overlays a series of moving averages that tell them when to start initiating their hedges. He says that the fund's market exposure can go from 100% long down to 0% when fully hedged. On the long side, Mr. Kahn says that they try to identify companies that have experienced meaningful breakouts both in terms of price and increased trading volume. According to Mr. Kahn, big surges in volume indicate a huge institutional demand behind these stocks, and that demand usually unfolds itself in waves. These breakout companies are then subjected to rigorous fundamental analysis to weed out momentum stocks before being considered for their portfolio.

Companies discussed: Amazon.com (NASDAQ:AMZN); Trade Desk (NASDAQ:TTD); Crispr Therapeutics AG (NASDAQ:CRSP) and Invitae Corp. (NYSE:NVTA).

selection. One of the things that we tried to do when we went and did a 10-year backtest on this strategy before we ever even started the fund is we're trying to identify companies or stocks that have experienced what we call "meaningful breakouts."

"We do have some of the larger names in the portfolio — i.e., Amazon — because they have been market leaders and the fact that they're bigger weightings in the portfolio is also part of managing volatility. Those stocks tend to be less volatile than some of the other names, and so in terms of managing volatility, we can hold them at larger weightings versus some of the smaller names."

By these meaningful breakouts, what we're looking for is not just a stock that's had a big breakout in price, but also ones that are accompanied by large increases in trading volume. For us, we have to see those two things in tandem to qualify as meaningful. So we're looking for these large breakouts in both price and volume. Every day we are running our screens to look for stocks that are experiencing these breakouts, so that's kind of the first phase of our screening process.

The second phase is, once we've identified those breakout candidates, we go through and do our more rigorous fundamental analysis to whittle the list down to only the highest-quality companies. What that second phase of our screening process does is the fundamental analysis and that helps us wean out just pure momentum stocks that might be coming through the first part of our screening. Maybe those stocks that don't have much trading volume, or they don't have any earnings, or have really poor fundamentals. Those aren't the type of stocks that would make it in the portfolio.

We are looking for real quality stocks, but ones that have also experienced these high-volume breakouts. For us, it's the combination of those two factors that helps us to identify what could be real market-leading stocks. That is how we build the portfolio. It is not really driven by top down. We are building it from a bottom-up basis so we are looking for our best ideas of stocks that have these leadership qualities that have superb fundamentals, but have also experienced these big breakouts.

Another constraint is that we ensure the portfolio doesn't get too top heavy in any one sector, so we won't let any one sector be more than 25% of the fund. So even if there are, let's say, there's dozens and dozens of tech stocks that are experiencing these breakouts, we would cap it, so you would never see the fund with 50% tech exposure or something like that.

TWST: Right. So when you talk about the trading volume being up, it almost sounds a little bit like you would be moving along the wisdom of the crowds where other people were swimming as well. What are other levels of criteria are used when you select?

Mr. Kahn: We certainly don't stop there. We dig deep down and look at the fundamentals of these companies. We look for a huge spike in trading volume — we look for something that's multiple standard deviations above the average.

When I was in my RIA days, and I was running stock portfolios, I would have stocks that experienced these big breakouts, and they would go to new highs and they'd be on big volume. Often, I would use that as an opportunity to take some profits for our clients, pat myself on the back for doing the good job. Over time, when I would go back and look, I was shocked at how often those events would have been just as good of a buying opportunity as when I had used them as an opportunity to take profit. So I thought there was something there, and that's when I hired a grad student to go do this 10-year backtest on the strategy using these breakouts as a buying event.

What these big surges in volume indicate is that there is huge institutional demand behind these stocks, and that demand usually unfolds itself in waves. It can't be satisfied just on that one day of that volume. So, often, it's those follow-on waves of institutional demand that can help continue to propel a stock and drive it higher over time.

1-Year Daily Chart of Amazon.com, Inc.

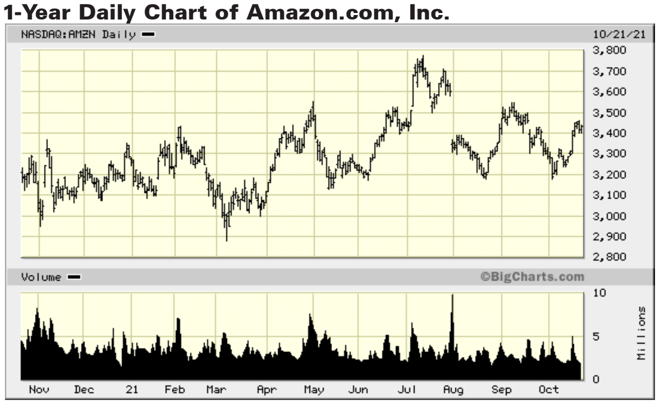

Chart provided by www.BigCharts.com

TWST: Can you dive a little bit into one of these stories? Talk about one of your holdings that you think may not be as well understood or known?

