REPRINTED FROM AUGUST 28, 2017

THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

A Long-Term, Trend-Following Investment Strategy

MARTIN H. BERGIN is the President and Owner of DUNN Capital Management, LLC. He oversees all mission-critical operations of the firm, and directs the firm's research and development efforts as well as the construction and management of the firm's managed futures portfolios. Mr. Bergin also manages all operational and financial activities of DUNN Capital Management, LLC. His duties include overseeing day-to-day trading and risk management, directing the accounting, budgeting and long-range planning processes, and managing the human resources function. Mr. Bergin joined DUNN in September 1997 as Accounting Systems Manager, and was promoted to Vice President and Chief Financial Officer in March 2001. In May 2007, he was promoted to President. In January 2010, a business succession plan was implemented that resulted in sole ownership of the company by Mr. Bergin as of August 2015. Mr. Bergin earned a Bachelor of Science in business administration from George Mason University in 1987, and became a Certified Public Accountant in 1988. From 1987 through 1997, he practiced public accounting in Northern Virginia, where he became Partner at a local CPA firm, managing audit, tax and consulting engagements for clients in the managed futures, banking and defense industries.

JAMES R. DAILEY is Chief Executive Officer of DUNN Capital Management, LLC. Mr. Dailey has responsibilities in the areas of strategic planning, business and product development, client relations and financial reporting. Mr. Dailey joined the company in 2003 as a Financial Analyst and was promoted to Vice President of Finance in 2007, CFO in 2008 and CEO in 2016. He earned a B.S. in business administration from The Pennsylvania State University in 1994 and an MBA in finance from the University of Maryland in 2000. Prior to joining DUNN Capital Management, LLC, Mr. Dailey worked for Marriott International in corporate financial planning and analysis and spent several years in public accounting.

SECTOR — GENERAL INVESTING

TWST: We're going to focus our conversation today on risk management, so let's start by discussing what the main approaches are to risk management.

Mr. Bergin: We take a little different approach than the investment industry as a whole. In most cases, people refer to risk on an annual volatility basis. So, most people will quote their vol. They either target a certain vol, or more likely, it's based on past experience. Especially in equity investing where it's all long-only for the most part, people will respond by stating what the average vol has been over a certain period of years.

We approach it from the standpoint of value at-risk targeting, or VaR targeting. The two things about that that are interesting are, one, our type of strategy or alternative strategy — not all of them, but most of them on the whole — has the ability to target a risk, as opposed to just stating what the actual volatility has been. If you have a VaR that is a static VaR, it will pretty much equate to a certain level of volatility. It's a mathematical formula that's fairly simple. But the fact that we, and anybody else in the managed futures space for the most part, are able to either have a static VaR and they will recalibrate that daily, or in our case we have a moving VaR target that allows us to target whatever risk we want the investor to have on any given day, and that's adjusted every day.

The second interesting thing is that VaR becomes more important when you don't have an ordinary return distribution. If you have fat tails, for instance, by using a VaR calculation you're able to take those into account, whereas a volatility calculation wouldn't allow that to be taken into account without some major adjustments.

TWST: Is there anything else you'd add in terms of the pros and cons of the different approaches?

Mr. Dailey: I think in managed futures, just to add a little bit more to what Marty was saying, it's really a managed risk. Because we aren't long-only, we're not just accepting what the market is doing. We are actively managing the risk that we're taking on, and we are calibrating the portfolio to our targeted risk every day. We may stay long or short in our position, so we're not directionally changing positions frequently, but we're tweaking them by either adding or paring them back on a daily basis to stay right at our targeted risk.

Mr. Bergin: Or even adjusting the targeted risk given the market conditions.

TWST: I understand that prior to 2013, you had a higher level of risk tolerance. Why was that the case then, and how did you perform as a result?

Mr. Bergin: Just to be clear, what we did prior to 2013 is we targeted a static VaR. Our VaR was a 1% chance of losing 20% or more in one trading month, which would normally be considered somewhat high, especially as compared to the industry standard. The belief was that if we were going to make money over the long term, we chose a VaR that would allow us to make as much money as possible without putting so much money at risk that we could go out of business. We've been around since 1974, and we've lost more than 20% within a given month 1.2% of the time over the last 43 years.

Given what was the ability to compute numbers back in the 1970s, when you were using punch cards, it was a pretty good targeting by Bill Dunn, who created the firm. Risk is really an art form, because nobody knows what the future is going to hold. You're positioning yourself as best you can to take on whatever the market brings you going forward, and being able to adjust that every day should give you the opportunity to be more proactive with changes in the market than if you left it static and took whatever the market gave you over days or months or even years.

