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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

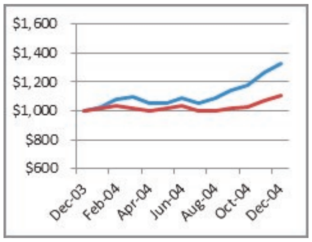
Using Alternatives to Make 1 + 1 > 2.

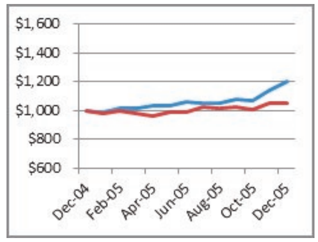
For us, there are two main characteristics an investment can have that make us consider it an "Alternative Investment". The first is that whatever is owned has a low to negative correlation to other asset classes, especially stocks and bonds. "Correlation" in this sense means that whatever is causing traditional asset classes to increase or decrease in value has little or even the opposite impact on an alternative asset class. For instance the price of gold will not always fluctuate in the same direction as the price of most other asset classes most of the time, and if it does it's frequently coincidental, because the daily activities that make us assign value to stocks and bonds have a weak relationship to how value is assigned to an ounce of gold. As a result, owning gold is considered owning an alternative.

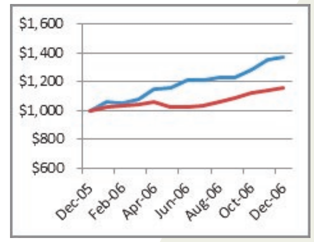
The second characteristic that makes us consider an investment an Alternative is if it is being managed for a different purpose than just to provide investors exposure to a particular asset class. When you own an equity mutual fund, you do so in order to have exposure to a particular stock market and are fully prepared to watch its value fluctuate in the same directions as that stock market. An alternative on the other hand can be managed to achieve a goal other than asset exposure. For instance, there are investments whose primary objective is to target a specific rate of return, or to target a specific level of risk. These investments may own stocks some or all of the time, but they can also own other assets and can increase or decrease how much stock they own in order to achieve their objectives. Some also have the ability to bet against asset classes, so should the asset class decrease in value, the alternative investment's value will actually increase.

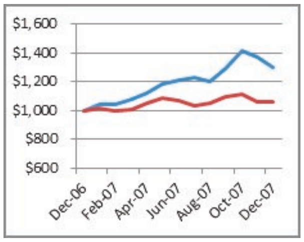
To keep these two characteristics straight, consider one class of alternatives as being different because of what it owns, and the other class as being different because of how it is managed.

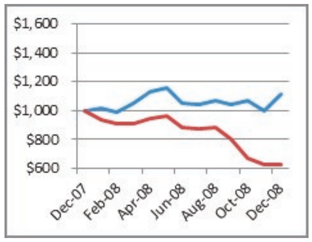
Regardless of which characteristics define the various alternatives, we frequently use them to protect portfolios in bad times. As a result, we look for portfolios to be cushioned against extreme losses by alternatives that will either participate in very few of the downward moves, or break even, or even increase in value as most other asset classes decrease. The downsides to owning alternatives are sometimes their protective nature will cause our returns to lag in boom years, and how their values change over time can confuse clients that are used to most investments going up and down at the same time. Consider the following series of returns for two different investments. Each graph is what would have happened during a calendar year to a $1,000 investment made in each. We are purposefully not identifying what these are yet:

