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Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Is There a Future for Alternatives?

With the stock market making all-time highs on a seemingly daily basis, it's hard to feel good about anything else, especially an investment category that has experienced the most difficult stretch of performance in its history – Alternatives. These are investments that are designed to work differently than stocks and bonds, usually in an effort to reduce risk and register gains in any market or economic environment. At Cadence, we use third parties to help our clients gain exposure to this asset class as well as manage alternative strategies in house. As a whole, alternative investments have struggled lately. In fact just about everything outside of global stocks has performed unusually poorly over the last two to three years, leading to a very dangerous situation for investors – the desire to ditch the underperforming asset classes in favor of more stock. The media doesn't make it any easier for us either. The following quote was from USA Today on August 13, 2014:

"Investors in alt funds haven't fared well. The Standard and Poor's 500 stock fund has gained an average 19.57% the past three years, with dividends reinvested. Most alt funds have lagged."

Our feeling is that these statements miss the point. In a truly diversified portfolio, there will always be investments that perform poorly while others thrive. That's a good thing. It's when everything's moving in the same direction that we have to be concerned. Big gains don't come without occasional, but inevitable big losses when everything's behaving the same way. If you care about your long-term portfolio performance, fight the urge with everything you have and don't assume just because recent performance has been poor that the investment category won't be valuable going forward. History suggests that returns tend to track back toward their long term averages over time, which means better returns typically follow periods of lackluster ones – there's no reason to believe this won't be the case with alternatives. Possibly even more important than that is considering what role an asset class plays within a portfolio and how it adds diversification to the mix. Alternatives by definition are supposed to behave independently of stocks and bonds, so there's a very good chance that they'll add meaningful diversification to stocks and bonds at times when we need it most. If the goal is to limit risk of loss on the whole portfolio while pursuing steadier returns, then ignoring misleading and doubt provoking performance comparisons between unlike asset classes is a good start.

Why Have Alternatives Struggled?

It's our opinion that alternative investment strategies have trailed their longer-term average performances mainly due to global central bank intervention. Low interest rates, quantitative easing (money printing), and forward-looking policy pronouncements have had the desired effect of propping up stock markets while keeping interest rates low almost uniformly. Rates in Europe, where countries like Greece, Spain, and Italy only months ago were at risk of defaulting on their debt, are at historically low levels – we would argue much lower than they probably should be based on the inherent risk of investing in its bonds. This intervention has created an environment where risk has taken a back seat to return, while volatility in markets has sunken to unusually low levels. Markets have also been very highly correlated as the rising tide of central bank liquidity has lifted most of the boats in the harbor in unison. Unfortunately for alternatives, they tend to benefit from more "normal" environments where volatility is higher and correlations are lower.

For alternative strategies, differentiation between markets is important and trends need to be able to develop in both the upward and downward directions for a well-reasoned investment thesis to play out. An example would be where a manager believes small cap stocks are too expensive relative to large cap stocks. In an environment where risk is secondary to returns, that riskier small cap category can run up for much longer than it normally would, ultimately creating even more of an imbalance. The prudent alternative manager taking a position that benefits when the relationship between the two moves back into alignment, with the objective of reducing risk for the investor, would lose money as long as small cap stocks continue to rise faster than large caps. Take this one example and apply it to a host of other possible alternative portfolio positions and it becomes pretty easy to see how a broad category designed to reduce risk while achieving solid long term returns has struggled.

According to Altegris Funds, the most recent performance high for the managed futures and macro indices was April 2011 and the most recent low was September 2013. That's a pretty long stretch for two broad alternative categories to be underperforming. If anything, it likely speaks volumes about the abnormality of this environment we're in right now. At a conference in May of 2014, macro legend Paul Tudor Jones was quoted as saying, "Macro trading has probably been as difficult as I have ever seen it in my career."

The Bigger Picture

It's also worth remembering that alternative investments aren't soley risk reducers with no return potential. According to StyleAdvisor, since 1997, a broad mix of alternatives have generated a higher compound annual return than stocks with roughly a third of the volatility.

	Stocks	Alternatives
Compound Annual Return	7.67%	8.24%
Annual Standard Deviation	15.81%	5.36%
Maximum Decline	-50.95%	-20.35%

Prognosis

Alternatives have struggled while global markets have soared, but the long term track record for the category remains as strong today as it ever has been. Given that the reasons for the underperformance are explainable in our opinion, and those factors can't remain in place indefinitely, we're optimistic. Central banks will be forced to tighten, markets that have risen uninterrupted will crack and risk will once again matter to investors. When these things come to bear, alternatives should benefit nicely. So if your objective is to achieve a solid long-term return while managing effectively against loss, we would strongly suggest you view alternative investments through a longer-term risk management lens versus one that compares its recent performance to the stock market – a dangerous case of apples and oranges.

Key Takeaways:

- The recent poor performance across the alternative category is likely mostly attributable to global central bank intervention as opposed to a more lasting deterioration in investment performance.
- Alternatives as a broad category remain an critical piece of a well-diversified investment portfolio.
- Even with the poor performance of late across the category, alternatives continue to have a track record of stock market like returns over the long term with a fraction of the risk. In an environment where risk of loss in traditional stock and bond markets is building rapidly, the low correlation and diversification benefits of alternatives look very appealing.

Financial Planning Isn't About the Money

There are scientists out there right now researching whether or not money buys happiness. Seriously. We don't wonder that ourselves because we believe it is common knowledge people need money to feel secure, and it's difficult to feel happy on a day to day basis without security. As financial planners, we know that the best and possibly only way to feel financially secure is to find out if you are on track toward your goals through the financial planning process.

People assume that the point of financial planning is to help them know how to best meet their future financial goals. While that is definitely a focus of planning, the positive outcomes from the process are not just enjoyed that future day the goal is finally achieved. Because we have been planning for people since before the bubble burst, and we mean the tech bubble, not the housing bubble, we would argue that frequently overlooked benefits to financial planning are both the peace of mind people have every day knowing they are on track, as well as knowing how much extra money they can afford to spend on what makes them happiest.

Just knowing that you are saving enough for your goals and financially protecting yourself and your family from potential catastrophes certainly helps you feel happy. However, the planning process is not just about putting you on track toward reaching your big goals, but also about the enjoyment you get along the way by knowing you are on track. For example, have you ever worried over expenses while on vacation? It doesn't feel like much of a vacation. However, when you know you are already on track toward achieving your goals, you are free to fully enjoy the moment. It is more difficult to enjoy the day to day without knowing you are on track toward your big goals.

In fact, once people are on track toward achieving their major financial goals, research has shown that those who spend money on making more time and adding to their life's experiences are happier than those people who spend that extra on material things. People make more time by paying other people to do things that they themselves would rather not do and then taking that saved time and doing something they enjoy more. Hiring a housekeeping service doesn't necessarily make a person happier. It's allocating those two extra free hours to spending time with family or friends, or volunteering, or finally working on a hobby you haven't felt able to get to in a while. That is a tangible, day to day benefit of financial planning: knowing that you can afford to make extra time for yourself for enriching experiences in all the months leading up to the big financial goals.

We deal with money and investments all day, so it's probably easy to assume that we do believe money can buy happiness. First through an adequate amount of security and second through helping people enjoy their lives more. However, we do understand why the phrase "money can't buy happiness" is also true, because in most of the moments when we ourselves felt the happiest, it wasn't money that did it. It was a bucket list item achieved, or a moment shared, or a child's accomplishment. So yes, we financial advisers understand why money itself doesn't buy happiness, but having a plan to use it wisely certainly does.

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