

# How to Distinguish Between Talent and Tourists

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A CHECKLIST FOR CUTTING THROUGH THE MARKETING HYPE IN AI, MACHINE LEARNING, AND VOLATILITY STRATEGIES



# Volatility Strategies

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## Red Flag

The “Hurricane” Insurance  
Analogy

## Questions

Are the manager’s interests aligned?

Is short volatility the core strategy?

Are you ever net short options?

Does any single name ever carry short options?

How do you assess convexity correlation across products?

# Volatility Strategies

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## Red Flag

### High Sharpe ratios

(Annualized Net Return / Std Deviation)

## Questions

Is this an option selling strategy?

What is the strategy's correlation during tail events?

Are you long or short skew?

What is the maximum margin to equity ratio?

Note: The Sharpe ratio formula punishes positive skew. Sortino utilizes *downside* standard deviation and is a better metric for evaluating volatility strategies.

# Machine Learning / AI

## Unsupervised Learning

Algorithms inherent structure from unlabeled data

Ex: Classify these images into groups

## Supervised Learning

Predict output data from labeled input data

Ex: Predict the daily move of the SP based on the daily move of its 10 largest constituents

Fundamental



Quantitative

## Classification Problems

Used to predict which class a data point is part of

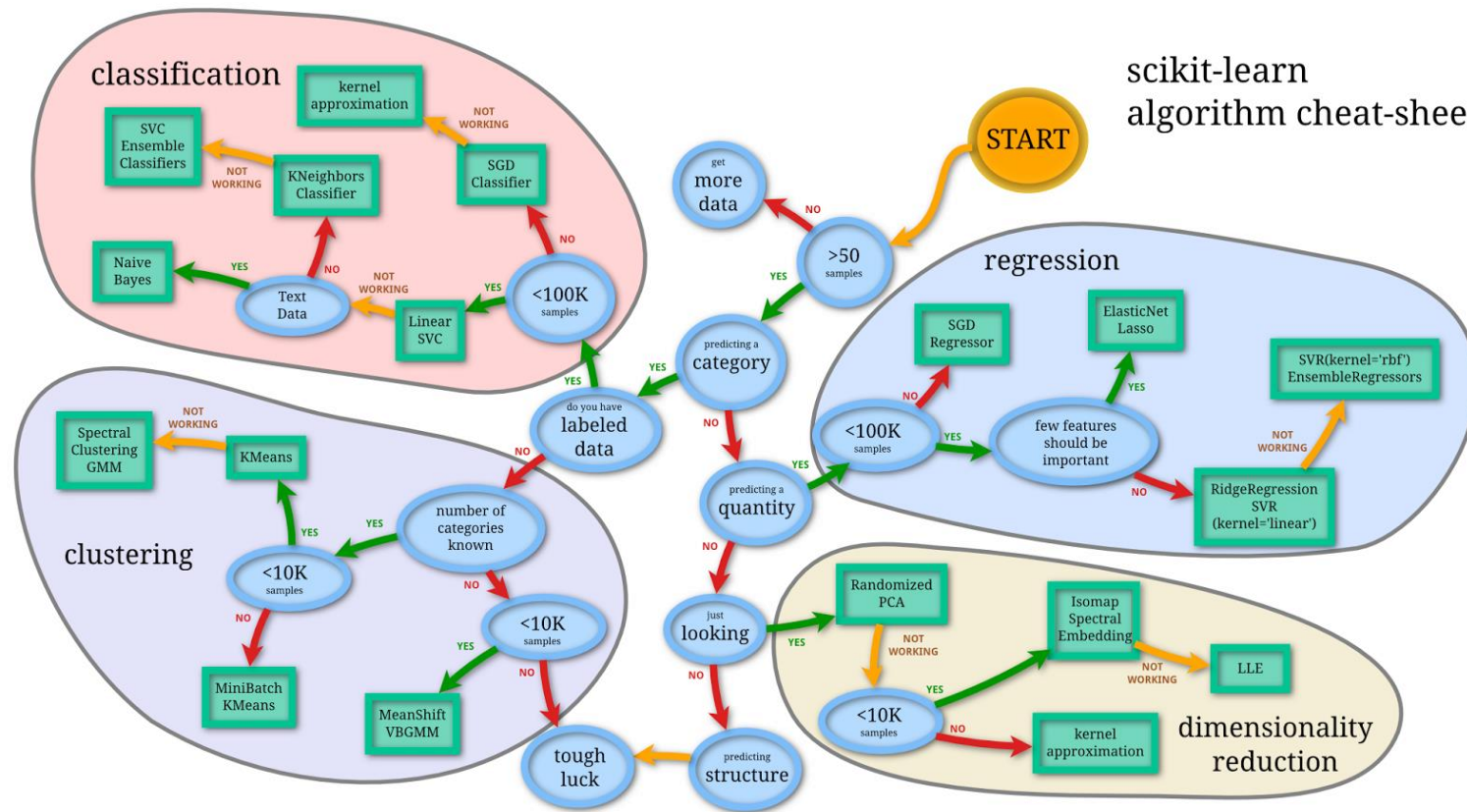
Ex: Is this a picture of a cat or a dog?

## Regression Problems

Used to predict continuous values

Ex: Predict how much heating oil will be consumed based on temperatures

# Multiple approaches to employing AI



Neural Networks

Genetic Algorithms

Deep Learning

Moral: There are many paths and approaches.

Make sure your manager has competency in the relevant algorithms.

# The Data Scientist Arms Race

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## Product Specialists

Portfolio Managers

Traders

Analysts

Wall Street

## ML Specialists

Computer Scientists

Programmers

Data Scientists

Silicon Valley & Academia


How would each evaluate a 3 year old biotech firm that was facing FDA review on its only drug?

# The Fitness Function

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**Quantify and define investing objectives**

**Optimal Portfolio**

<u>Objective</u>	<u>Weighting</u>		<u>Portfolio</u>	<u>DI score</u>
Sortino	60 %	Apply Predictive Model  	1	.8
Return	20 %		2	.5
Max Drawdown	15%		3	.35
Win Loss Ratio	5%		4	.2
			...	0.0

# Manager Cross Examination

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- Establish the manager's core competencies
- What is your fitness function?
- Do you rely on supervised or unsupervised learning? What data do you apply it to?
- Do you exclusively test your models on out of sample data?



# Manager Cross Examination

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- How do you maintain edge as more players enter the market?
- What is the worst case scenario? How do you know that?
- What are your average and maximum margin to equity ratios?
- Use the phrase “I don’t understand that”

**Remember: Buy the manager, not the strategy!**

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