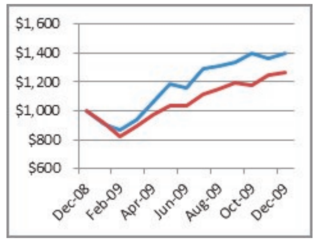


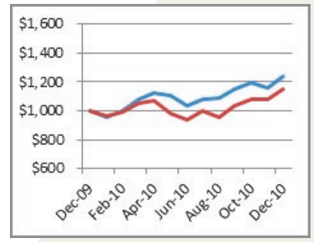


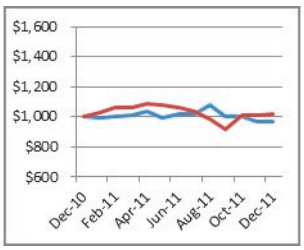


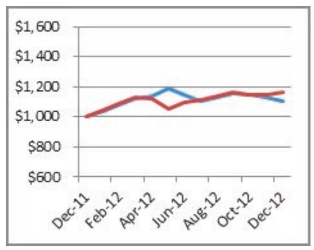


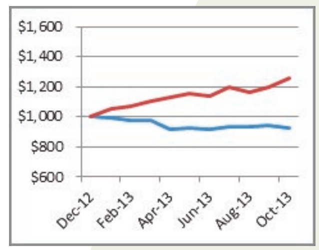




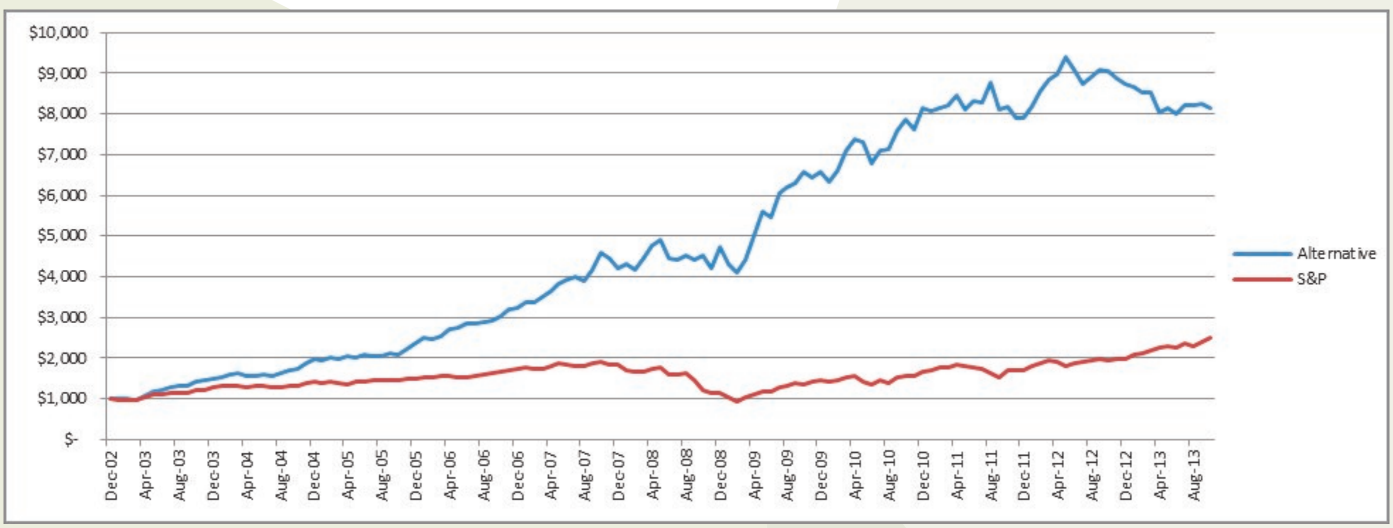






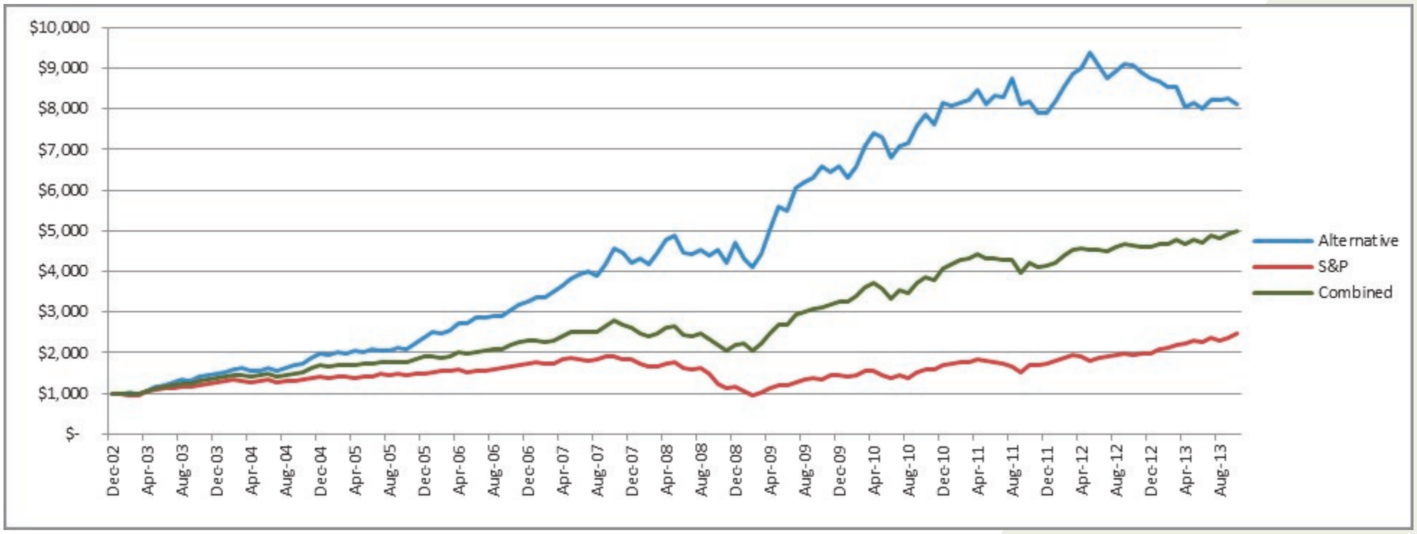


For the eleven periods, both investments have seemingly performed well, only having one bad year each. The red is worth more than the blue at the end of three of the periods, which also happen to be the most recent three periods. Can you guess the end result of stringing all eleven periods together for each investment?



At the end of the 10.8 years, the blue investment, which is one of the alternative strategies we run for clients, is more than triple the value the red investment, which is the S&P 500 with dividends minus investment expenses. Even though the alternative ends up being worth so much more, it was still moving sideways over 40% of the time. In fact, in the end it hasn't increased in value beyond where it was three years ago, at a time when the S&P 500 is up nearly 75%. This movement over time shows that even investments worth owning can grind through some ups and downs and seem to not make progress in the short term, and it also shows the potential long term benefits of utilizing investments that do not move in tandem with each other all the time.

Now consider the benefits of owning both:



A portfolio of 50% in each strategy rebalanced annually and net of assumed expenses illustrated by the green line has a 5% better annual rate of return than the average of the two investments, and its volatility is nearly 15% lower than the average of the two. This appears to be an actual case of the whole being greater than the sum of its parts from a risk-reward perspective. That's how we believe using alternatives in diversified portfolios can lead to 1 + 1 > 2 over time.

The Risk-Management Conundrum

Every asset class goes through its ups and downs and we're certainly seeing a good example of that today. Stocks, primarily U.S. and developed international, have been doing fairly well lately while just about everything else with the exception of the new Bitcoin virtual currency is struggling. The irony of this is that most of the asset classes that one would consider using in their portfolio if they want to minimize risk are among those suffering most. How widespread is this?

