An Equity Note

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What's Inside:

- *Introducing New MO Trading Strategy Idea: Compounder Momentum Factor (CMF)*
- *Thoughts on Initial Backtest*
- *Portfolio Moves*

Companies Mentioned:

- *Nvidia (NVDA)*

Equity Note: Working On Something New …

"After spending many years in Wall Street and after making and losing millions of dollars I want to tell you this: It never was my thinking that made the big money for me. It always was my sitting. Got that? My sitting tight!" - Jesse Livermore

Alex traveled this week, which means another 100% hit rate on our *"Alex is traveling so the markets will implode"* factor strategy.

One day we'll create a fund vehicle around that trade.

Despite the market's wild gyrations, there isn't much to do in our portfolio. We're sitting on roughly 65% cash and a ~6% net short position in Ethereum (ETHUSD).

It's not "fun" sitting in this much cash, but it's what's necessary for downwards/choppy environments. Plus, it allows us to bet *big* when we have conviction in a tradable/long-term market bottom.

That said, choppy markets give us time to find new ideas, engage in deep fundamental research, and concoct/backtest new trading strategies.

We're introducing a new long-term trading strategy idea dubbed the **Compounder Momentum Factor (CMF)** in this weekend's *Equity Note.*

The goal of the CMF is to create yet another non-correlated trading strategy along with our existing toolkit (FBO/FVBO, FOMC trades, Earnings Strategy, etc.).

Please note that we're still in the early stages of developing this strategy. However, we want to open-source it and leverage the knowledge/creativity of the *Collective* to make it the best version of itself.

Also, thank you, Octavio, for providing and cleaning the data to run this backtest. Octavio was instrumental in creating this system's first iteration of the rules.

Let's get after it.

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What Is The Compounder Momentum Factor (CMF)?

The CMF is a monthly trading strategy designed to buy breakouts after at least a 30% drawdown from prior all-time highs (ATH) in the highest quality "Compounder" companies.

Let's break each of those components down.

First, our tradable universe must consist of the **highest quality "Compounder" companies**. We'll expand on this topic in the next section.

Second, we only trade **monthly** closes (exits and entries). The goal is to create a simple system that takes ~5 minutes to execute once a month.

Third, we trade **breakouts from all-time highs**. This means the system *triggers* a potential trade only if a stock *closes above* its most recent all-time high. For example, a stock *will not trigger* if it breaks new ATHs, only to close the month below the most recent ATH.

Finally, a stock *must* experience **at least a 30% drawdown** from its most-recent ATH to trigger a potential set-up. Anything less than a 30% drawdown can easily be normal volatility (read: noise). And anything above 30% would result in minimal trade set-ups.

How Do We Define "Compounders"?

There are a couple of ways to define Compounder stocks. One way is to consider all the qualities we'd *want* in a Compounder, like high ROIC, sustainable and expanding gross margins, strong operating profits, and history of accretive capital allocation. Then use those qualities to populate a tradable universe.

But that would take a while. So we did something different.

We used two inputs to find our tradable universe of Compounders:

- **10 Year Linearity (R^2) of Total Returns**
- **10 Year CAGR**

We got this idea from *Long Equity*, a concentrated global equity fund and an excellent Twitter follow. I highly recommend reading his source material here.

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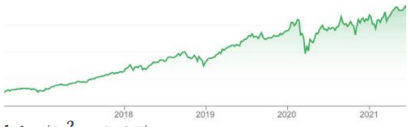
What is linearity?

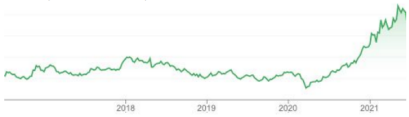
LONG EQUITY

Knowing that a company grew its share price by 100% over the last 5 years doesn't tell you whether the growth was incremental or occurred rapidly in a short burst. In investing, returns can either by consistent or erratic. We prefer consistent incremental growth.

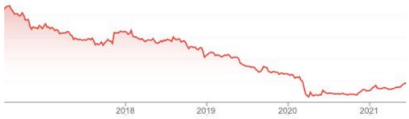
Filtering for linearity helps find companies that look like this (R^2 = 0.98):



and avoid companies that look like this (R^2 = 0.27):



and especially this (R^2 = -0.97):



What about valuation?

Any share price growth over any time period can be understood by the growth of earnings or the change in valuation.

We seek to understand what has driven share price growth and whether the balance leans more towards earnings growth (good) or towards an increased valuation (less good).

Return linearity is an excellent heuristic for identifying market compounders. We're effectively saying, "Okay, out of all the stocks in the tradable universe, find me the ones with the most consistent return profiles over time."

And in many ways, it self-selects for traditional "Compounder Bro" stocks (I'm looking at you, Charter Communications!).