Mr. Kahn: We do have some of the larger names in the portfolio — i.e., **Amazon** (NASDAQ:AMZN) — because they have been market leaders and the fact that they're bigger weightings in the portfolio is also part of managing volatility. Those stocks tend to be less volatile than some of the other names, and so in terms of managing volatility, we can hold them at larger weightings versus some of the smaller names.

I'll tell you, one of our biggest winners over the years has been a stock called **The Trade Desk** (NASDAQ:TTD), which has been our number-one performer. At one point, it was a 10 bagger in our portfolio over a matter of just a few years. I certainly don't think that it's a household name yet, even though they are the leader in what's called programmatic advertising. So all of these ads that are moving to what they call the connected TV, whether it's YouTube TV or Roku, and all these other things, they use kind of an algorithmic strategy to help figure out where ads would be most valuable to the advertisers placed across all of these digital platforms.

That is a company or a stock that came on our radar because it experienced one of these big high-volume breakouts. If you go back, we first bought this back in 2018. So early in 2018, the stock has a huge breakout and it has one of these big spikes in volume, comes on our radar, we dig into it deeper. We see that, wow, this is a great company — they have great growth prospects with high margin and they were a leader in this emerging industry with really solid fundamentals. So we take a position in the stock. Next quarter, when the stock reports, boom, the same thing happens again and there is another huge high-volume breakout — more and more funds getting involved in this. Next quarter — now we're getting into August of 2018 — the same thing happened, and they reported blowout earnings, and a huge gap higher on volume.

"But what we're saying is, we see these big spikes in volume as a good early warning signal to us that there's going to be continued waves of institutional demand and that buying a stock on that day or the next couple days means we're going to look back on it favorably."

And so that's a good example of when this strategy really works. These things unfold in ways that these companies are doing something special and they have really, really strong earnings power and that has more and more institutional investors waking up to the story, so they have these large funds that are trying to get into the stock. That is what can help you identify a true market leader, as in a real long-term winner.

TWST: And you're accentuating the fact that you feel like you've gotten in early on that? You saw the trading volume when it had its first significant uptick?

Mr. Kahn: Yes. You have to kind of just get in and realize that even though on that day, if you were to pull up the chart on that day when the stock has spiked higher and it's on huge volume, if you're looking at the chart that day, it looks like the stock is already high. But we know that our strategy is going to mean months and hopefully years down the road, when we look back, that that's going to be a good starting point. So that day, when we first bought the stock, it looked high to us, but we were confident that it would continue to go higher. And with stock splits and everything, it turns out that that our average cost basis of the stock was trading at something like the equivalent of $6, then today it is at $72.

TWST: Because you're talking about a life cycle, and you're saying you're looking at it appreciating and that's why your fund is talking about long-term capital appreciation?

Mr. Kahn: Yes, exactly. We strive for long-term capital appreciation. So it's hard for some people to buy the stock on those days when they're having these big breakouts because when you pull it up on that given day, and it looks like the stock is really high, because often this is the highest price that the stock has traded at. But what we're saying is, we see these big spikes in volume as a good early warning signal to us that there's going to be continued waves of institutional demand and that buying a stock on that day or the next couple days means we're going to look back on it favorably.

TWST: Just out of curiosity, and I know you're bottom-up, but on the fact sheet on August 31st, it says health care in terms of your sector weightings is at 2.25%. Why might a sector like that be so low?

Mr. Kahn: It has nothing to do with our top-down view. It's not that we think that health care isn't favorable in terms of how sectors are performing, it just has to do with the fact of how many stocks are coming through our screens on any given day and how many from a given sector have made it into the portfolio. There just haven't been that many that have made it into the portfolio. Earlier in the year, we had some of these genomic stocks, like **CRISPR** (NASDAQ:CRSP) and **Invitae** (NYSE:NVTA), and things like that, that have made it into the portfolio, but some of those got trimmed and/or we have taken profits on some of them. We just haven't seen as many ideas from that area of the market. There's been more things coming up from the consumer space and financials and even industrials as we've gotten deeper into this economic expansion.

TWST: What is your average turnover?

