

# Cognios Market Neutral Large Cap (COGMX)

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Jonathan Angrist

*Cognios is one of the few market neutral funds that has gotten it right, in up-markets and down.*

**Objective and strategy** The fund seeks long-term growth of capital independent of stock market direction. The managers balance long and short positions in domestic large cap stocks within the S&P 500 universe. They calculate a company's Return on Tangible Assets (ROTA) and Return on Market Value of Equity (ROME). The former is a measure of a firm's value; the latter measures its stock valuation. They buy good businesses as measured by ROTA and significantly undervalued firms as measured by ROME. Their short positions are made up of poor businesses that are significantly overvalued. As a risk-management measure and to achieve beta neutrality, their individual short positions are generally a lower dollar amount, but constitute more names than the long portfolio.

**Adviser** Cognios Capital LLC. Cognios, headquartered near Kansas City was founded in 2008. It's an independent quantitative investment management firm that pursues both long-only and hedged strategies. As of December 31, 2015, they had \$388 million in assets under management. They manage a hedge fund and accounts for individual and institutional clients as well as the mutual fund. The senior folks at Cognios are deeply involved with charitable organizations in the Kansas City area.

**Manager** Jonathan Angrist, Brian Machtley and Francisco Bido. Mr. Angrist, Cognios' cofounder, president and chief investment officer, has co-managed the fund since its inception. He co-owned and was a portfolio manager at Helzberg Angrist Capital, an alternative asset manager that was the predecessor firm to Cognios. He helped launch, and briefly managed, Buffalo Micro Cap fund. Mr. Machtley, Cognios' chief operating officer, has co-managed the fund since its inception. Previously, Mr. Machtley served as an associate portfolio manager at a Chicago-based hedge fund manager focused on micro-capitalization equities. Mr. Bido is Cognios' head of quantitative research. Prior to joining Cognios in 2013, Mr. Bido was a senior quantitative researcher with American Century Investments.

**Strategy capacity and closure** At \$3 billion, the managers would need to consider closing the fund. The strategy capacity is limited primarily by its short portfolio, which has more numerous but smaller positions than the long portfolio.

**Management's stake in the fund** Messrs. Angrist and Machtley have between \$100,000 – 500,000 each in the fund. Mr. Bido has between \$10,000 – 50,000. One of the fund's trustees has an investment of \$10,000 – \$50,000 in the fund. The vast majority of the fund's shares—98% of investor shares and 64% of institutional ones, as of the last Statement of Additional Information—were owned by the A. Joseph Brandmeyer Trust. Mr. Brandmeyer founded the medical supplies company Enturia and is the father of one of the Cognios' founders.

**Opening date** 31 December 2012

**Minimum investment** \$1,000 for the individual shares and \$100,000 for the institutional shares (COGIX).

**Expense ratio** Excluding dividend expenses, borrowing costs and brokerage expenses on securities sold short, the expense ratio is 1.70% on institutional class shares and 1.95% on investor class shares, calculated on assets of \$31 million, as of January 2016. Once the “excluded” expenses are factored-in, the expense ratio bounces to 3.97% on the retail shares and 3.72% for the institutional ones.

**Comments** Market neutral funds, mostly, are a waste of time. In general, they invest \$1 long in what they consider to be a great stock and \$1 short in what they consider to be an awful one. Because there are equal long and short positions, the general movement of the stock market should be neutralized. At that point, the fund’s return is driven by the difference in performance between a great stock and an awful one: if the great stock goes up 10% and the awful one goes up 5%, the fund makes 5%. If the great stock drops 5% and the awful one drops 10%, the fund makes 5%.

Sadly, practice badly lags the theory. The average market neutral fund has made barely 1% annually over the past three and five year periods. On average, they lost money in the turbulent January 2016 with about 60% of the category in the red. Only two market neutral funds have managed to earn 5% or more over the past five years while two others have lost 5% or more. No matter how low you set the bar, the great majority of market neutral funds cannot clear it. In short, they charge hedge fund-like fees for the prospect of cash-like returns.