Here's how we filtered our final trading universe. We multiplied a company's 10-year return linearity by its 10-year return CAGR. This gave us a "Composite Score." Then, we took all stocks with a Composite Score => 15.

For example, NVIDIA (NVDA) generated a 38 Composite Score (40% CAGR * 0.95 Linearity).

You can check out our full tradable universe dataset here, all 55 companies. Note that we took this data from 2011 to 2021.

At this point, you know the CMP trades monthly charts and *only* trades stocks with the highest Composite Score (Return Linearity * Return CAGR). Next, let's dive into trade structure.

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Buy Signals, Execution Protocol, and Trade/Risk Management

The first requirement is that a stock *must* sustain *at least* a 30% drawdown from a prior all-time high during the given backtesting period. This means our stocks needed 30% drawdowns from 2011+.

There is no need to overcomplicate our buy signal and entry/exit execution once we get that confirmed 30%+ drawdown. Here are the rules.

First, we need a **monthly close** above the previous ATH (before its 30% drawdown). That's our **Setup Bar.**

Our **Buy Signal** comes when the stock trades above the **Setup Bar** before its subsequent 30% drawdown.

Finally, we place our stop-loss a tick below the **Setup Bar** lows. However, it's important to note that we exit trades monthly (no hard intraday stops).

Let's use NVDA as an example. NVDA experienced a 30%+ drawdown from 2007 to 2016. The stock printed a monthly close above its prior ATH in May 2016. **That was our Setup Bar.**

The stock broke out above the **Setup Bar** and triggered a **Buy Signal** in June 2016. We then would place our stop-loss a tick below the May 2016 lows (see below).

Then there's **Risk Management**, which the system assumes is 100bps per trade.

Finally, let's discuss Trade Management. Currently, the strategy automatically sells each position after a full calendar year. For example, if you bought a breakout in June 2016, you sell it on a June 2017 **monthly closing basis.**

At this point, I don't know if that's the optimal exit strategy. I also want to backtest a trailing stop (like a 20 or 50D MA) and compare the results.

I bet that you'd close substantially fewer trades (less recycling), but you'd generate significantly higher R-multiples on the winners. The good news is that we'll constantly improve this strategy over time (and with your help).

I also want to reiterate a few things before diving into the preliminary results. First, our data is from a legendary bull run, so I expect this cohort's win rate to stand higher than future cohorts.

Second, we only used US companies in this first backtest. We plan on backtesting various global markets including Switzerland, Netherlands, Canada, the UK, France, Germany, and more.

The more data we have, the more effective our strategy.

Alright, let's see the results.

The Results: Signs of Early Success

Here are the highlights of our backtest:

- **Average Return:** 34.66%
- **Total R Return:** +298.06
- **Average R-Multiple (Winners):** 2.24
- **Average R-Multiple (Losers):** -1.05
- **Total Trades:** 132
- **Win Rate:** 83.33%
- **Loss Rate:** 16.67%
- **Expectancy Ratio:** 1.70
- **Average Annual Trades:** 12.0

Again, you can find the backtest file here.

There were a few things that stood out to me. One was the Win Rate, standing at an impressive 83%. The other one was the Average Annual Trades.

Running a monthly close strategy is interesting because you never know *how many* trades the system will generate. Fortunately this dataset offered ~1 trade per month. Talk about low maintenance.

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Thirdly, I was surprised to see the Average R Multiple on losing trades so close to -1R, given the fact that we close trades on a month-end basis.

Let's zoom in on the dataset to get a more granular view of returns. For example, check out the annual breakdown of R-Multiple returns (from entry date):

- **2011:** +2.67
- **2012:** +18.19
- **2013:** +29.25
- **2014:** +4.13
- **2015:** +10.48
- **2016:** +40.39
- **2017:** +11
- **2018:** +28.46
- **2019:** +38.12
- **2020:** +100.44
- **2021:** -3.26

While those numbers are great, we *still* need more data to confirm how robust it is against other countries, decades, etc.

Concluding Thoughts: Exciting Start But More Work To Be Done

We have exciting data from this first backtest, but we just need more data.

Like I mentioned earlier, we're in the process of backtesting different countries *and* decades to validate the robustness of this strategy.

However, for a low-maintenance, once-a-month trading system, there is reason to get excited.

I can't wait to share more backtests with you in the coming weeks. Also, *please* shoot Octavio a DM in the Slack Channel if you get a chance. He's an invaluable part of our MO Team and I couldn't have done this initial backtest without his data capture/clean-up work, and his thoughts on trade parameters.

Portfolio Updates

Sells

- **SOLD** Full Micron, Inc. (MU) Long
- **SOLD SHORT** Third Leg Ethereum (ETHUSD)

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