March 2021

"But as long as the music is playing, you've got to get up and dance. We're still dancing." - Charles Prince, CEO Citigroup, July 9, 2007

From the front page of Thursday's WSJ:

Investors Embraced Big Risks In a Wild Quarter for Trading

BY AKANE OTANI

Financial markets went into overdrive in the first quarter of the year.

Meme stocks such as GameStop surged. Celebrities dove into blank-check companies. Christie's auctioned off a nonfungible token attached to a digital image for $69 million (see below). And just before the quarter's end, a fire sale of stocks that Archegos Capital Management had bet on caused well-known companies such as ViacomCBS and Discovery to ~~decline~~ (plunge).

If there is a unifying theme, it is that investors big and small showed no fear of risk-taking to start 2021. In fact, they embraced it. Interest rates jumped in the quarter, but they remain near historically low levels. The 10-year U.S. Treasury yield is around 1.7%, compared with 0.9% at the start of the year. Stocks are sitting near records, with the S& P 500 up 5.8% for the year and the Dow Jones Industrial Average up 7.8%. Factor in social media and a few rounds of government stimulus checks, and it almost makes sense why many investors have been so drawn to speculative corners of the market. ...

It is a stark shift from how money managers started 2021.

When 2021 began, investors didn't know that Democrats would win control of the Senate, allowing the government to push through a bigger stimulus package than many had expected.

They didn't know what would happen as corona-virus cases surged to new highs, or pro-Trump rioters stormed the U.S. Capitol.

But soon, investors saw reasons to be hopeful. The Covid-19 vaccine rollout began to gather pace. Economists raised their expectations for a powerful recovery, as opposed to the more sluggish rebound many had been anticipating. And through it all, investors had the reassurance that the Federal Reserve would continue to hold interest rates near zero and that the federal government would deploy trillions more dollars in aid for the economy.

Markets responded in force. In one of the most powerful market rotations in years, investors shifted money out of technology shares and into long beaten-down sectors such as financials and energy. Their bet: that improving economic activity would lift up shares of these cyclical companies.

The Dow outperformed the Nasdaq Composite Index by around 5 percentage points in the quarter—the largest difference since the fourth quarter of 2018. Big technology stocks are no longer trouncing everything else in the market. Exxon Mobil is up 35% for the year, while Amazon.com is down 5% and Apple is down 7.9%.

So what lessons have investors taken away from the past three months? Money managers point to the following: When Reddit traders dove into shares of companies such as GameStop and AMC Entertainment Holdings in January and February, many professional money managers wrung their hands. They warned that individual investors were getting ahead of themselves. Maybe picking and choosing stocks was best left to the professionals.

Just in the past week, though, money managers were reminded ultra-risky behavior isn't just the domain of individuals trading tips on Reddit's WallStreetBets.

Bill Hwang's Archegos Capital Management took massive positions in companies through a controversial product called a total return swap. When Mr. Hwang's bets soured, Archegos scrambled to post collateral. The investment banks that Archegos used for its trades wound up having to sell the losing stocks in huge blocks, causing a swift decline in the share prices of companies such as Viacom and saddling the late sellers with painful losses. (From yesterday's Notes on the News: **$8 billion** — The money lost by former hedge-fund manager Bill Hwang's family office ... over ten days, marking the biggest single-firm meltdown since the financial crisis. ... leaving institutions including Credit Suisse and Nomura with billions of dollars in losses.)

Countless other examples in history have shown smart money failing. Melvin Capital Management lost 53% on its investments in January after heavily shorting stocks including GameStop. Going back to the 1990s, there was Long-Term Capital Management, which was run by Nobel Prize winners, professors at Harvard Business School and executives with respected careers at Salomon Brothers. It collapsed in such spectacular fashion that the Fed was forced to step in and organize a multibillion-dollar bailout.

"It's not just being driven by the Robinhood traders," said Liz Ann Sonders, chief investment strategist at Charles Schwab. "There's a tremendous amount of speculation everywhere, and we don't know if there are other whales out there [like Archegos] that could cause broader turmoil in the financial system."

Investors with a skeptical view have been trying in vain to predict when frothy parts of the market would start falling in earnest. The problem is that bubble-like markets have often gone on for far longer than experts have predicted, said Jeremy Grantham, co-founder of Boston money manager Grantham, Mayo, Van Otterloo & Co.

Mr. Grantham, who successfully predicted the market crashes of 2000 and 2008, said he considers the markets now to be incredibly bubble-like. (Keeping in mind that the S&P 500 closed at an all-time high on Thursday, this from a Bloomberg January 22, 2021 article titled "Grantham Warns of Biden Stimulus Further Inflating Epic Bubble": For now, however, stocks keep rising to records and Grantham's reputation as a perma-bear who misses out on rallies only grows. GMO's cautious stance has been costly. Assets under management fell by tens of billions of dollars during the decade-long bull market, as the firm steered clear of growth stocks. Then in April, GMO doubled down, insulating its portfolios from directional bets on the market and largely missing out on the second leg of the 2020 rebound.)

Bitcoin was trading above $58,000 Wednesday morning, up more than double from where it closed out last year. Blank-check companies—also known as SPACs, or special-purpose acquisition companies— have cooled lately, but only after a stunning stretch of gains. Between November and February, 231 consecutive SPACs went public without dropping below their IPO price on their opening trading day, according to data from University of Florida finance professor Jay Ritter.

"People have long lost interest in value. It's about what is going up and how fast it's going up," Mr. Grantham said.

When trends work, they really work. At its peak, GameStop was up 1,744% for the year to date. Star fund manager Cathie Wood's ARK Innovation ETF, which heavily weights technology companies including Tesla, Roku and Square, outpaced the S& P 500 by 21 percentage points at one point in mid-February.

But markets are fickle. And what works one month won't necessarily be in favor the next. GameStop has never reclaimed the high it hit late January. And after long-term bond yields jumped in February and March on bets of a powerful economic recovery, the fervor for growth stocks faded, too.

The ARK Innovation ETF is now down around 3.6% for the year.

Three from Morningstar:

