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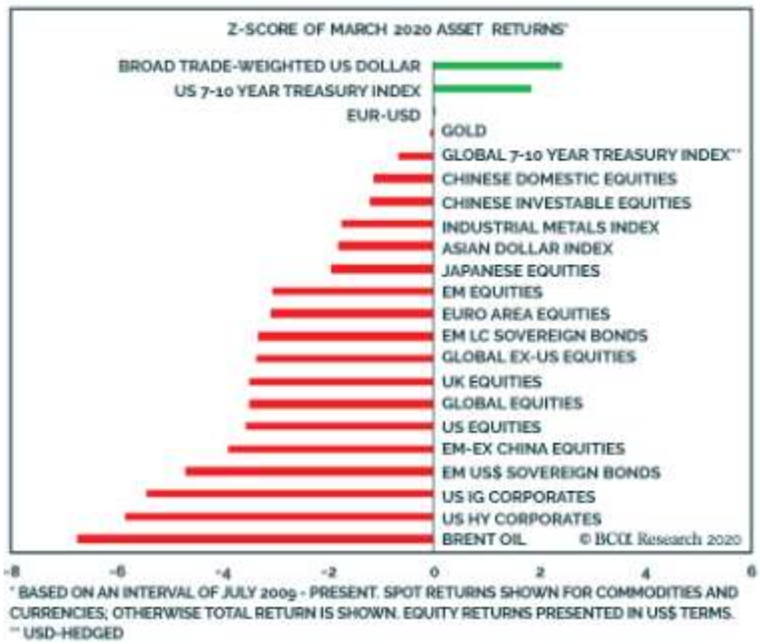
From the Apr. 6th BCA Research | Daily Insights:

March 2020: A Month Many Investors Would Prefer To Forget



The chart above presents the March monthly returns of a variety of important financial assets, shown as the number of standard deviations from the average that has prevailed since the end of the Great Recession in 2009.

Several points are noteworthy:

- The combined effect of extraordinary demand destruction and a market-share war between Russia and the Kingdom of Saudi Arabia (KSA) led to an almost 7-sigma decline in the price of oil, representing the largest monthly percent decline since 1950.
- Relative to its own post-crisis return history, the US credit market suffered losses nearly on par with those of oil as US fixed-income investors moved to price in both a sharp contraction in economic output and a massive surge in energy sector defaults.
- Emerging market assets fared extremely poorly, as evidenced by the terrible performance of EM US$ sovereign bonds. The EM equity index fared comparatively well versus global stocks, but this performance was buttressed by the significant outperformance of Chinese equities. Excluding China, EM equities had a worse Z-score in March than US stocks.
- Similarly, industrial metals fared comparatively well given its high cyclicality, and this too reflects the relative outperformance of China-related assets.
- Finally, while the broad-trade weighted dollar saw a +2 sigma move, the performance of EUR-USD underscores that most of this performance was not versus major currencies; the Fed’s trade-weighted dollar versus other important trading partners rose almost 7% in March.

In 2018 we provided a series of 3 Worth Sharings on Alternative Funds: **Alternative Funds - 1/28/18**, **Managed Futures - Uncorrelated Volatility - 2/17/18**, and **Private Equity - The Crown Jewel of Alternatives - 2/25/18**. With the regrettable exception of QMNIX, our advice was to avoid all of them. We have seen nothing since then to change that recommendation. Last year Morningstar's John Rekenthaler came to the same conclusion:

Judgment Day

John Rekenthaler 16 May 2019

Retail alternative-investment funds, practically speaking, are 10 years old. Alternatives have long been in institutional portfolios, but they attracted little attention from retail buyers before the 2008 financial crash. After the disaster, however, the people craved protection, and the fund companies responded. Launching a spate of alternatives funds, they marketed the strategies hard, gathering much of the mutual fund industry’s headlines. Hundreds of alternatives funds were launched over the next several years. Exchange-traded funds followed suit, with offerings that ranged from staid to highly speculative.

The timing was poor. With one notable exception (more on that later), equities have since pounded all rivals. For stock-heavy investors, alternative investments have come in two flavors: 1) thoroughly useless and 2) mostly useless.

The problem is not just that the insurance was sold after the fire—a customary practice in investment management—but also that many of the alternatives have been flat-out losers. Even if U.S. stocks hadn’t compounded by 13% annually during the decade of 2009 through 2018, those funds would have been poor choices.

Thoroughly Useless
Following are the five poorest alternative Morningstar Categories since 2009, in descending order from worse to worst. For each category, I provide the trailing 10-year average annualized return, along with the number of times that the category beat the S&P 500 during the three calendar years when stocks faltered: 2011, 2015, and 2018. The index barely broke even during the first two of those years and lost 4.4% during the third. Those are the sorts of years when investors expect alternative investments to compensate.