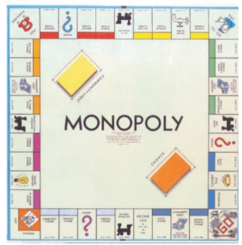
Even the safest of bonds, as measured by the Barclays Aggregate Bond Index, that have been the staple holding for conservative investors looking for stable income, are down more than 1% this year. Seeking safety in U.S. Treasury bonds would have set you back over 9%, while sticking to your neighbor's gold recommendation would have left you with 21% less money this calendar year. Ouch! Okay, so some of the most conservative and common options for managing risk in uncertain times haven't performed well, but what about the second category of alternatives we referred to earlier - strategies that are managed to behave differently than stocks and bonds? A mutual fund company that specializes in alternative investments and allows smaller investors to gain access to some of the best hedge fund managers in the world has a couple offerings that fall firmly into the alternative category we're referring to. One is a managed futures strategy which at its core is a trend strategy deployed across multiple asset classes. If gold is falling and the Japanese Yen is rising, then it can aim to profit from both scenarios as long as those trends continue for long enough to do so. The other is what's referred to as a "macro" investment strategy, where the manager looks at the world and a wide range of investable asset classes and forms an opinion on what will do well over time and what won't. Similar to a trend strategy, money can be made in any asset class whether it rises or falls, but positions are typically taken before these trends begin to emerge. An example would be if international stocks appear to be more reasonably priced than U.S. stocks, the manager of a macro strategy can buy international stocks while betting against U.S. stocks, hoping to profit as the valuation gap narrows. It may take some time for this to happen, but the "macro" manager would be willing to wait in an effort to keep risk in check. Also, this would be one of many positions in the portfolio, so hopefully there would be others that are working while the manager waits on this particular idea to play out. Both trend and “macro” strategies have historically done a fantastic job of reducing risk in an investment portfolio while generating more than acceptable rates of return. They’ve also done a great job minimizing losses in falling markets, which has always posed one of the biggest threats to investor’s long term returns.