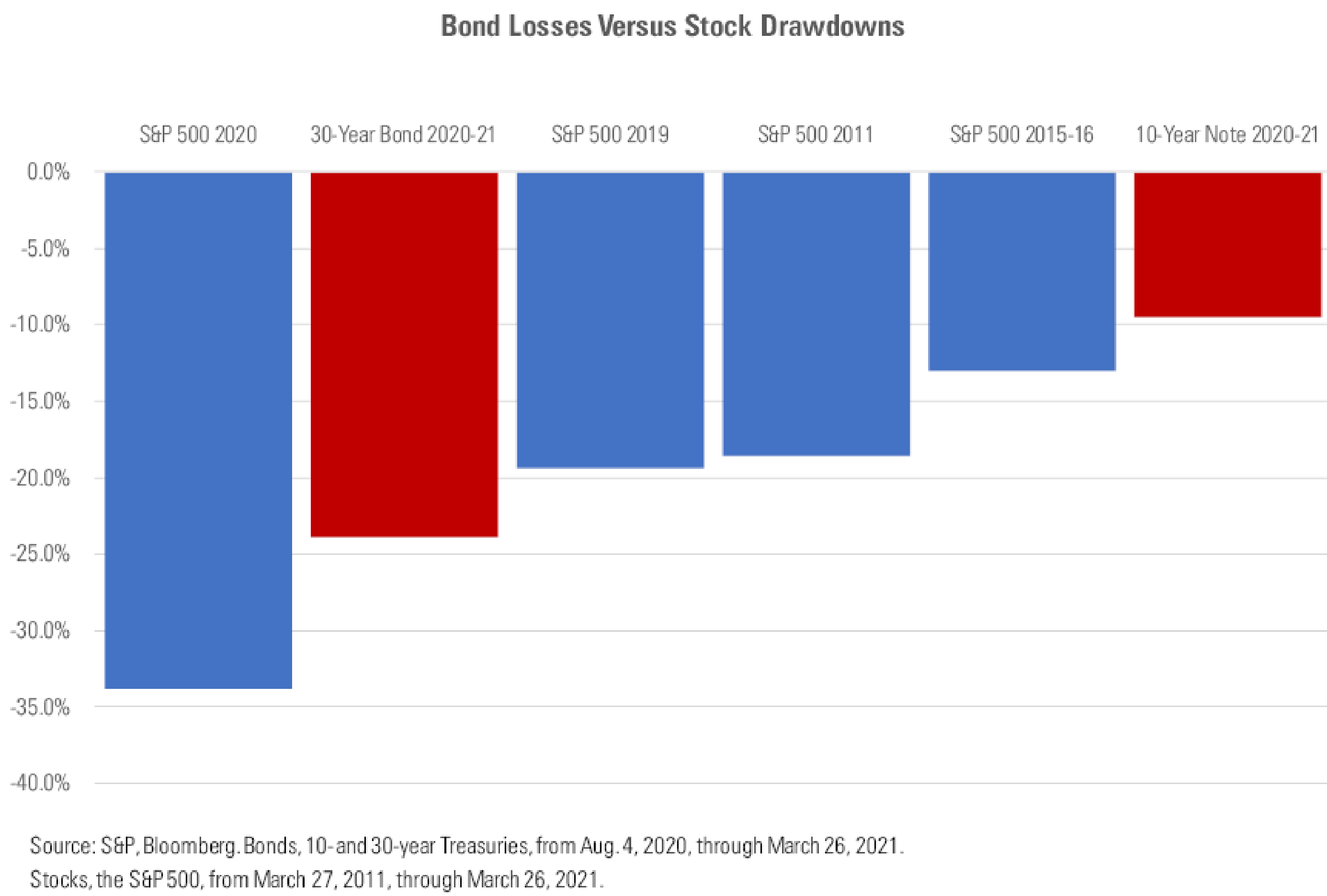
Will the Treasury Rout Continue?

Quietly, high-quality bonds have taken a beating.

John Rekenthaler
Mar 29, 2021

Surprisingly Risky

Today's investment headlines focus on the winners, such as GameStop (GME), ARK ETF Trust (ARKK),



Tesla (TSLA), and celebrity Special Purpose Acquisition Companies. But relatively little attention has been paid to what has been something of a historic bond-market decline. Over the past eight months, 10-year Treasury notes have shed 9.5% of their value, while 30-year bonds have dropped by 23.9%.

The chart above shows how those results compare with the largest drawdowns of the S&P 500 over the past 10 years.

Ouch! To be sure, the 10-year note's loss pales next to the steepest S&P 500 downturns, but it nonetheless outdoes all but four stock-market slides over the past decade, a disappointing outcome for an allegedly safe investment. The 30-year bond's battering, meanwhile, stings by any standards. Since Ronald Reagan was president, stocks have suffered greater drawdowns than the long bond's 23.9% decline on only three occasions (2000-02, 2008-09, and early 2020).

There have been two reasons for the slide: One bodes well for the future performance of high-quality bonds, and the other bodes ill.

The Bright Side

The good news is that bonds have been on the wrong side of investment fashion. According to this explanation, customarily referred to as risk-on/risk-off, asset prices are often established by emotion, not economics. When investors possess animal spirits, aggressive holdings rally while cautious assets languish. Eventually, sentiment reverses, and so does performance. By this logic, Treasury owners need not worry. Before long, risk will once again be off and bond prices will settle.

Risk has certainly been on in recent months. Not only have global equity markets rallied, on the expectation of strong economic growth, but so too have alternatives, such as Bitcoin, vacation homes, and non-fungible tokens. Investors have sought capital gains. When risk is on, what matters is not guarantees or income, as with Treasuries, but instead the prospect of reselling an asset at a higher price.

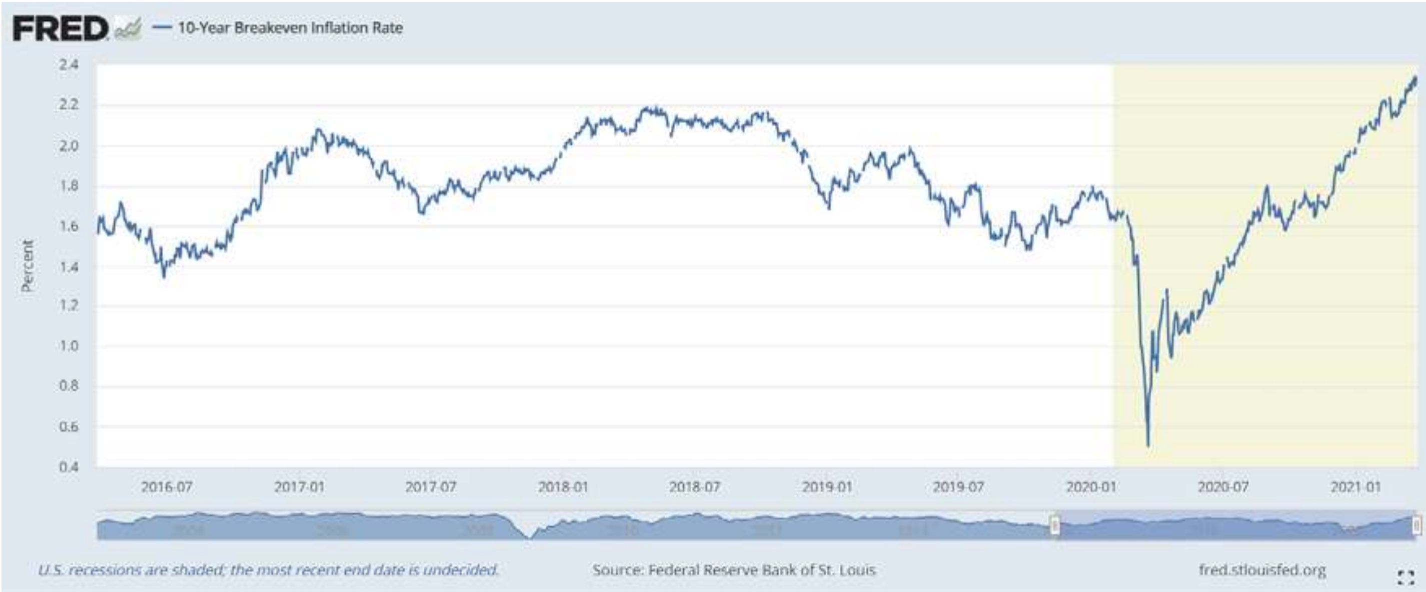
The Danger

Unfortunately for Treasury owners, their losses do not owe to sentiment alone. There have also been increasing concerns about inflation. To date, these worries are theoretical rather than actual; as measured by the Consumer Price Index, inflation remains modest, particularly when the effects of food and energy prices are removed. But market expectations have changed sharply since last summer.

This can best be demonstrated by the break-even inflation rate on Treasuries, which is calculated by comparing the payouts on conventional issues with those offered by the government's Treasury Inflation-Protected Securities. For example, 10-year Treasury notes currently yield 1.69%, while 10-year TIPS yield negative 0.66%. The break-even inflation rate is therefore 1.69% (negative 0.66%), or 2.35%. That represents the market's consensus forecast for annualized 10-year inflation.

The break-even forecast for 10-year notes has risen steadily since March 2020, and is now at its highest level over the past five years.

The reason for these fears is so obvious in hindsight, one wonders why it was not reflected in 2020's bond prices. Even before the passage of this month's American Rescue Plan Relief Act, U.S. money supply was rising at its sharpest rate in recorded history. Although the link between money supply and inflation has greatly weakened, at some point more money *will* create more inflation. (That is a mathematical certainty; the question



is not that the relationship exists, but rather whether today's money-supply increases are sufficient to trigger the response.)