5 Multicurrency
10-year annualized return: 0%
1 for 3 against the S&P 500

There are three flavors of currency funds. Leveraged currency funds are for speculation. Single-currency funds are unleveraged and serve as substitutes for the foreign-exchange markets. Multicurrency funds are also unleveraged. Being more stable than single-currency funds, they are relatively painless devices for diversifying away from U.S. stock (and bond) market risk.

Unfortunately, they have also been profitless. Multicurrency funds delivered on their hope of low volatility. Over the decade, the category’s worst calendar-year loss was just over 3%. Alas, the same was true of its best calendar-year gain. Multicurrency funds didn’t lose much money, but they didn’t make any either. Might as well have stashed your cash under a mattress.

Their performance, at least in nominal terms, will improve when global interest rates rise. Whether they will turn a profit after inflation is less certain. One thing is for sure: With such low expected total returns, multicurrency funds had better be cheap. Even more than most, these funds cannot overcome steep expenses.

4 Market Neutral
10-year annualized return: 0%
1 for 3 against the S&P 500

If you swapped the calendar-year returns for the market-neutral category with those of multicurrency funds, nobody would know the difference. As with the multicurrency group, market-neutral funds gently fluctuated around a mean of zero. (Perhaps they should be called "return-neutral" funds.) So gently that the category never gained nor lost as much as 3% in any year. One needs to pinch the funds to ensure that they are alive.

Although the performance was identical to multicurrency funds, I placed the market-neutral category one notch lower because, unlike with the aforementioned group, I see no hope for market-neutral funds. Multicurrency funds can fare well if global fixed income thrives or if the U.S. dollar suffers. The expected return for market-neutral funds, on the other hand, is perpetually the Treasury bill rate minus fund expenses. That is the category's math, and it is not a pleasant equation. (QMNIX falls into this category, and is covered below.)

3 Managed Futures
10-year annualized return: –1.6%
0 for 3 against the S&P 500

What a disappointment. Managed-futures funds were the 2008 success, notching a 5% gain even as all stock funds, all lower-credit bond funds, and even many alternatives funds cratered. (The average hedge fund, for example, dropped 18% for the year.) The reason cited was that their performance was not related to their underlying holdings. It matters not if they held stock, bond, currency, or commodities futures, nor if those contracts rose or fell. Managed-futures funds profit from anticipating price movements.

The story sounded convincing, particularly when accompanied by that 2008 gain. It no longer carries much credence. Not only have managed-futures funds fared badly overall, losing money for the decade, but when they were most needed, they shirked the cause. They declined during the S&P 500's two drab years, then dropped even more than the index in 2018. They didn't prevent the fire; they stoked it.

They may behave better during the next downturn. The strength of managed-futures funds is that they are truly unpredictable. Their positions change with the trends, as do their relative and absolute performances. Against that must be weighed the reality that, in aggregate and after their funds' expenses have been paid, the group's portfolio managers have been dart-throwing monkeys. Sometimes up, sometimes down, eventually landing (before costs) somewhere near zero.

2 Energy
10-year annualized return: 0.5% for equity energy;
–9.1% for commodities energy
0 for 3 against the S&P 500

Energy funds come in two varieties. One breed consists of traditional mutual funds, which invest in energy-related equities; Morningstar calls them "equity energy" funds. The other consists of exchange-traded funds, which primarily hold energy futures. They are titled "commodities energy." Both types of funds move with oil prices, but not in lockstep. Thus, equity energy funds eked out a small gain for the decade, while commodities energy ETFs got clocked with an annualized 9.1% loss.

Regrettably, energy funds were reliably awful when equities faltered. Rather than being alternatives, they were something of a super equity, performing best during the stock market rebound years of 2009 and 2016 and among the worst in 2015 and 2018. In no way, shape, or form were energy investments, either as equities or as futures contracts, effective hedges for stock portfolios.

They failed because inflation remained dormant. Consequently, oil prices primarily were affected by industrial production—which, unsurprisingly, also strongly affected stock quotes. Energy became just another stock market surrogate. That will likely hold until inflation once again becomes a global concern.

1 Bear Market
10-year annualized return: –18.9%
1 for 3 against the S&P 500

This is a bit of a cheat, because there are few bear-market funds, and they have hardly any assets. But it's an amusing cheat, and Morningstar continues to support the category, so why not?