Why bother? The short answer is, because we need risk mitigation and our traditional tool for it—investing in bonds—is likely to fail us. Bonds are generating very little income, with interest rates at or near zero there’s very little room for price appreciation (the price of bonds rise when interest rates fall), there are looming questions about liquidity in the bond market and central bankers have few resources left to boost markets.

Fortunately, a few market neutral funds seem to have gotten the discipline right. Cognios is one of them. The fund has returned 7.6% annually over the three years of its existence, while its peers made 1.2%. Since the fund’s inception through January 2016, the S&P 500 has posted 13 losing months. The fund outperformed the S&P in 11 of those 13 months. A more striking result: the fund posted gains in six of those 13 months. In the most recent instance, January 2016, the fund returned 4.3% while the stock market dropped 5% and its peers lost a fraction of a percent. That record places it in the top 4% of its peer group in the company of two titans: BlackRock and Vanguard.

What has Cognios gotten right?

**1 Their portfolio is beta neutral, rather than dollar neutral.** In a typical dollar-neutral portfolio, there’s \$1 long for \$1 short. That can be a serious problem if the beta characteristics of the short portfolio don’t match those of the long portfolio; a bunch of high beta shorts paired with low beta long positions is a recipe for instability and under-performance. Cognios focuses on keeping the portfolio beta-neutral: if the beta of the short portfolio is high relative to the long, they reduce the size of the short portfolio. That more completely cancels the effects of market movements on the fund’s return.

**2 Their long positions are in high-quality value stocks, rather than growth ones.** They use a quantitative screen called ROTA/ROME®. ROTA (Return on Tangible Assets) is a way of identifying high-quality businesses. At base, it measures a sort of capital efficiency: a company that generates \$300 million in returns on a \$1 billion in assets is doing better than a company that generates \$150 million in returns on those same assets. Cognios’ research shows ROTA to be a stable identifier of high quality firms; that

*Mr. Angrist has a good question about most market neutral strategies: “Really, why bother?”*

is, firms that earn high returns in one period tend to continue doing so in the future. As Mr. Buffett has said, “A good business is one that earns high returns on tangible assets. That’s pretty simple. The very best businesses are the ones that earn a high return on tangible assets and grow.” The combined quality and value screens skew the portfolio toward value. They also only invest in S&P 500 stocks—no use of derivatives, futures or swaps.

**3 They target equity-like returns.** Most market neutral managers strive for returns in the low single-digits, to which Mr. Angrist echoes the question: “why bother?” He believes that with a more concentrated portfolio—perhaps 50 long positions and 100 short ones—he’s able to find and exploit enough mispriced securities to generate substantially better returns.

**4 They don’t second-guess their decisions.** Their strategy is mechanical and repeatable. They don’t make top-down calls about what sectors are attractive, nor do they worry about the direction of the market, terrorism, interest rates, oil prices or the Chinese banking system. If they’ve managed to neutralize the effect of market movements on the portfolio, they’ve also made fretting about such things irrelevant. So they don’t.

**5 They focus.** This is their flagship product and their only mutual fund.

**Bottom Line** A market neutral strategy isn’t designed to thrive in a bull market, where even bad companies are assigned ever-rising prices. These funds are designed to serve you in uncertain or falling markets. It’s unclear, with the prospect that both stocks and bonds might be volatile and falling, that traditional strategies will fully protect you. GMO’s December 2015 asset class returns suggest that a traditional 60/40 hybrid fund will lose 1.4% annually in real terms over the next five to seven years. Of the three market neutral funds with the best records ([Vanguard Market Neutral VMNFX](#) with a \$250,000 minimum and [BlackRock Event Driven Equity BALPX](#) with a 5.75% load are the other two), Cognios is by far the smallest, most accessible and most interesting. You might want to learn more about it.