In short, while initially it's tempting to blame high-quality bonds' problems on investor sentiment, which so clearly has favored speculation, the economic backdrop has worsened. Aggressive government spending, both in the U.S. and elsewhere, has meaningfully increased the possibility that inflation will resurface. This has hurt bond prices, which in 2020 assumed that inflation was indisputably conquered. Today, it must be regarded as being disputably conquered.

Looking Forward

That, I think, rules out the likelihood of a strong bond-market recovery. The fundamentals don't support such gains, at least not until the effects of the massive spending bills--which, if the president has his way, have not concluded--have become apparent. But what about this question posed by this column's headline? Will the rout continue?

The answer is: probably, as long as the stock market keeps rolling. Risk-on/risk-off is a powerful force. Once that process concludes, though, I expect bond prices to stabilize. Although the 10-year break-even inflation rate is high by recent standards, it remains below its long-term average. In other words, inflation has not suddenly become a problem. Rather, it was temporarily disregarded, sparking a Treasury rally. That Treasuries have since retreated is a return to normalcy.

Also, while break-even inflation rates reflect the wisdom of the crowd, and thus presumably are more reliable than those generated by individual experts, that doesn't mean that they are correct. Forecasting future rates of inflation may lie beyond the collective ability of bond investors, meaning that the increase in the break-even rate is nothing more than noise. (Such was the conclusion of a 2015 article by the Federal Reserve Bank of San Francisco--although, ironically, the break-even rate that existed in 2015 has so far proved highly accurate.)

Finally, this isn't the first time that Treasuries have attended this unpleasant dance. In 2009 and then again in 2012-13, Treasuries also delivered painful losses. Just as has occurred over the past year, Treasury yields dropped dramatically, thereby increasing their prices, only to soon retrace their steps. Each time, inflation fears were the culprit. But the alarms were false, and Treasuries gradually recovered.

One unalloyed positive: Treasuries once again have successfully diversified an equity portfolio. Of course, it has not felt so successful in practice, to those bemoaning how their bond losses have watered down their equity gains. But better such behavior than what occurred in March 2020, when bonds and stocks briefly headed south at the same time. The less that Treasuries act like equities, the happier the investment math. ...

The Morningstar Rating for Funds: What to Know

Sometimes past performance is indeed predictive, and then so is the star rating.

John Rekenthaler
Mar 22, 2021

From the Beginning

There are two versions of the Morningstar Rating, or star rating: one for funds, and the other for stocks. This column concerns the former, as the latter is quite different.

The star rating was first used for mutual funds shortly after the company's 1984 inception. At that time, investors evaluated funds almost solely by their total returns. As a freshly minted MBA, Morningstar's founder Joe Mansueto had learned from his professors that investments should be measured by risk-adjusted performance, not by returns alone. Thus was born the star rating.

The rating was instantly popular because although its computation was messy, the picture was simple. Five stars, excellent. One star, poor. The rating system became a fixture. When Morningstar expanded its coverage to include other types of funds, such as closed-end and exchange-traded, so did the star rating.

In the early days, Morningstar spent much time explaining how the star rating differed from the academic standard for risk-adjusted performance, the Sharpe ratio. That effort was wasted. As William Sharpe himself pointed out, the two measures offer nearly identical conclusions. If one fund has a higher star rating than another, it almost certainly has a higher Sharpe ratio as well.

Switching to Categories

What matters instead are the peer groups. At first, Morningstar compared funds very broadly. There were only four ratings buckets: 1) U.S. stock, 2) foreign stock, 3) taxable bond, and 4) municipal bond. (Allocation funds, holding both stocks and bonds, were rated against all funds from the first three buckets.)

This approach had the advantage of being independent of how funds were categorized, so that the ratings were unaffected by such decisions, but the disadvantage of being highly prone to "style effects." If, for example, the leading technology companies strongly outgained the broad U.S. market, as was the case until very recently, then almost all large-growth stock funds would receive high star ratings. Conversely, even the most successful small-value funds would not.

In 2002, Morningstar therefore shifted to assigning star ratings by investment category (which, predictably, led to lobbying by fund companies to have their funds placed into what they believed would be the most favorable categories). That change ameliorated the style-effect problem, but, as we shall shortly see, did not eliminate it.

From Penthouse to Doghouse

The star ratings initially were treated reverently. It was the era of "star managers" (a phrase that preceded Morningstar's existence). Investors widely believed that although top investment managers might struggle temporarily, when the markets moved against them, their skill eventually would triumph. Consequently, the star ratings were thought to be relatively permanent. Once a 5-star manager, always a 5-star manager, although perhaps with some bumps along the way.

Over time, investors--and Morningstar researchers--learned otherwise. Because they were generated on up to 10 years' worth of performance, the star ratings were stable from month to month, but they frequently changed over longer time periods. This occurred even after the calculation's 2002 revision. Many top-rated funds subsequently languished.

The pendulum then swung markedly in the opposite direction. "Morningstar Star Rankings Fail Mutual Fund Investors," stated one article. Asked an academic paper, "Kiss of Death: A 5-Star Morningstar Mutual Fund Rating?" A third article advised flatly, "Ignore Morningstar's Stars."

Such warnings were helpful, as the star ratings had become too popular. For example, when funds dropped a star, many investors would sell, believing that Morningstar had "downgraded" those investments. Of course, that was not the case; the rating was a calculation, not an analyst's judgment. Also, the rating might have declined because a strong result from 10 years ago rolled off the fund's record, rather than because of recent weakness.

Differing Signals

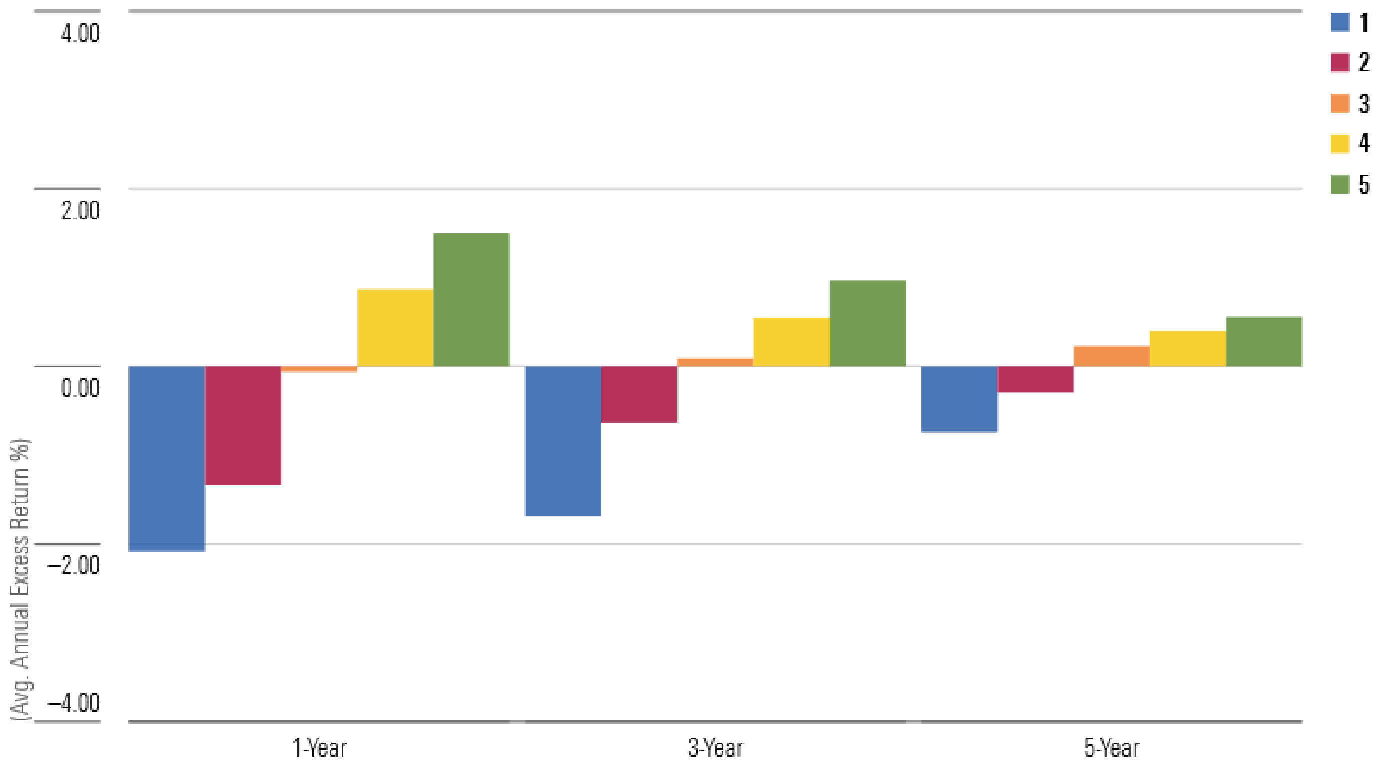
However, the criticisms of the star rating misstated the problem. Some--as with the "Kiss of Death" paper--suggested that the stars consistently failed, such that the top-rated funds underperformed, while the low-rated funds outperformed. Not only were such implications false, but they wouldn't have been problems if they had been true, because reversing the ratings would have made them usefully predictive. Buy 1-star funds, avoid 5-star funds, profit.