The bear-market category contains actively managed mutual funds that short stocks, as opposed to indexed (and often leveraged) ETFs, which are placed into Morningstar's "trading" categories. Their managers purportedly can identify overpriced securities, thereby permitting their funds to soar when stocks weaken and giving them a fighting chance at posting profits during flat markets.

That has not, shall we say, occurred. The bear-market category suffered double-digit losses for the decade's first six years, improved to a 4% drop in 2015, promptly got whacked during the next two years, and recorded a profit in its final attempt, in 2018. Its average annualized return is negative 18.9%, which happily does not lead to a 189% cumulative decline, thanks to the wonders of compounding. It would, however, have left the January 2009 investor with $0.12 on the dollar.

Mostly Useless
Now for the past decade's five leading alternative investments, working up to the best.

5 Precious Metals
10-year annualized return: 3.9% for commodities precious metals; –3.4% for equity precious metals
0 for 3 against the S&P 500

There are two varieties of precious-metals funds. One consists of ETFs, which indirectly hold bullion—mostly gold—through futures contracts. (During the current Bear Market, 2/19-3/23/20, GLD, an ETF whose underlying assets consist of gold bullion stored in secure vaults, fell 3.6%, having dropped 12.5% from 3/9-19.) Morningstar categorizes those funds as being commodities precious metals. That category gained an annualized 3.9% for the decade. The other group of precious-metals funds contains traditional, actively managed mutual funds that invest in mining stocks. Those funds, labeled equity precious metals, lost an annualized 3.4%.

Precious metals scraped into the "mostly useless" group, rather than landing in the "thoroughly useless" list, because the ETF category turned a profit. That was enough to place precious metals ahead of the worst batch, which couldn't figure out how to make any money at all. That doesn't mean that precious-metals funds were much good. After blazing to a fine 2009–10 start, they frittered through the next eight years, including losses in all three years when stocks (relatively speaking) struggled.

The problem, if it can be called one, was the absence of inflation. When inflation is dormant, precious-metals prices tend to respond to industrial demand, which means that their funds aren't particularly alternative. They require inflation to demonstrate their merits by diverging from the crowd. Should that event occur, precious metals will likely thrive once again. They are a reasonable, albeit highly volatile, complement to inflation-protected bonds.

4 Nontraditional Bond
10-year annualized return: 2.9%
1 for 3 against the S&P 500

As with so many other alternative investments, nontraditional bond funds were developed to combat inflation. (All those dire 2010 predictions!) Traditional bond funds have positive durations, always, meaning that they can't avoid losses when interest rates rise. Nontraditional bond funds attempt to be craftier. When interest rates are heading north, they can reduce their durations, in some cases even below zero (meaning that they directly profit from interest-rate increases).

Or so the theory goes. In reality, it's very difficult to time interest-rate movements and quite easy to be "nontraditional" by owning credit-sensitive securities instead of Treasuries. Which is what most funds in the category have done. They have behaved rather like high-yield bond funds, profiting in most years but struggling, as do all credit-sensitive securities, when the stock market falters. The category lost money in 2011, again in 2015, and once again in 2018 (although it did outdo the S&P 500).

Meaning that it wasn't much of an alternative. In truth, I don't regard nontraditional bond funds as alternative investments, not in the sense of diversifying a balanced portfolio. Most are solid investments, which is why they qualified for the top five, but they should be thought of as bond funds, not as alternatives.

3 Multialternative
10-year annualized return: 2.5%
1 for 3 against the S&P 500

Multialternative funds, which invest in several alternative strategies (you probably guessed that from the name), gained slightly less over the decade than did nontraditional bond funds and fared similarly during the test years of 2011, 2015, and 2018. Multialternatives, too, lost money on each of the three occasions but did stay slightly ahead of the stock market index in 2018.

The problem for multialternatives was the same as with nontraditional bond funds: too much equity exposure. Although alternative strategies strive to be uncorrelated with stock performance—or better yet, negatively correlated—most cannot completely escape the connection. As with stocks, most alternative strategies benefit from a healthy global economy. Thus, multialternatives are unreliable stock market diversifiers.

They do, however, carry the potential to behave somewhat less conventionally than the nontraditional bond fund category, which is why I have placed them one notch higher on this column's list.

2 Cash
10-year annualized return: 0.5%
1 for 3 against the S&P 500

By cash, I mean Treasury bills (the source of the above calculation) or something of similarly high quality. "Cash substitutes" that assume credit and liquidity risk so as to earn extra yield aren't viable alternatives because, when stocks plummet and the alternative is required, it doesn't show up. Many such cash substitutes suffered double-digit losses in 2008.