**Fund website** [Cognios Funds](#)



## Disclosures

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| Performance<br>as of 3/31/2016      | Q1 2016 | 1 Year | 3 Year<br>(annualized) | Since Inception<br>(annualized) |
|-------------------------------------|---------|--------|------------------------|---------------------------------|
| COGMX                               | 6.70%   | 11.31% | 8.65%                  | 7.13%                           |
| COGIX                               | 6.75%   | 11.55% | 8.90%                  | 7.39%                           |
| HFRX Equity Market<br>Neutral Index | -2.59%  | 1.02%  | 2.50%                  | 2.48%                           |

Annual Expense Ratio: Institutional Class (COGIX) – Gross 5.68%/Net 3.72%. Investor Class (COGMX) – Gross 5.92%/Net 3.97%†. The Adviser will reduce the fees payable to limit the Total Annual Fund Operating Expenses to 1.70% of the Fund's average annual net assets. *The performance data quoted above represents past performance. Past performance is not a guarantee of future results. Investment return and value of the Fund shares will fluctuate so that an investor's shares, when sold, may be worth more or less than their original cost. Performance may be lower or higher than performance data quoted. Fund performance current to the most recent month-end is available by calling 855.254.6467 or by visiting [www.cogniosfunds.com](http://www.cogniosfunds.com).*

Cognios Capital, LLC (the "Adviser") has agreed contractually to reduce the fees payable to it under the Advisory Agreement (but not below zero) and/or reimburse other expenses of the Fund attributable to services provided by ALPS Fund Services, Inc. and its affiliates including, but not limited to, organizational expenses and offering costs), to the extent necessary to limit the Total Annual Fund Operating Expenses (as defined in Item 3 of Form N-1A) of each of the Investor Class and Institutional Class shares of the Fund (exclusive of brokerage costs, interest, taxes, dividends, litigation expenses, indemnification amounts, borrowing costs, brokerage expenses and dividend expenses on securities sold short, distribution/12b-1 fees and extraordinary expenses (as determined under generally accepted accounting principles) to 1.70% of the Fund's average annual net assets. This agreement is in effect through January 31, 2017 and may not be terminated or modified prior to this date except with the approval of the Fund's Board of Trustees. The Adviser will be permitted to recover, on a class-by-class basis, expenses it has borne through the agreement described above to the extent that the Fund's expenses in later periods fall below the annual rates set forth in the agreement. The Fund will not be obligated to pay any such deferred fees and expenses more than three years after the end of the fiscal year in which the fees and expenses were deferred.

S&P 500 Index – This Index is a market value weighted index that includes 500 stocks chosen by Standard & Poor's based on market size, industry grouping, liquidity and other factors. It is designed to be indicative of the large cap universe capturing approximately 75% coverage of U.S. equities.

Beta – Statistical measure of the sensitivity of a company's stock price to the movement of a broad stock market index. For the Fund, the Adviser uses a company stock price Beta relative to the S&P 500 Index. A Beta of 1.0 means a stock generally moves up and down in proportion to the movement of the stock market. A Beta greater than 1.0 means a stock generally moves up and down more than the movement of the stock market. A Beta less than 1.0 means that a stock generally moves up and down less than the movement of the stock market.

HFRX Equity Market Neutral Index – Common benchmark for long/short market neutral hedge funds (funds traditionally only available to high net-worth accredited and institutional investors that are also “qualified clients” as defined by the SEC). More information about this index may be found at [www.hedgefundresearch.com](http://www.hedgefundresearch.com).

One cannot invest directly in an index.

**Risk Considerations:** As with any mutual fund, there are risks to investing. The value of the Fund's assets will fluctuate as the equity market fluctuates, although the Beta-adjusted market neutral focus of the Fund should reduce the effect of general market fluctuations on the valuation of the Fund as a whole. Utilization of leverage, such as borrowings and shorting positions, involves certain risks to the Fund's shareholders, including potential for higher volatility of the net asset value (“NAV”) of the Fund's shares and the relatively greater effect of portfolio holdings on the NAV of the shares. The Fund may not always be able to close out a short position on favorable terms. Short sales involve the risk that the Fund will incur a loss by subsequently buying a security at a higher price than the price at which it sold the security short.

*The Cognios Market Neutral Large Cap Fund is not suitable for all investors. Subject to investment risks, including possible loss of the principal amount invested. An investor should consider investment objectives, risks, charges and expenses carefully before investing. To obtain a prospectus which contains this and other information, call 855.254.6467 or visit [www.cogniosfunds.com](http://www.cogniosfunds.com). Read the prospectus carefully before investing.*

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