Others argued that the star rating's predictions are unreliable. Sometimes low-rated funds shine--although mostly not, because they are on average the costliest funds, and that extra cost generates an ongoing headwind--sometimes there are no patterns, and sometimes top-rated funds triumph. That claim is correct. If you are asked, "Will the 5-star funds outperform the 1-star funds over the next five years?," the appropriate response is, "That is likelier than the alternative, but I certainly cannot guarantee it."

Generally missed, though, is that the star rating's results are often predictable *in hindsight*. This occurs because of those pesky style effects. The 2002 methodology change ensures that there will always be as many 5-star large-growth stock funds as 1-star funds. However, if large-growth stocks lead the market for several years, the ratings within the category will be persistent, because the "purest" large-growth funds will continually perform best, while the "watered down" large-growth funds--that is, those funds that border other categories--will lag.

That, in fact, is what has recently occurred. As shown by Morningstar's Jeff Ptak in "Past Performance Has Been Predictive Lately. Wait, What?," the star ratings assigned to mutual funds in January 2016 aligned with subsequent results. Over the next five years, 5-star funds outgained 4-star funds, which in turn beat 3-star funds, and so forth. That transpired because, broadly speaking, the previous market conditions persisted. Funds that had previously benefited from their style effects continued to do so, and vice versa.

Exhibit 1 Average Excess Returns versus Average Peer, by Starting Star Rating (as of 12/31/20; Including Dead Funds)



Source: Morningstar analysts.

Wrapping Up

The SEC requires funds to disclose that "past performance does not guarantee future results." Commonly, this warning is reworded as implying something stronger. For example, one website states that "past performance is no indicator of future performance." That is taking the caution too far. There are times when past results *do* correlate with future results, and when that happens, the star rating--along with other historic performance measures--can be predictive.

Whether investors can identify such conditions before they occur, of course, is another story.

When Stocks Become Collectibles

The anecdotes entertain, but the economic implications should not be ignored.

John Rekenthaler
Mar 11, 2021

Cash Was King

Traditionally, equity research evaluated the ability to generate cash. Published three years after Joy of Cooking and equally influential in its field, Benjamin Graham’s Security Analysis recommended buying companies that were valued by the stock market at less than the amount of money on their books. That was the ideal situation. Failing such opportunities, prudent investors could purchase firms that had high expected future cash flows relative to their stocks’ current price.

For Graham, what mattered was corporate operations, rather than the actions of rival investors. Wrote Graham, “The stock investor is neither right nor wrong because others agreed or disagreed with him; he is right because his facts and analysis are right.” Similarly, “Investing isn’t about beating others at their game. It’s about controlling yourself at your own game.”

From Graham derived both Warren Buffett and the Chartered Financial Analysis program. Buffett followed in Graham’s footsteps to become *the* modern investment master, accumulating a self-made $100 billion. (... Buffett’s accomplishment required not only smarts but also longevity.) Meanwhile, since the CFA program began in 1963, it has trained tens of thousands of investment professionals. Its curriculum, too, evaluates companies primarily for their ability to produce cash.

Branching Out

However, not every publicly traded company lends itself to traditional analysis. Some businesses burn cash rather than create it, as they are unprofitable. Such losses may occur because the company is emerging and has yet to post earnings, or they may happen because a once-successful entity has suffered hard times. Either way, unless future profitability can reliably be predicted, traditional security analysis struggles. Implicitly, it advises to avoid such situations.

That can be poor counsel. The IPO investor who dismissed Amazon.com (AMZN) when it went public in 1997 because the company was years away from profitability forfeited the chance to pay $1.50 per share (when split-adjusted) for a stock that is now worth $3,000 per share. Similarly, Apple (AAPL) struggled mightily from 1996 through 2000, losing a collective $1.7 billion. It has since gained over 40,000%.

Thus, dollars-and-cents calculations cannot be applied to all stocks. Some money-losing companies are very much worth buying. Their merits cannot be determined only through computations that rely on the assumption that the future will largely resemble the past. The investment math must be supplemented by an understanding of how things might change.

All fine and good. Venture capitalists are often asked to envision what might become, not what currently is. So, at times, are public-market investors. There’s nothing wrong or unusual about using narratives to evaluate stocks. Although such trades are sometimes criticized by conservative shareholders, they are mainstream activities. No less than investing by the numbers, investing on the prediction of how a company will fare is based on economic fundamentals.

Becoming Collectibles

What crosses the line is when the trade becomes detached from corporate fortunes, so that the purchase comes not from considering how the company will fare but instead, to use Graham’s words, from wanting to beat other investors at their game. A stock is to be prized because it is expected to rise and to be avoided because it will fall. These outcomes depend not upon the company’s results but instead upon the investor’s view of how the marketplace will react.

Consider Tesla (TSLA). Most of the company’s terrific stock market performance owes to its business results. In 2010, Tesla’s annual revenues were a modest $117 million. Early believers were undeterred, believing that the firm’s sales would skyrocket. They were correct. Last year, Tesla recorded $31.5 billion in revenues, making for a 75% annualized 10-year growth rate. Tesla would not have appealed to Ben Graham, but he would have appreciated the reason for the stock’s success.

Recently, though, Tesla's stock price has sometimes appeared to diverge from its corporate affairs. In 2020, for example, Tesla gained 780%, although the firm's revenues and profits finished slightly below analysts' estimates. True, those results were achieved during an unanticipated global recession, so there was good reason for the stock to rise. But the amount seems excessive. So, too, does the stock's 19% increase on March 9, a day without significant company news.

It's hard to avoid the conclusion that, to some extent, Tesla's stock has become a collectible--a security that is prized not solely for its company's virtues but also for the belief that it will appreciate because others desire it.

A clearer case is GameStop (GME). Over the past two months, its price has soared from $20 to a peak of $480, retreated to $40, and then advanced once again, now registering $260. None of these movements have had anything to do with the company's operations. As was the case entering this year--again, nothing has changed--GameStop is currently unprofitable, with rapidly declining sales. Its stock's price has become divorced from its business.

Broader Ramifications
To date, few stocks qualify as collectibles. It is, however, a development that bears watching because of two economic implications.