However, over the last year, they too have struggled. The fund offering access to some of the best managed futures or “trend” managers in the business is down just under 10% over the last year, with the fund representing the best of the best in the macro world being down just a bit over 14%. That’s quite a bit worse than the zooming stock market here in the U.S. and in other developed countries around the world. It’s important to remember that these types of strategies don’t always perform poorly when stocks excel. This isn’t typical. They can and have done well at the same time the market has. It’s our observation and that of some pretty well respected minds in the business that this dramatic and rare underperformance of late is because things are out of whack and markets aren’t working the way they normally do. Investors have favored the aforementioned categories of stock for a whole host of reasons, very few of which are considered organic and normal. We won’t go into why, but if you want our thoughts on the matter, re-read any one of our last handful of monthly newsletters. In any case, it’s the scary moments that these types of imbalanced environments inevitably create that alternative investments are designed to protect us from. It’s unfortunate that they’ve underperformed stocks just as bonds and other conservative investments have, but it’s really not productive or profitable to fault the investments or strategies for their recent shortcomings. The blame rests elsewhere. Again, feel free to peruse our past editions.

So what’s one to do? Let’s start with what not to do. One shouldn’t follow their neighbors and co-workers into the burning building of stocks to any greater extent than they already have. If anything, a basic rebalance of your overall portfolio would require you to reduce your allocation to stocks at this point as you sell the winners and place more money in the categories that are selling for less right now. We also don’t feel it would be prudent to “load up” on bonds and alternative investments just because you think (and potentially rightly so) that they’ll begin outperforming stocks at some point. The timing of this transition is always tricky. If stocks continue to outperform over the short term, the disappointment of being left out would test your ability to stick to the plan, even if over time this was the right call.

And so that leaves us with the recommendation you likely anticipated. Stick to your plan. If your plan had you exposed to bonds and alternatives over the past year, although they didn’t do as well as we’d like, they serve a purpose. Getting rid of them now is like cancelling your auto insurance just because you haven’t had an accident in a while and you don’t want to pay the premium any more. Everyone’s at risk and as we all know, it’s not always your above average ability as a driver that keeps you out of trouble, but the below average skills of the other driver that puts you at risk. Putting more money in stocks just because they’ve gone up this year (and you feel you can’t afford to miss out) is akin to cancelling that insurance just so you can save a couple hundred bucks a month. Having that extra money in your pocket won’t change your life nearly as much as getting into an accident without insurance would. And this analogy misses a crucial point: Unlike paying auto insurance premiums without ever needing to use the benefits, the protection you gain from having alternative investments in your portfolio, though they may have a cost over short term periods, can lead to better performance than you’d get without them. Although the current environment that will ultimately lead us into our next market crisis is making alternatives look unappealing, we can’t forget that over time one plus one can equal something greater than two.

A Timeline of the Top-Selling Holiday Gifts... Ever.

			
1929: Yo-Yos (Duncan)	1936: Monopoly (Parker Brothers)	1943: The Slinky (Poof-Slinky)	1952: Mr. Potato Head (Hasbro)
			
1959: Barbie (Mattel)	1975: The Pet Rock (Rock Bottom Productions)	1978: Hungry Hungry Hippos (Milton Bradley)	1980: Rubik's Cube (Ideal Toys)
			
1982: BMX Bikes (Schwinn Sting-Ray)	1983: Cabbage Patch Kids (Caleco)	1989: GameBoy (Nintendo)	1995: Beanie Babies (Ty Inc.)
			
1998: Furby (Tiger Electronics)	2007: iPod Touch (Apple)	2010: iPad (Apple)	2011: Let's Rock Elmo (Hasbro)

Source: http://www.esquire.com/

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