The pleasant aspect of cash is that its nominal returns are almost always positive. The unpleasant aspect is that they often are very low, such that cash lagged the S&P 500 in 2011 and 2015, even though the index gained only a couple of percentage points those years. Cash isn't much of a long-term investment unless things head really south. On the other hand, in such a dire scenario, cash is one of the few alternative investments that can absolutely, positively be relied upon.

Which places it high up on this list, despite its sloth. Also, it is worth noting, its seemingly poor 0.5% annualized rate of return from 2009–18 places it ahead of all the worst-five alternative-investment category in the bottom-performers list. (Vanguard Short-Term Treasury ETF, rated 4 stars for past performance & Silver by Morningstar's analyst, currently yields a taxable 0.39%, while the Fed, prior to the crash, was targeting 2% inflation. Doubt they are concerned about inflation currently.)

1 Inflation-Protected Bonds
10-year annualized return: 3%
1 for 3 against the S&P 500

Inflation-protected bonds sometimes act strangely. Because their prices are affected more by expectations of future inflation than by current reports and because they have fairly long durations, inflation-adjusted bonds can surprise. Who was to know that they would gain almost 11% in 2011 and then decline by 8% two years later, when inflation rates and conventional-bond performances remained pretty much constant?

Thus, they lack cash's dependability. They compensate for that deficiency—and more, in my view—by having superior total returns, while retaining cash's main protections. Most funds in the inflation-protected bond category are Treasury-heavy, meaning that their holdings not only guard against inflation (duh), as do most alternatives, but also perform well during flights to safety. (Of this categories' 14 ETFs, PIMCO's LTPZ, the only one rated 5 stars, crashed 22.6% from 3/6-18.) Of all security types, inflation-protected bonds offer the highest chance of recording a real, post-inflation profit over the next 10 years.

That makes it this column's alternative-investments winner.

All this is meant as a description of the past, not a prediction. Few alternative funds proved useful during a decade of stock market triumphs, but they might prove so over the next 10 years.
Things change.

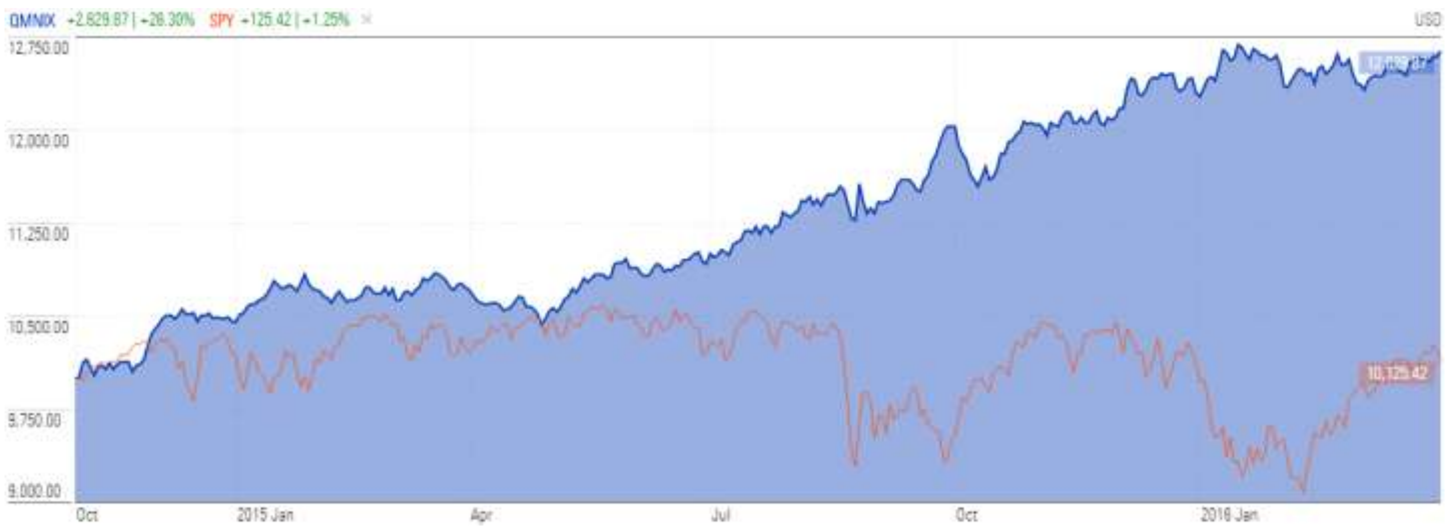
Outside the Box
Finally, there's that notable exception that I mentioned at this column's beginning: cryptocurrencies. Bitcoin made more money than, well, anything from its 2010 inception through December 2016. Since then, it has lost 80% of its value. Whether that makes it the best or worst of alternative investments depends upon one's purchase date. I suppose that it would be fair to say that bitcoin wins both awards. It delivered the best of times, and then it delivered the worst of times. (During the current Bear Market, 2/19-3/23/20, Bitcoin fell 29.9%, having plunged 37.2% on 3/10.)