The first being that the public might become disenchanted with stocks. The happier that investors are with equities, the more they will participate in the stock market, thereby making their monies available to entrepreneurs. That is a social good. So far, the market's recent gyrations have not harmed investor enthusiasm. However, should enough stocks behave as if they were collectibles, the perception that the stock market resembles a casino could damp interest. (Our concern here is indirect. When an expanding number of stocks become lottery tickets it has historically signaled an approaching top, and the subsequent plunge, if extreme enough, can cause the average investor to once again swear off stocks.)

The other potential problem is that the financial markets are the mechanism by which capital is allocated. Historically, that mechanism has been driven by the ability of businesses to generate cash. Companies that earn ongoing profits, or at the least hold the promise of doing so, raise more capital than those that do not. If stock prices no longer operate by those rules, then capital will be allocated differently--and almost surely less efficiently. That would damage the economy.

Early days yet, to be sure. However, it's worth noting that beneath the amusing stories about how some stocks have run amok lie serious concerns.

John Rekenthaler has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.

Signs of speculation (insanity?) continue to mount. The headline and accompanying photo from the front page of March 12th's WSJ:

Collage Sets Record for Digital Art, Selling for $69.3 Million

Digital Image Sells For $69.3 Million

BY KELLY CROW AND CAITLIN OSTROFF

Cryptocurrency and blue-chip art collided when a self-taught artist named Mike Winkelmann, who goes by the professional name of Beeple, sold a digital image online at Christie's for $69.3 million. That is more than anyone has ever bid for artwork by Frida Kahlo, Salvador Dalí or Paul Gauguin—and it makes Beeple the third most-expensive living artist after Jeff Koons and David Hockney.

It is also the most expensive digital asset to ever sell with an accompanying digital certificate of authenticity known as a nonfungible token, or NFT, according to NonFungible.com.

The sale Thursday could prove a watershed moment for crypto asset markets as well as an art world suddenly obsessed with NFTs, even as many top collectors and dealers admit they are still figuring out what the digital trademarks do.

NFTs incorporate technology similar to bitcoin, the decade- old digital currency, albeit with a key difference: Whereas one bitcoin is exchangeable with another bitcoin, each NFT serves as a singularly unique marker for the digital asset it tags. NFTs are also being used by tech giants like Twitter founder Jack Dorsey, who recently turned his very first tweet into an NFT, and the NBA. A trading-card like video NFT of LeBron James dunking a basketball recently sold for over $200,000.

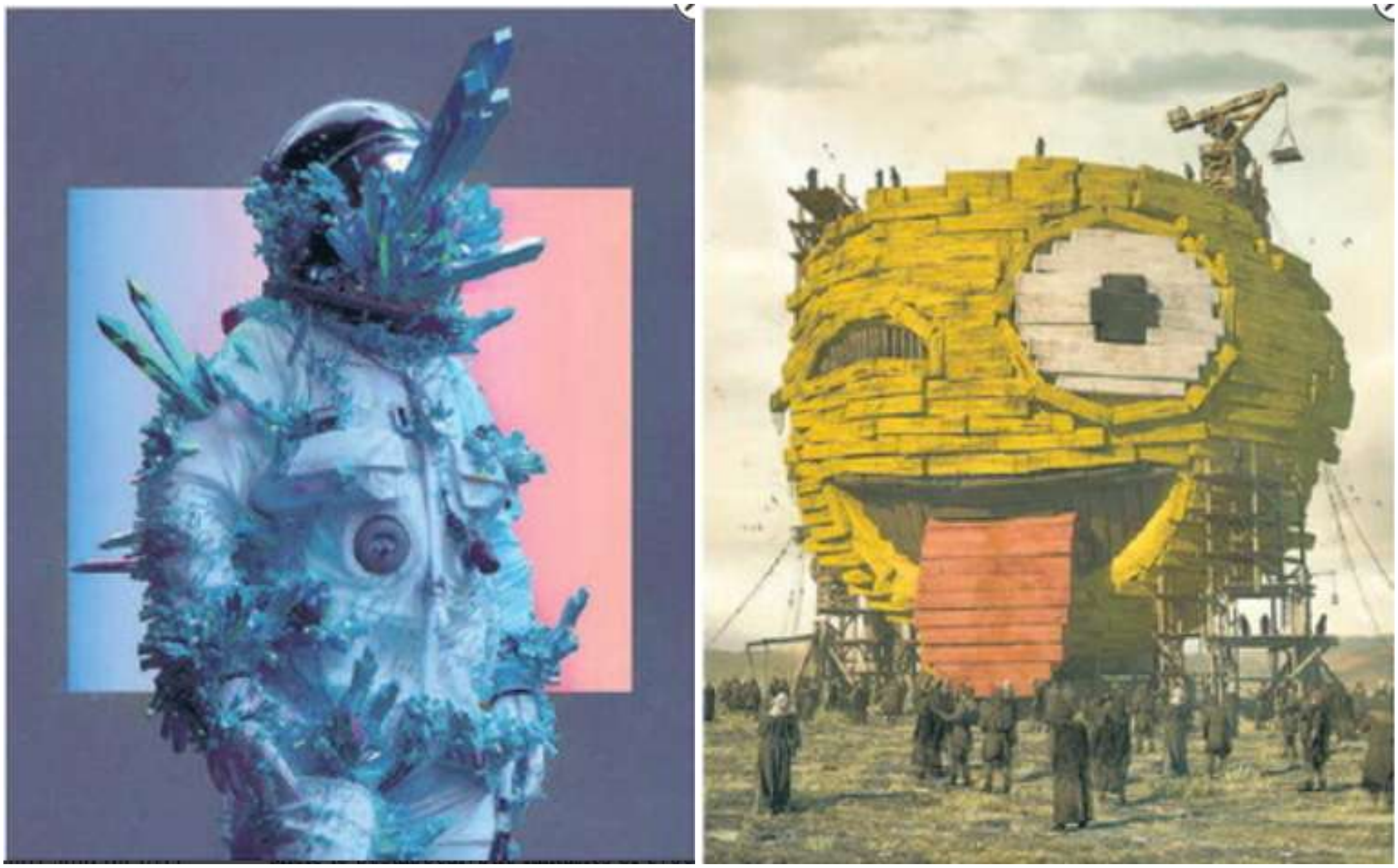
The winner of Beeple’s 2021 piece, “Everydays: The First 5000 Days,” will receive the image along with its unique token, which will be sent to the winner’s address—the unique identifier for a crypto-currency account. This token will convey ownership from the artist to its new owner.

This same token will be recorded on a digital ledger known as a blockchain that will store details about the work’s creation along with its new owner ... and any future owners should it get resold. In the same way an artist’s signature and ownership history helps authenticate a painting, the NFT on this $69.3 million image will ensure it remains certified in perpetuity. Copies of the same image uploaded elsewhere won’t.

The Wisconsin-born artist, whose name Beeple nods to an 1980s yeti-like monster toy, said he was clueless about NFTs until last fall when he was tipped to the format’s popularity among cryptocurrency investors. He doesn’t have ties to a traditional gallery. “People describe it as falling down a rabbit hole,” he said in an interview before the sale, “and that is quite accurate.”

His piece, which elicited 353 bids over the course of the nine-day auction, depicts an amalgam of political cartoons and lush, videogame-like scenes that the 39-year-old artist created over slightly more than 13 years, completing one new work each day. Christie’s said the resulting mashup will remain intact; its owner will be able to zoom in to see the 5,000 individual artworks that make up the collage—from endearing early portraits of Beeple’s uncle to postapocalyptic fantasies of cyborgs and a lactating Michael Jackson—but the works can’t be broken up and sold individually.

Christie’s expert Noah Davis said NFT art is still so new that the house didn’t put an estimate on the work, the artist’s first top-tier auction appearance. Mr. Davis was introduced to the artist after Beeple sold a small group of his NFT artworks online for $3.5 million three months ago on a platform called Nifty Gateway. Beeple followed up last month by selling another tokenized artwork online for $6.6 million. Christie’s said it decided to accept cryptocurrency for the first time with this sale, but it is unclear yet if the winner paid that way or with cash.