In January 2013, what we did is we started modifying our VaR each day, depending on the market conditions. We have a proprietary method of measuring the market conditions, and given whatever our holdings are, we adjust our risk depending on whether we consider it a good market or a poor market. It's not risk-on, risk-off. We don't have a switch that we flip. It's a very small adjustment that happens every day.

The important thing is, the outcome is it reduces the downside volatility by about 25%, and therefore it will reduce the drawdowns. And if there is one thing that most investors remember negatively, it is if they have a drawdown in their account. So we're able to reduce that by 25% without sacrificing any of our profitability that we've had in the past, and that's important to us because we don't charge management fees. We strictly work on an incentive basis, so I'm interested in making money for our clients as opposed to just accumulating assets, which some managers feel is more important.

Mr. Dailey: What we do is trend following. It's a completely systematic strategy, but the markets that are most conducive for us to make money are markets where there is a sustained trend, either up or down. We have no long or short bias, and where there is directional volatility and low intermarket correlation, we do very well in those markets. But there are sometimes long periods of time where markets are mostly sideways, and they're not trending in a sustained way.

Previously, when we had a static VaR, we were still ramping up our risk to a high amount, even during these sideways markets. So the dynamic VaR has allowed us to calibrate the portfolio to what's actually going on. During sideways markets now, we will pull back a lot of the risk and be trading at a much lower volatility than we used to. And then as markets begin to trend, we'll incrementally increase our targeted value at risk, and eventually get up to what used to be our high permanent static VaR.

Mr. Bergin: Actually, it is about 5% of the time that we'll be at or slightly above the level of risk that was fixed in the past. But 95% of the time we're trading at some level below what used to be our static risk. The fact that we're able to opportunistically take on the risk that we have in the past allows us to still make the same type of returns that we have in the past in a good market environment.

Highlights

Martin Bergin and James Dailey talk about their investment strategy and risk management approach. They approach risk management from the standpoint of value at-risk targeting, or VaR targeting. The two executives emphasize that they have a systematic strategy, but the markets that are most conducive for them to make money are those where there is a sustained trend. They are 100% quantitative investors, so there is no subjective decision-making.

Mr. Dailey: Our value at risk used to be pegged at 20%, so that's a 1% chance of a 20% or more loss in a rolling one-month period. Now, it will fluctuate between 8% and up to 22%, and over time it will average 15%. That translates into an annualized volatility of about 22%, whereas before it was 36%. So the results — and we have 4.5 years of trading now, actual results — since we implemented this change to our methodology, we've had a material improvement in our risk-adjusted returns.

The firm has been around since 1974, but our flagship program that's still operating today began trading in 1984. From the period of time from inception to the end of 2012, when we were still trading with our static VaR, our Sharpe was 0.41. And the period of January 2013 to present, our Sharpe is at 0.74. So it's a smaller amount of time, but it's still an amount of time with enough data points to start making some conclusions that what we've done has been a real big improvement.

TWST: So the results have been what you expected when you started?

Mr. Bergin: Yes. The reality is we have a process here for our research and implementation, so we have a very good idea before we actually implement something into the program of what the effect will be, and then we monitor it. And we've had enough data points that what we've come up with is statistically clear that what we expected did happen. If it hadn't, there would be a problem, because we'd have to go back and look at our process and see where we had failed. It's pretty simple when everything you do is just driven off of numbers.

Mr. Dailey: We're 100% quantitative, so there is no subjective decision-making to what we do. When we say that our VaR is now targeted to current market conditions, that's not a person saying, "We think this is a good trading environment." There are actual data inputs, and this is a systematic calculation that targets our portfolio value at risk. There are three main inputs to that calculation: There is our trend confidence, volatility and intermarket correlations. We have a proprietary metric that uses those data points, and that automatically adjusts our VaR on a daily basis.

TWST: Is there anything else you would add, without giving away proprietary information, about your methodology?

Mr. Bergin: You know, all that we're doing is trend following, which at a basic level is pretty straightforward. People usually look at time and volatility or noise, and if the price is going up, you buy; if the price is going down, you sell. The question is, how much are you willing to stay in a position that's losing before you switch? If the market is constantly going up and down, you can get caught in these channels where you're buying the highs and selling the lows all the time, and that's always a losing proposition.

There are different methodologies for measuring different trends, and we try to use different methodologies to give us a more robust system for calculating those streams; I call them revenue streams. Each methodology will generate a different revenue stream, and if you can put uncorrelated revenue streams together in any kind of an investment portfolio, that will give you better risk-adjusted returns. So that's our goal, to make the system as robust as possible.