Cryptocurrencies certainly deserve consideration as alternative investments. They may very well be sound choices. However, they lie outside this column's scope, in part because your author knows little about them and in part because, due to the SEC's reluctance, cryptocurrencies cannot be held by retail funds.

Our thoughts:

Two of the Funds we were using to reduce **Risk** while still providing an acceptable return failed:

QMNIX - In our very first Worth Sharing, **Hedging to Reduce Drawdown - 7/7/2016**, under **Our Thoughts**, we wrote: "Our quest to lower Maximum Drawdown for HCM clients that are transitioning to Capital Preservation led us to QMNIX, a Global Long/Short OEF we are already using ...." Our first purchase of QMNIX for a client came on 4/5/16. This was what we were seeing compared to the S&P 500 (orange line):



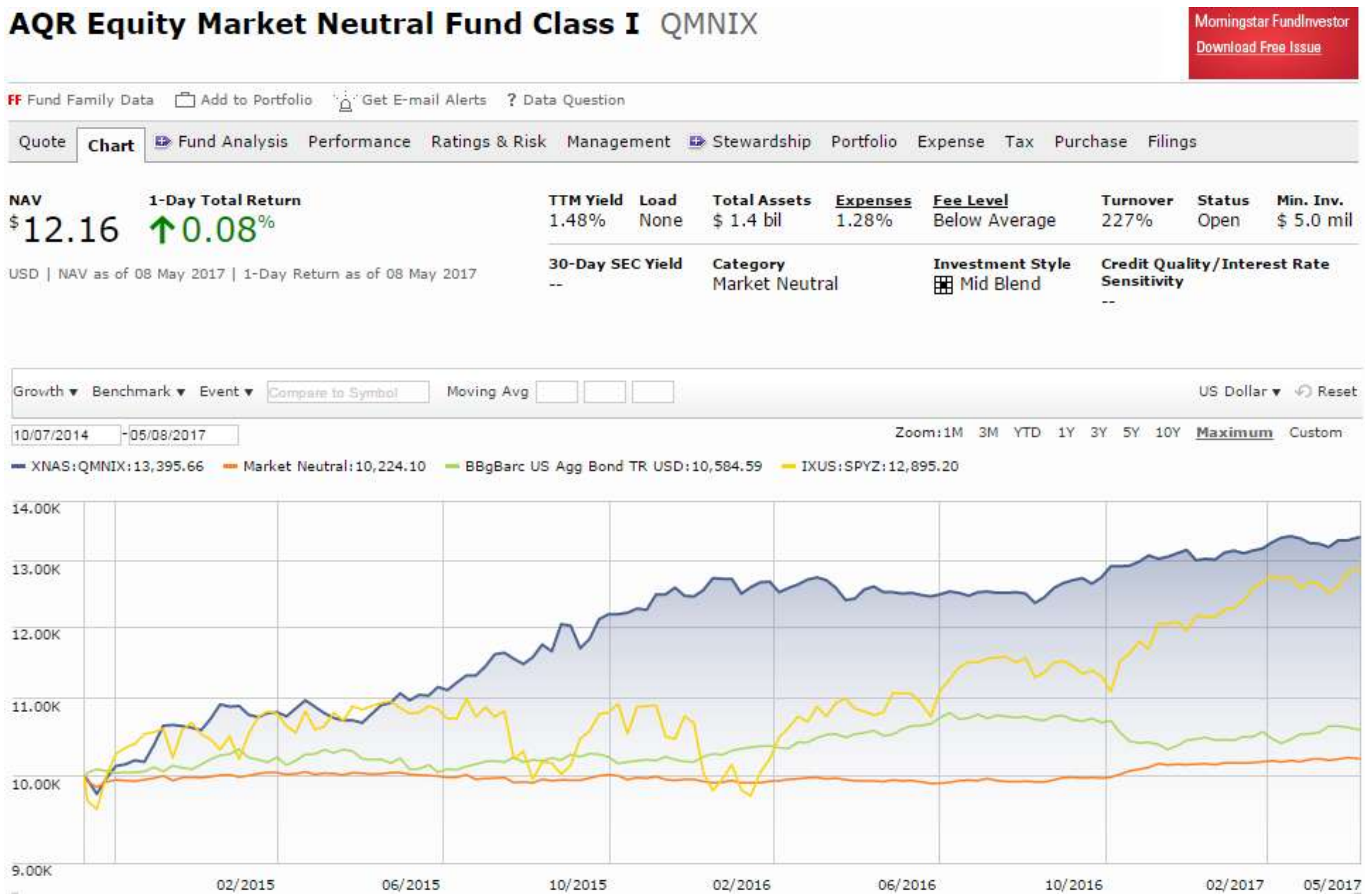
On 7/31/16 we wrote to a client: "We are also concerned that AQR may close the fund. It would likely start with a soft close ...." That concern has now become a reality. If your Risk Profile, a subject thoroughly reviewed on our website and where every investor should start, indicates that your portfolio should reduce **Risk**, QMNIX remains the best Fund we have found.