Details from Beeple's 2021 piece, 'Everydays: The First 5000 Days,' The winner will receive the work along with its unique token.

The sale could "push traditional artists to think about how they could do interesting things with their work in a digital way," the artist said, "and I think it's going to push digital artists like myself to think of how they can come into the physical realm."

Certainly his arrival on the art scene—and the NFT art phenomenon overall—is churning up the kind of feverish ebullience, and brewing backlash, that has largely been absent from the art scene amid the pandemic. Now, it is all anybody in art circles can talk about, on the Clubhouse app and beyond. The artist moderated his own "closing party" chat on the app the morning of the sale, and one of the members of his panel was Jehan Chu, longtime collector and co-founder of a cryptocurrency venture-capital firm. During the forum, Mr. Chu said, "I think there was a malaise in the art world, but now everyone is excited again—and it's because of this."

From March 8th's WSJ:

How to Understand the Small-Stock Rally

Small-caps are drubbing large ones this year. What does it mean for what's ahead?

By Mark Hulbert

Small stocks so far this year have beaten their large-capitalization brethren by a wider margin than they have in more than two decades, raising questions about what is driving the outperformance and what it means for the overall market ahead.

The year-to-date return for small-caps through the end of February was a remarkable 25 percentage points greater than that of large-caps (as measured by the 20% of stocks with the smallest market caps vs. the comparative quintile of the largest). While it isn't unexpected for small-cap portfolios to beat large-caps over time—a long-term tendency that Wall Street analysts refer to as the "size effect"—what is unusual is the magnitude of the outperformance. It has averaged just 0.9 percentage point over all two-month periods since 1926, according to data from Dartmouth professor Ken French.

You have to go back to January and February of 2000, at the top of the internet-stock bubble on Wall Street, to find a two-month stretch in which the small-caps beat the large-caps by more. Their margin of outperformance over those two months was 41 percentage points.

Any parallel to the top of the internet-stock bubble is ominous, to be sure. But there are several idiosyncrasies to small-caps' recent performance that stand in the way of drawing any straightforward analogies to the frenzy in small stocks that heralded the 2000 tech-stock crash.

Indeed, according to several researchers, small-caps' recent strength may actually be something else in disguise—that is, it may have to do with factors other than just size, such as the battle between growth and value stocks.

That doesn't mean there is nothing to worry about in this bull market, where valuations are stretched thin for many stocks. But it does mean that investors who are focused solely on the small-cap/large-cap divergence could be missing the bigger picture.

Here's why.

1. Value versus growth

One distinction that is crucial for understanding the relative strength of small-caps this year has to do with where small- and large-cap stocks lie on the growth-versus-value spectrum. Small-cap stocks currently are far closer to the value end of the spectrum than large-caps, meaning they are trading for lower prices relative to their net worth.

A stock's place on this spectrum is defined by its ratio of price to per-share book value (As previously shared, Book Value is the weakest of several metrics that Value can be weighed.), with the highest ratios at the growth extreme and the lowest at the value extreme. Consider the Russell Microcap Index, which contains the smallest 1,000 stocks in the broad-market Russell 3000 index. Its average price-to-book ratio was 2.5 as of the end of February, according to Russell Indexes. That compares with a 4.2 ratio for the Russell 1000 Index (which contains the largest 1,000 stocks) and a 5.7 ratio for the Russell Top 50 Mega-Cap Index (which contains the largest 50 stocks).

These are significant differences, according to Kent Daniel, a finance professor at Columbia University and a former co-chief investment officer at Goldman Sachs. He says that, on average, small-cap growth stocks tend to underperform the market, while small-cap value stocks tend to outperform. Since 1926, he says, the smallest-cap stocks closest to the growth end of the spectrum have lost 3.3% annualized, while the smallest most value-oriented stocks have gained 13.3% annualized.

This pattern has been especially strong in recent months, making it difficult to determine what accounts for small-caps' relative strength this year. But Prof. Daniel says there is the distinct possibility that it is really a "value effect masquerading as a size effect." If so, a bet on small-cap relative strength continuing is really a bet that value will outperform growth.

That bet may pay off in coming months, he says, and value could continue to outperform growth for many years. But he also says that value stocks have lagged behind growth stocks for at least a decade now, and while there have been numerous predictions of a value resurgence over that time, it hasn't happened—at least not yet.

2. Sector bets

The benchmark indexes for small-caps and large-caps have different sector weightings, which also makes it difficult to gauge whether the recent relative strength of small-caps is actually due to company size.

Consider the information-technology sector. The ETF benchmarked to the largest 50 stocks currently has a 38.6% weighting to this sector, more than three times the 12.7% weighting of the Russell Microcap Index.

Conversely, the microcap index has more than 10 times the weighting of the largest-50-stock ETF to the industrials sector (11.7% versus 0.8%) and more than double the allocation to the financials sector (17.6% to 7.1%).

These differences are a big part of small-caps' year-to-date performance, since industrials and financials have each outperformed the information-technology sector. It was just the opposite for calendar 2020, and sure enough, the smallest stocks lagged behind the largest last year.

Until there are small-cap and large-cap benchmarks with the same sector weightings—Prof. Daniel says he is unaware of any currently—it will be difficult to determine what is driving small stocks' relative strength. If it is being caused by differences in sector weightings, however, it is likely to persist only if the sectors in which the small-caps are overweight continue outperforming.

3. Is the small-cap effect real?

This discussion also points to a more fundamental question that many researchers have been asking in recent years: Does the small-cap effect even exist, in and of itself? That is, do smaller firms really have higher returns than larger firms, on average, over long periods?

Andrea Frazzini, a principal at AQR Capital Management and an adjunct professor of finance at New York University, has concluded that it exists only among a very narrow group of stocks. He says that some of the relative strength of small-caps in recent months traces to speculative fervor for stocks outside that narrow group, making it risky to bet that it will continue.

According to his research, small-caps are a good bet to outperform the large-caps only if you limit your focus to companies with high financial quality. (This is not accurate. While AQR's referenced research, as previously shared by us, was focused on combining the Size Factor with various Quality metrics, to our knowledge they have never claimed that Size "only" works with the Quality Factor. In fact, as we have also previously shared, most academically proven Factors perform better with Small Caps.) By financial quality he means firms that are profitable, have robust profit growth and a stable earnings stream and a high dividend-payout policy, among other characteristics. Many of the small companies that have performed the best so far this year don't qualify.

Companies that have been bid higher in recent weeks through social-media investor campaigns—such as GameStop and AMC Entertainment —are two obvious examples, but they are hardly alone in not qualifying for Prof. Frazzini's high-quality category. Nearly half of the 2,000 companies in the Russell 2000 small-stock index had negative earnings in 2020.

Prof. Frazzini's research therefore suggests that, if you want to bet on a continuation of recent small-cap relative strength, you should focus on small stocks that score high on various measures of financial strength, safety and quality. And don't sweat the comparisons to that internet-stock frenzy of 20 years ago.

Follow-ups

From MarketWatch's Mike Murphy on Mar. 18th:

Investing in bonds has 'become stupid,' Ray Dalio says. ...

Ray Dalio is not a fan of bonds.

The founder of Bridgewater Associates, the world's largest hedge-fund firm, decried the "ridiculously low yields" of bonds in a LinkedIn blog post Monday, while urging a diversified portfolio. ...

Dalio has never been a fan of holding cash either — and he still isn't.

"I believe cash is and will continue to be trash (i.e., have returns that are significantly negative relative to inflation) so it pays to a) borrow cash rather than to hold it as an asset and b) buy higher-returning, non-debt investment assets," he wrote.