Mr. Kahn: Most people will go and look at something like Morningstar to see the turnover ratio. The way that they calculate it, it makes our turnover look higher. I can tell you that the turnover on our underlying stock portfolio is about 50%, so not very high.

TWST: Over a year?

Mr. Kahn: Yes.

TWST: OK. That might seem high for some investors.

Mr. Kahn: Yes. I guess you're right, it might seem high. Some of that is also because we trade around our positions. When positions have run up, we'll trim them back a little bit. When things pull back, we'll add to them. So we are a little bit more active on that front. But it's relatively low compared to most funds in our category peer group.

1-Year Daily Chart of Trade Desk Inc.

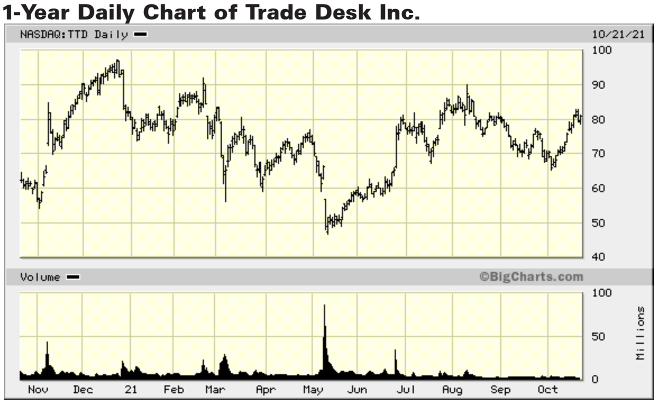

Chart provided by www.BigCharts.com

TWST: So you're saying, in other words, that might be the same name, but you're trimming back on the allocation? That would be considered turnover.

Mr. Kahn: Yes, exactly. We'll trade around our core positions and adjust the weighting depending on run-ups and pullbacks over the course of a year, so we try to be a little bit more active. We're always looking to manage our risk, whether it's adjusting our market exposure, adjusting our position sizes, trimming things that have had the big run-ups, and all of those things.

But to your point about the turnover ratio, when Morningstar looks at it, they're also calculating what's happening in our hedge model. So if the market has a correction and we add 25% or 50% in hedges, we put on all those shorts, and then when the market starts to come back up, we take off those hedges. They're adding all of that in. So that's why when you look up our portfolio turnover in something like Morningstar, it looks a lot higher because it depends on how much hedging activity there was going on in a given year.

But I'll tell you one other thing is that when most people ask what a portfolio's turnover is, what they're really alluding to is how tax efficient the fund is or how much it pays in capital gains. We are in our seventh year of live performance. And three out of the last six years, we were able to pay out zero capital gains to our clients. We were able to defer those and offset them. So in that sense, the fund is highly tax efficient relative to our peer group.

TWST: Looking at the economic situation going forward, economists might say the market may be a little bit more on the volatile side, particularly if there are inflation concerns. Why would it be wise then to move money into your fund?

Mr. Kahn: For most people, the reason why having our fund in addition to their regular long exposure makes sense is that most people can't make the adjustments as quickly as we can. So if the market does continue on the upside, then our hedge model is going to pick up on that and not try to get too defensive against it. We're not going to add in our hedges until our model tells us to and we're going to continue to hold these leading stocks that should do a good job in participating. When the market does roll over, our models are going to pick up on it and we're going to get hedged very quickly, just like we have in every other market correction and downturn.

So by having our fund as part of an investor's portfolio or long exposure, they're going to have the confidence in knowing that, at least part of their portfolio will do a good job in getting defensive and getting hedged quickly during the next downturn. We like to say that, for as long as the market is going to run, we can help them continue to participate on the upside. But we've done a good job in acting defensive during market downturns. When the downturn comes, we won't hesitate to get hedged and help get defensive.

TWST: Is there anything else you wanted to add that we haven't covered? Anything else that you think is important for people to know that differentiates your funds from others in sort of the same category?

Mr. Kahn: The big picture part of it we've already reiterated. Our goal is really to help our investors participate on the upside in the equity market while having a strategy to protect capital or preserve capital during the downturns. And that's going to give them better overall risk-adjusted returns over the long term.

The problem that the average investor makes is that when markets look really good, they tend to start taking on the most risk and adding the most stocks to their portfolio. Then when markets turn down, in the beginning, they think, this isn't so bad, I can stomach it. But then the worst it gets, they start to say I can't stomach this anymore and they begin to sell stocks usually at about the worst time. So we're really trying to help protect our investors from shooting themselves in the foot.

TWST: Thank you. (KJL)

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