Our Worth Sharing of 5/9/17 detailed our overly optimistic view:

QMNIX will Soft Close on June 30th

If you go shopping for a Registered Investment Advisor (RIA), one of your first questions should be whether any of their clients are invested in QMNIX. If not, cross them off your list. Take a close look at its chart. This OEF, which we have extensively written about in the past, is in Morningstar's Market Neutral Category with a Beta of 0, which matches its **Risk** ratio based on the average historical Maximum Drawdowns to S&P 500 declines greater than 10%. During the last correction, which ended on 2/11/16, QMNIX actually had a positive return. It achieves the results shown below (blue line) with a Long/Short portfolio based on 3 Factors: Value, Momentum and Quality, having outperformed the S&P 500 (yellow line) since inception. Its Peers (orange line) however have actually underperformed our Bond benchmark (green line) during this period. While we doubt it can sustain this level of outperformance, it remains our primary Fund for reducing client **Risk**.

As we have noted before, the "$5.0 mil Min. Inv." shown above does not apply to clients of RIAs like Hughes Capital Management. AQR Capital Management is considered by many, including us, to be the preeminent Quantitative Fund provider. Morningstar: "AQR boasts a strong quantitative research culture, competitive fees, and high manager retention .... Quantitative research underpins all of the firm's strategies. ... The leadership team has close ties to academia. In fact, 11 of the firm's 26 principals have doctorate degrees, and five are current or former professors. ... Equity ownership and attractive compensation have promoted high manager retention (99% over the past five years)."



From AQR's website:

"The Fund seeks to deliver positive absolute returns by taking long and short positions in equity and equity-related instruments that, based on proprietary quantitative models, are deemed to be either undervalued (and likely to increase in price) or overvalued (and likely to decrease in price).

The Fund is designed to be market neutral, targeting a portfolio beta to equity markets of zero over a normal business cycle. We construct the portfolio based on our global security selection and asset allocation models, employing the following indicators:

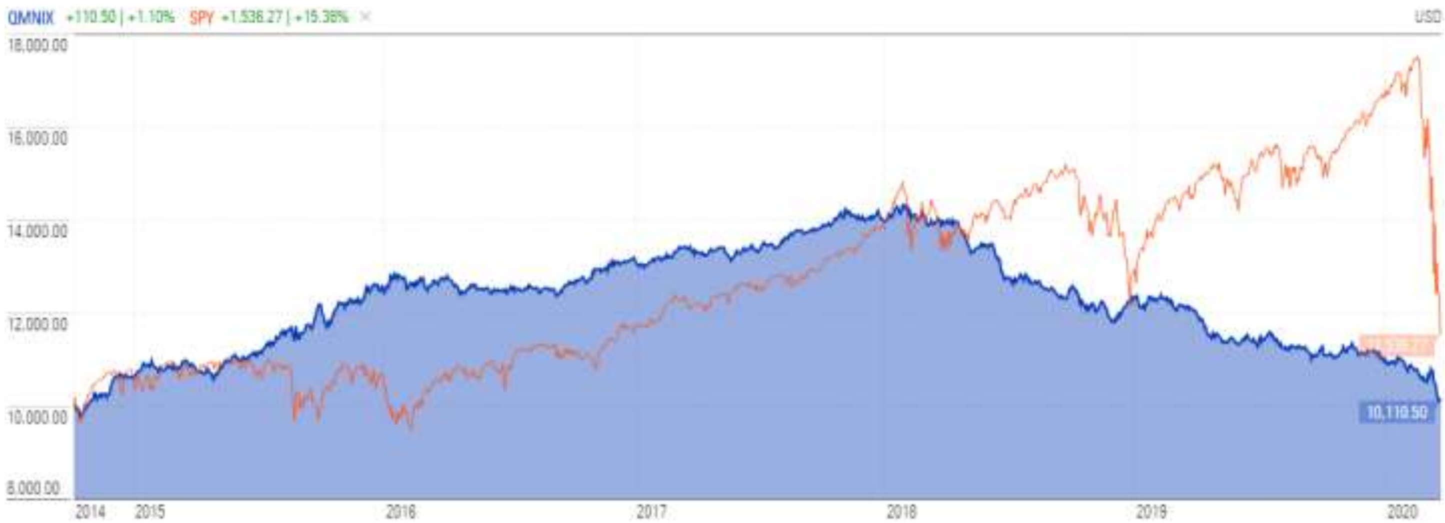
Value indicators to identify investments that appear cheap based on fundamental measures, such as price-to-earnings and price-to-book ratios.