"History and logic show that central banks, when faced with the supply/demand imbalance situation that would lead interest rates to rise to more than is desirable in light of economic circumstances, will print the money to buy bonds and create 'yield curve controls' to put a cap on bond yields and will devalue cash," Dalio said. "That makes cash terrible to own and great to borrow."

Too Many Smart People Are Being Too Dismissive of Inflation

Fears were overblown for years. But let's not be blasé about how hard it could be to halt high prices if they haunt us again.

By Steven Rattner
Mr. Rattner, a contributing opinion writer, covers economics and finance.

March 5, 2021

We are all, to one degree or another, shaped by early experiences.

My father grew up during the Depression and never lost his fear of debt. I spent an early part of my career as a reporter at The New York Times, chronicling the rampant inflation that scarred the economy in the 1970s and the Federal Reserve's struggle to contain it.

So far, the wary eye that I have kept on prices for four decades has been unnecessary. But now, with Congress poised to approve an additional $1.9 trillion in spending through the American Rescue Plan Act, I'm worrying again.

Yes, the monthly price index that tracks consumer prices continues to look benign. But even when casting aside the stimulus that the Biden administration wants to add to the economy, some important early warning signals have begun flashing.

The prices of many commodities are surging — copper and lumber because of a jump in home building. Global steel demand has pushed up iron ore prices. Even tin, heavily used in electronics, has soared as suppliers rush to meet consumer demand for new gadgets.

Inflation expectations are also on the rise among traders. Interest rates on long-term Treasury bonds — a reliable inflation indicator — remain historically low, but have been marching upward. That, in turn, has shaken financial markets, which rightfully view climbing interest rates as the enemy of their investments.

It is against this backdrop that Congress is on the verge of injecting an additional $1.9 trillion into an economy that has already received more than $4 trillion in boosts from Washington. According to several estimates, the measure's spending far exceeds the extent of the shortfall in economic output caused by the pandemic.

And let's not forget the effects of easy money from our central bank. The Federal Reserve, which has driven short-term interest rates to near zero, has also injected more money into the economy in the past year than it did fighting the Great Recession in 2008.

It's true that, with the benefit of hindsight, we did too little to address that recession. But we are in serious danger of overreacting to this one.

Now that the Covid-19 vaccination campaign has picked up, consumers are set to unleash trillions of dollars in excess savings this spring and throughout the rest of the year. Estimates suggest that in the aggregate, U.S. families saved $1.6 trillion more this year than they normally would have. This large amount of "dry powder" was goosed by a combination of less spending in general and households that held on to the money from direct government checks.

As the pandemic, with some luck, eases, people will doubtless open their wallets and restart vacations and shopping sprees. Jobs in the service sector are already starting to come back.

Some commentators, and White House advisers, dismiss inflation fears on the grounds that the economy has fundamentally changed since the 1970s. Indeed, right before Covid-19, our unemployment rate was down to levels that in the past caused inflation to pick up.

That has led to many pronouncements that when it comes to inflation, this time will be different. "It's better to overreact than underreact to crises" has become a conventional mantra, along with a promise that if inflation picks up too much, the Fed has the tools to deal with it.

OK — but let’s not be so blasé about how hard it would be to put that tiger back in its cage. Forty years ago, curbing the painful hike in prices took the Fed raising interest rates to 20 percent, forcing the economy into a brutal recession. ...

The end of the party looms for markets high on stimulus

An economic boom could make last year’s gains go flat for investors

Ruchir Sharma FEBRUARY 28 2021

The writer, Morgan Stanley Investment Management’s chief global strategist, is author of ‘The Ten Rules of Successful Nations’

It was a jarring image. As deaths from the pandemic rose in 2020, financial markets high on government stimulus partied through a devastating global downturn. Most people expect the revelry to continue as economies recover. But now there are signs the recovery could turn into a boom — and an overheating economy could end the market party. This year could unfold as a mirror image of 2020, with markets going flat amid soaring economic growth.

To understand why, follow the money. After a brief crash last March, markets started rallying the day after the US Federal Reserve announced its first pandemic relief measures — and kept on rallying. Nearly 20 per cent of all dollars in circulation were printed in 2020 alone. Major central banks followed the Fed, and governments topped that up with stimulus spending. US disposable incomes rose at the fastest rate in decades, but much of that went unspent. Americans saved at the highest rate since the second world war, putting away an additional $1.7tn, or more than 16 per cent of their 2020 income.

With more money in the bank, and more time on their hands because of lockdowns, many workers turned to punting in the markets. Of 49m online brokerage accounts in the US, 13m opened in 2020, according to calculations by Scott Rubner of Goldman Sachs. The week after stimulus checks went out in April, trading by middle-class Americans soared.

US retail investors helped fuel flash manias for bankrupt companies like JC Penney, and more recently for another faltering retailer, GameStop. From South Korea to India, individuals bought stocks at a furious pace. The huge winners were large growth stocks, particularly in the US and China. Together they accounted for most of the 2020 market gains worldwide.

Where will all the money go when the virus fades? Epidemiologists say the pandemic could be contained by summer, perhaps even by spring in the US and UK, where vaccines are rapidly rolling out. As consumers emerge from lockdown, excess savings are likely to drop sharply. Even by conservative estimates, the release of pent-up demand could add two to three percentage points to gross domestic product growth in the US alone.

The consensus prediction for global GDP growth in 2021 is just over 5 per cent. But my team thinks growth could top 6 per cent worldwide, and reach 8 per cent in the US. I think other forecasters are underestimating the recovery, given the savings glut and the apparent eagerness of policymakers to err on the side of overstimulating. Ironically, a booming economy may not be good for markets. Savers will become shoppers again. Resurgent demand for leisure travel, fine dining and other services will strain the capacity of industries gutted by the pandemic.

The deflationary impact of business closures could give way to the potentially inflationary impact of supply shortages, which are already visible in sectors such as shipping, airlines and semiconductors. The prices of commodities from oil to soyabeans have also been surging of late.

The bond market is beginning to price in higher inflation, and the prospect of higher yields could suck money out of stocks, which are now much more vulnerable to interest rate swings. Last year stock valuations received an unusually large boost as rates plunged. A sharp rise would deliver a proportionately large shock. Further, the rally was driven mainly by growth stocks — the kind most sensitive to interest rate shifts — and they now dominate many stock market indices.

Higher long-term interest rates could end the extraordinary bull run for giant tech stocks in the US and China and move flows towards a new set of countries and industries. The buzzwords of last year — the virus, virtual, work from home, recession — are likely to make way for vaccines, the real world, back to the office and reflation. This transition may be more disruptive than imagined for financial markets, which have become hooked on last year's themes and low long-term interest rates.

Markets often underestimate the impact of big shifts in the global economy. In the early 1980s, disinflation led to a sharp fall in interest rates, with much greater fallout for the markets than most investors had foreseen. Now the risk is that inflation resurfaces, and bond yields rise more sharply than anticipated, overwhelming the rise in earnings during a recovery. The impact could easily end the rally of 2020, leaving markets suffering withdrawal symptoms despite a global economic boom.

Positions

BILPX for **ANGIX -** On 3/31 we sold the last position in ANGIX @ 10.37, replacing it on 4/1 with BILPX @ 10.10 for a client focused on Income/Capital Preservation. Both OEFs have a **Risk Ratio** compared to the S&P 500 of **0.4**. The Morningstar chart below is from the date of BILPX's change in manager and strategy. ANGIX's performance (orange line) has been added for comparison:

BlackRock Event Driven Equity Instl BILPX ★★★★★ Bronze

NAV / 1-Day Return	Total Assets	Adj. Expense Ratio	Expense Ratio	Fee Level	Longest Manager Tenure
10.10 / ↑0.40 %	7.3 Bil	1.330%	1.360%	Average	5.91 years
Category	**Alt Style Correlation / Relative Volatility**	**Min. Initial Investment**	**Status**	**TTM Yield**	**Turnover**
Market Neutral	Low / Medium	2,000,000	Open	0.00%	63%

Strong across the board.