That also affects the risk of the system, because if your system has been data mined and it's not very robust, it may work for a very short period of time in a certain market environment, but then in all remaining market environments it fails. We try to avoid that at all cost, because 20% to 25% of the money we manage — we manage $1 billion— is internal proprietary money. The employees, employees' families, our pension is being traded by us. So if we were making mistakes like that, it would affect our own capital. I think that's an important thing for people to understand: Whenever you're looking to have somebody manage capital, you want to make sure that managers believe in it enough to have some money invested.

each market, and I think that's something that a lot of individual investors don't really get. They'll look at their allocations in their overall portfolio, and say they have the money in stocks, bonds, real estate and alternative investments. When they say, "Well, I want to be 50% stocks, for example, and 30% bonds," they're talking about 50% of their cash available to invest, and what we suggest is that investors look at 50% of whatever the targeted percentage is of their risk.

Mr. Bergin: People have to understand that they should be approaching their portfolio on buckets of risk, not buckets of cash. People talk about, "Well, DUNN trades at such a high volatility compared to its peers." There is a reason for that, because we don't charge a management fee. Our belief is that you should have 20% to 25% of your portfolio risk — note the term "risk" — allocated to a managed futures product. If you put 25% of your cash in a managed futures product, you get a whole different allocation if you give that to somebody with low volatility versus giving it to DUNN with a higher volatility. You get more bang for your buck by providing that to DUNN, which would then allow you to reduce the amount of cash you allocate to our type of strategy, and still get the same amount of risk allocation. That is a very positive scenario from the investor's point of view — that they can allocate half as much to us and still get the same advantages they could with another manager. And, they're not paying when they're losing money.

"The reality is we have a process here for our research and implementation, so we have a very good idea before we actually implement something into the program of what the effect will be, and then we monitor it."

Mr. Dailey: Yes, our money is invested in the same exact product as our clients' money.

TWST: Given your approach, how do you allocate by asset class? And what about cash?

Mr. Bergin: That's a really good question, especially how we approach each market or asset class that we trade. A lot of managers try to take assets and put them in certain categories, like energies and stocks and bonds and such, and they approach each sector with a different methodology or a different philosophy around trading. Because we're quantitative, we don't really care about whether they're called an energy or whether it's a bond, or whether it's an equity index or a currency or a grain. We look at each market as an individual market, and we treat them all equally, and we treat them all the same.

Now, when you look at market correlations and when you put together our matrixes, intermarket correlations, any kind of sector correlations that happen between markets is handled within that correlation. But you could have a grain and that market may be moving exactly the way a bond is, and we would treat it as being very correlated. Of course, if it was oppositely correlated, we would treat it as being oppositely correlated. We aren't driven by old thought processes or theories, we're just driven by the numbers, and we give equal amount of risk to every single market we trade.

I'll let James expand on the cash side of things.

Mr. Dailey: So we calculate an equal amount of risk allocated to each market; that's potential risk, before we do our signal generation. But that doesn't mean that the same amount of cash is invested to buy a position in each market, because different markets have different levels of volatility. So we allocate our risk equally to

TWST: How should investors be thinking about that when they're choosing a manager?

Mr. Bergin: Maybe I'm talking my own book, but I think they ought to look for a number of things. They have to look for how long a manager has been doing what he is doing, because, especially with managed futures, you want to have a manager that has gone through bad periods of performance. That really shows whether the manger has staying power or not. If you get with a manager that has a very short track record and it always has gone well, as soon as things go poorly you don't know how they're going to react — what changes they may make to the system, whether they may do things that they wouldn't normally do because of the stress of the situation. We clearly have withstood some pretty bad times.

The other thing is, you want to have somebody that has some AUM to show they can handle a decent size. You want to look at the fee structure. You want to be on the same side of the table as the manager, and you want to verify that the manager has some skin in the game, that they believe in their system as much as they want you to believe in their system.

Mr. Dailey: I would also recommend that people understand why they're selecting a manager. Most people invest in trend following not as a standalone investment, but for the complementary attributes that it brings to their overall portfolio. Trend following has a very low or almost no correlation to most traditional asset classes like equities, bonds, real estate, so it brings correlation benefits. And then, it tends to be negatively correlated during a crisis period, so over a sustained crisis — not a one-day blip, but over a sustained crisis like the tech bubble or the debt crisis — trend following does well when equities are doing poorly.

So if that's the benefit that an individual investor is looking for, they can evaluate different trend-following managers by looking at their track record and looking at how much they would invest to get the benefits that they're looking for. Do some stress testing. Look at various scenarios, assess their other investments, look at those returns, and look at what different allocations the trend following managers are going to do to their overall portfolio, and choose that way.

TWST: Thank you. (MN)

MARTIN H. BERGIN
President & Owner
JAMES R. DAILEY
Chief Executive Officer
DUNN Capital Management, LLC
309 SE Osceola St.
Suite 350
Stuart, FL 34994
(772) 286-4777
www.dunncapital.com