Momentum indicators, such as simple price momentum, to identify investments with strong short-term performance.

Quality indicators to identify stable companies in good business health, including those with strong profitability and stable earnings.

Applying these and other proprietary indicators, we take long or short positions in industries, sectors and companies that we believe are conditionally attractive or unattractive. The result is a portfolio that seeks positive absolute returns with close to zero equity market beta."

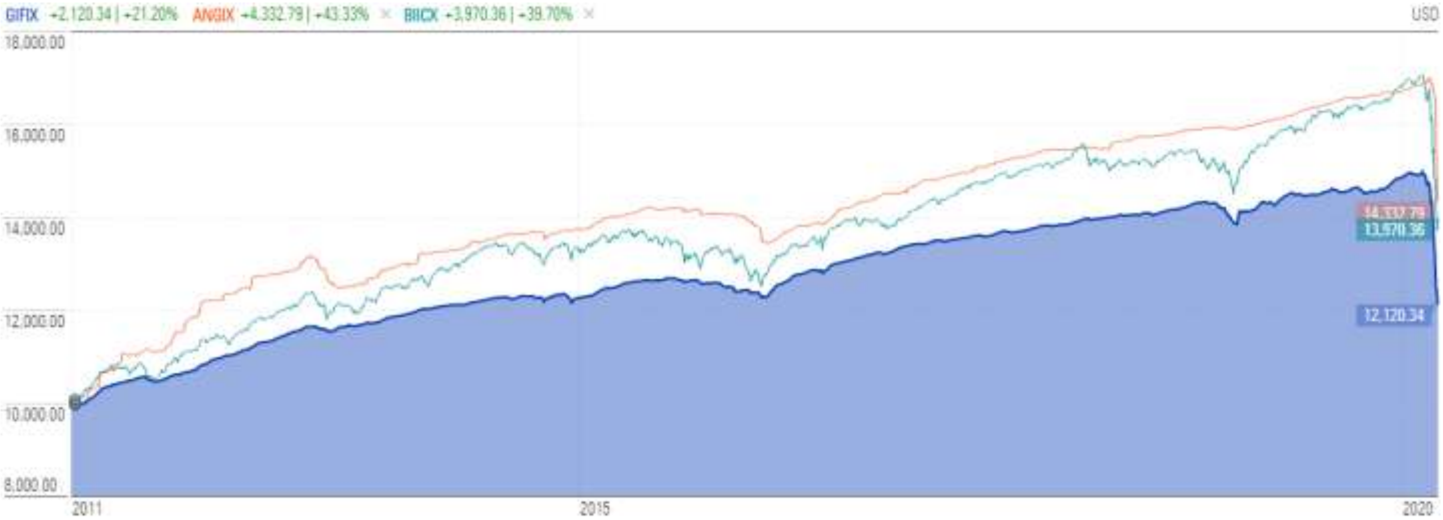
While our website also details QMNIX's trials and tribulations from Value's underperformance relative to Growth, and we did entirely eliminate this OEF for some clients, while reducing exposure for the clients still holding it, QMNIX remains our largest mistake among Funds. On 3/23/20 we sold the last 2 remaining positions in order to place the resulting funds into opportunities with more upside potential:



GIFIX - In March's Newsletter we detailed our substituting HFRO, a CEF, for this Bank Loan OEF. While we were well aware of the added risk of relatively illiquid assets when held by an OEF, similar CEFs when the initial position was purchased on 2/7/17, yielding 4.1%, were selling at a premium to NAV. Our updated Risk Ratio calculations, also for ANGIX and BIICX, relative to the S&P 500 are shown below:

