HEDGEYE CAPITAL ALLOCATION

Frequently Asked Questions Capital Allocation Model Portfolios

In May 2024 the **Capital Allocation (CA)** team initiated a new and noteworthy deliverable: **Model Portfolios** (**MPs**). Herewith answers to frequently asked questions (FAQs) about these **MPs**, illustrative editions of which appear on the last page of this memo.

- **What's the goal of each MP?** The goal of each MP is to maximize total returns over rolling 18+ month horizons without violating two constraints: (1) a portfolio-specific drawdown constraint (specified in the **MPs'** header); and (2) a turnover constraint common to all three **MPs** entailing a targeted sub-5% probability of turnover exceeding 40% over any rolling 18-month period.

- **Are the MPs long-only?** Yes, reflecting the typical **CA** patron's disuse of short sales.

- **Why -15%, -25% and -35%?** Because this trio strikes us as the optimal means of telegraphing efficiently the potential application of **RPs** to portfolio construction.

- **Why just three MPs?** Because more would likely constitute less in this context, the process of crafting **MPs** and updating them regularly entailing much work, with no **CA** patron known to us stewarding long horizon portfolios pursuant to drawdown tolerances falling outside our self-styled range of -15% to -35%.

- **Does the -35% MP have a higher expected return than the others?** Expected? No. Targeted? Yes, which helps explain why some exposures included in the -15% or -25% **MPs** don't clear the bar for the -35% version. Conversely, some exposures not included in our two less risk-tolerant **MPs** garner allocations in the -35% version, with defense stocks (ITA) exemplifying that phenomenon at present and with energy stocks (XLE) exemplifying a ticker included in the -15% and -25% portfolios but not the -35% version.

- **Any other noteworthy reasons why exposures' weights vary across the MPs?** Yes: an exposure's weight in a given portfolio depends not only on staff's views respecting the distribution of its potential returns but also on these returns' guesstimated correlations with those of other holdings, actual or potential. Differently put, when constructing drawdown-constrained portfolios allocators are unavoidably playing not merely "chess instead of checkers" but 3+ dimensional chess: nice work if one can get it while also being endlessly challenging.

- **Will the MPs eventually include individual stocks or bonds?** Probably not, at least not the current trio of **MPs**. That said, we like the idea of using select stocks or bonds as relatively low cost asset allocation tools and hope to draw on the fine work of Hedgeye's sector specialists to furnish such tools in due course, most likely as alternate allocations to those included in one or more **MPs**. When furnishing such tools, we'll be extending work

commenced some time ago, via our September 2023 endorsement of Extra Space Storage (EXR) as a potentially superior means of gaining long-term exposure to realty than XLRE or other comparably diverse REIT-focused ETFs. That endorsement can be accessed **HERE**.

- **Why limit turnover to 40% over rolling 18-month intervals?** Conceding that any such constraint is somewhat arbitrary, this formulation strikes us as an apt expression of the typical **CA** subscriber's need to keep turnover within reasonable limits while striving to produce attractive risk-adjusted returns.

- **How often will MPs get updated? MPs** will be updated monthly in accordance with our monthly refreshing of **RPs** underlying them, with intra-month changes promulgated on an as-needed basis.

- **How will turnover get computed?** For purposes of gauging compliance with the 40% ceiling, turnover will be defined as the sum of all reductions in position sizes, full or partial. For example, if the initial change to the **-15% Drawdown MP** entails a 1% reduction in its 15% allocation to the US dollar (UUP) with a corresponding 1% increase in that portfolio's allocation to Cash Equivalents, the portfolio's resulting turnover will be 1% and reported as such. Since the turnover ceiling is defined in rolling 18-month terms, any turnover occurring in Month 1 will get dropped from the running tally at the start of Month 19 and so on.

- **How often will MPs get rebalanced for performance reporting purposes?** This is a deceptively important question to which staff has given careful thought--a question confronted routinely and often ineptly by stewards of institutional funds benchmarked to multi-asset "policy portfolios". The challenge entails the adoption of rebalancing protocols consistent with real world boundary conditions governing management of the portfolios being benchmarked, including especially applicable constraints on turnover. Mindful that any such protocol is somewhat arbitrary, we've adopted a rebalancing rule entailing resets of **MP** position sizes or weights on the last trading day of each calendar quarter. Crucially, "resets" as just used mean the restoration for performance reporting purposes of whatever weights staff last adopted and promulgated for a given **MP.** What happens if we change these weights intra-quarter? We simply compute returns from the last reset through the date of the changes in question and use the new weights when computing the **MP's** going-forward returns. In investment-speak, the method just described is known as chain-linking or geometric compounding of returns: a method well-known to veterans of institutional investing including **CA** staff.

- **Are there videos discussing the MPs?** None discussing them comprehensively, yet, but the **MPs** were discussed at some length in Hedgeye's Macro Show for 6.6.24 posted **HERE**.

- **Did CA staff use generative AI to produce these FAQs?** Yes, senior management at Hedgeye having pressured all Hedgies including **CA** staff to use generative AI to simplify our published prose. We're keen to do so, while also being frustrated with Chat GPT's tendency to garble points we're keen to convey. Not knowing to what extent our valued patrons view prior **CA** posts (or this one!) as overly prolix, we welcome feedback on that question or indeed any aspect of our work. As always, we're reachable via emails to capitalallocation@hedgeye.com or calls to 203.562.6500 x127.