S&P 500											
2/19/20	3,386.15	9/20/18	2,930.75	1/26/18	2,872.87	11/3/15	2,109.79	4/29/11	1,363.61	10/9/07	1,565.15
3/23/20	2,237.40	12/24/18	2,351.10	2/8/18	2,581.00	2/11/16	1,829.08	8/19/11	1,123.53	3/9/09	676.53
	-33.9%		-19.8%		-10.2%		-13.3%		-17.6%		-56.8%
ANGIX											
3/6/20	11.09	12/3/18	11.04	2/7/18	10.73	7/30/15	12.13				
3/25/20	9.27	12/27/18	10.97	2/22/18	10.69	2/29/16	10.91				
	-16.4%		-0.6%		-0.4%		-10.1%				
	0.5		0.0		0.0		0.8				
BIICX											
2/19/20	11.01	10/1/18	10.62	1/26/18	10.68	4/27/15	10.77				
3/23/20	8.84	12/24/18	9.94	2/9/18	10.36	2/11/16	9.84				
	-19.7%		-6.4%		-3.0%		-8.6%				
	0.6		0.3		0.3		0.6				
GIFIX											
1/22/20	25.18	11/2/18	25.63	2/2/18	25.04	7/21/15	26.33				
3/24/20	20.39	12/27/18	24.73	2/23/18	24.95	2/24/16	24.79				
	-19.0%		-3.5%		-0.4%		-5.8%				
	0.6		0.2		0.0		0.4				

We have added ANGIX (orange line), and BIICX (turquoise line) to Morningstar's chart for GIFIX since inception. The inadequate risk/reward for GIFIX compared to the other 2 OEFs that we use for clients to reduce volatility is clear.



We have updated our Master List of all ETFs and OEFs held by clients. The 2nd of the 3 columns under **Risk** show how REITs (SFREX, FRIFX, and even SMMV) were especially hammered in the current Bear Market. While we continue to believe that Real Estate, via publicly traded REITs, remain an important Asset Class for most portfolios, we have always maintained, unlike some whose views we have shared, that their relatively low correlation with other stocks doesn't make them safer. **"The only thing that goes up in a market crash is correlation (and VIX, also known as the Fear gauge)."** - Rob Arnott

	Symbol	Name	Type	Description	Factors (1)	Yield	(2)	Exp.	M*	Risk (3)		
	ANGIX	Angel Oak Multi-Strategy Income Instl	OEF	Multisector Bond		5.0%	M	1.11%	2N	0.3	0.5	0.3
	BIICX	BlackRock Multi-Asset Income Instl	OEF	Tactical Allocation		5.6%	M	0.59%	4S	0.4	0.6	0.5
	SFREX	Schwab Fundamental Global Real Estate Idx	OEF	Global Real Estate-Large Blend		4.8%	Q	0.39%	3	0.9	1.2	1.0
	FRIFX	Fidelity Real Estate Income	OEF	US Real Estate		6.3%	Q	0.75%	3B	0.5	1.0	0.6
	MTUM	iShares Edge MSCI USA Momentum Factor	ETF	US Large Growth	M	1.7%	Q	0.15%	4S	1.0	1.0	1.0
	OMFL	Invesco Russell 1000 Dynamic Mltfct	ETF	US Large Blend	V, M, Q, LV	1.8%	Q	0.29%		0.9	1.0	0.9
	PRDSX	T. Rowe Price QM US Small-Cap Gr Eq	OEF	US Small Growth	S, V, Q, M	0.0%		0.80%	4G	1.3	1.1	1.3
	SMLF	iShares Edge MSCI Mltfct USA SmCp	ETF	US Small Blend	S, V, M, Q	2.0%	Q	0.30%	4	1.2	1.2	1.2
	SMMV	iShares Edge MSCI Min Vol USA SmCp	ETF	US Small Blend	S, LV	2.3%	Q	0.20%	5	0.8	1.1	0.9
	ISCF	iShares Edge MSCI Mltfct Intl SmCp	ETF	Foreign Small/Mid Blend	S, V, M, Q	4.0%	S	0.40%	4	1.3	1.1	1.2
	GPIIX	Grandeur Peak International Opps Instl	OEF	Foreign Small Growth	S, V, Q	0.3%	A	1.32%	3	1.6	1.1	1.4
	OBIOX	Oberweis International Opportunities	OEF	Foreign Mid Growth	S, M, Q	1.6%	A	1.60%	3N	1.4	1.2	1.4
	VIISX	Virtus KAR International Small-Cap I	OEF	Foreign Small Growth	S, Q	1.5%	A	1.31%	5B	1.0	1.1	1.1
	Notes											
1	V=Value, M=Momentum, Q=Quality, S=Size, LV=Low Volatility											
2	Distribution Frequency: A=Annual, M=Monthly, S=Semi-Annual, Q=Quarterly											
3	Ratio of average historical Max. Drawdowns to S&P 500 declines greater than 10% since 2007. In order: Pre-, 2020 Bear Market, Post											