Summary | by Bobby Blue Mar 19, 2021

BlackRock's scale and resources offer the experienced team that manages BlackRock Event Driven Equity a unique edge, which supports a Morningstar Analyst Rating of Bronze for its cheapest share class. The more expensive C share class is rated Neutral.

Lead manager Mark McKenna brings more than 15 years of event-driven management expertise to bear on this strategy, which he launched in 2015. Three additional managers and five analysts support him, often focusing on specific niches of event-driven investing. They turn to resources from the broader organization, including a risk and analytics group that built out a custom risk platform for the team.

The team can invest in corporate actions of all types, but its strengths lie in merger arbitrage. (A strategy that excels in the higher interest rate environment we have been expecting.) McKenna leverages the team's extensive network and BlackRock's sizable equity ownership stakes to gain access to corporate decision-makers, which allows him to push for more favorable shareholder outcomes. The team also invests in soft catalyst trades, such as management changes and credit ideas, including distressed lending. While the team has some experience in these types of trades, the broader range of outcomes and less certain payout profiles make them more challenging to execute. The team had historically allocated 90% of the portfolio to merger deals and 10% to soft catalyst trades, but the split was around 70%/30% through much of 2020. The ability to rotate into these trades when merger activity slows--as it did in 2020--can be a plus, but this shift away from the team's core competency in merger arbitrage bears watching.

For the first time since the strategy's inception, soft catalyst and credit ideas drove the majority of its performance in 2020, contributing to about three fourths of its 6.3% return for the year. This return came despite a 11.5% drawdown during the worst of the March sell-off, which was largely driven by deal spreads widening and not deals collapsing. The team's conviction through the sell-off helped it stay the course, allowing the strategy to recoup those losses as spreads recovered.

Process | Above Average

BlackRock Event Driven Equity invests in ideas across the corporate actions spectrum, focusing mainly on announced mergers but also including soft-catalyst events such as management changes. The team combines a deep understanding of the legal and business challenges facing these events with a topnotch risk platform, earning an Above Average Process rating.

The managers monitor hundreds of corporate events, though the portfolio has historically skewed toward merger deals. When they identify an idea with an attractive risk/reward, they assess the legal and business case and then use their network and BlackRock's large shareholder base to gain access to management teams to get a deeper understanding of the deal. This audience with management provides useful information and positions them to drive favorable outcomes. For example, BlackRock was among a consortium of investors during Dell's 2018 buyout of DVMT in which they negotiated DVMT's price up to $120 a share from $109.

The team's risk-management system helps with position sizing. Using BlackRock's tools, the team tracks a position's downside should its thesis fail to play out. The team tries to size positions so that if the deal breaks it will cause no more than a 3% hit to the fund's net asset value, a high number relative to more-cautious peers. To date, the strategy has not had a deal break the 3% threshold.

Because the team can invest in soft catalyst and credit ideas, its portfolio looks different from peers who invest solely in merger arbitrage. That was especially true in 2020, when a slow merger environment pushed the team into more of these types of trades. Coming out of the drawdown in March 2020, the team saw more opportunities in credit, bumping the portfolio's net credit exposure to as high as 14.5% of net assets at the end of May. It held a sizable (1.0%) stake in debt from El Dorado Resorts, a company it also held equity in as part of a merger arbitrage trade. The team's engagement with El Dorado as part of the debt underwriting process granted it confidence that its acquisition by Caesar's would close.

While the ability to access ideas outside of merger arbitrage helped in 2020, the growth of that exposure raises some concerns. The split between hard catalysts and soft catalyst/credit ideas has typically been around 90%/10%, but it was closer to 70%/30% for much of 2020. This not only changes the fund's risk profile by introducing more equity sensitivity but also moves it further from the team's core competency in merger arbitrage. The team maintains that its tilt into these types of trades reflected the opportunity set, but with assets under management across all its products now over $12 billion, the strategy's size may also be affecting the portfolio's composition.

People | Above Average

Lead manager Mark McKenna continues to build out a strong team that benefits from a wealth of resources. It earns an Above Average People rating.

McKenna has invested in corporate events for nearly two decades. His previous stops include building out Harvard Management Company's event-driven portfolio and running an event-driven hedge fund at Caxton Associates. At BlackRock since 2014, he has taken full advantage of the unique resources a firm of its size offers. He turned to the firm's risk and quant analysis group to build out a custom risk system for his team, and he can leverage the firm's active equity ownership stakes in companies to gain access to management teams.

Three comanagers support McKenna, although they are not listed managers on the mutual fund. Ben Brill, who worked with McKenna at Caxton, specializes in merger deals. Nathan Gordon specializes in soft-catalyst events, and Chris Murphy specializes in capital structure opportunities in credit. Both worked with McKenna in the early 2000s at Salomon Smith Barney, where they advised corporations on mergers and acquisitions. Of the five analysts supporting the managers, two have joined in the past year, showing the firm's willingness to bolster this team's resources. As it delves further into soft catalyst events, the team could benefit from more expertise dedicated to that space.

Parent | Above Average Jun 4, 2020

BlackRock's advantages outweigh its disadvantages; it earns an Above Average Parent rating.

BlackRock is a $6.4 trillion money manager with unparalleled scale and influence. It's a market-leading and standard-setting passive investor with iShares. It has a deep and talented fixed-income team. Its Aladdin software is a vital risk analysis and portfolio management tool for the industry. BlackRock Financial Markets Advisory has secured the trust and mandates of many governments, including the Federal Reserve’s pandemic-inspired debt-buying program. BlackRock also has designs on alternative, factor, and private-equity investing and has pledged to double its ESG ETFs and incorporate ESG in all its strategies. Fees also have improved.

Its ascent has had setbacks, though. Multiple attempts to revamp its active equity lineup have yet to produce the revival fixed income achieved. The firm has launched some gimmicky strategies. In 2019 and 2020, it fired two executives and a closed-end fund manager for violating company code of conduct policies, showing how difficult it can be to foster and enforce an ethical culture at such a behemoth. While it preaches ESG's virtue, it has often sided with management in ESG proxy votes.

BlackRock is not the best at everything it does, but it realizes the best way to serve its public shareholders is to fulfill its fiduciary duty.

Performance

This fund underwent a strategy overhaul in May 2015, before which it was a long-only fund whose results should be ignored. It has posted strong results since then, with its institutional share class returning an annualized 5.1% through February 2021. It has delivered that return with a beta to the S&P 500 that has hovered between negative 0.1 and 0.2, indicative of its uncorrelated return drivers. That strong performance and insensitivity to broad markets has helped deliver alpha of 2.0 versus the Morningstar Global Allocation index, which indicates this fund would improve the results of a globally diversified portfolio.

Despite a 5.1% loss in March 2020, the fund posted a solid 6.3% return in 2020. It quickly recovered the March losses, and by June it was positive for the year as deals continued to progress and deal spreads (the discount at which the acquisition company’s stock price trades to the announced purchase price) tightened back up. With the team leaning into credit and soft catalyst ideas coming out of the drawdown, those sleeves had a disproportionate impact on performance over the year, generating more than 75% of the fund’s gains, the first time that merger arbitrage wasn’t the primary contributor. The team’s ability to turn to other ideas in periods where merger activity slows is a plus, but continued reliance on these trades could be a sign that the team is stretching to invest its sizable asset base.

Price

It’s critical to evaluate expenses, as they come directly out of returns. The share class on this report levies a fee that ranks in its Morningstar category’s second-cheapest quintile. Based on our assessment of the fund’s People, Process and Parent pillars in the context of these fees, we think this share class will be able to deliver positive alpha relative to the category benchmark index, explaining its Morningstar Analyst Rating of Bronze.

Angel Oak Multi-Strategy Income Instl ANGIX ★★ Neutral

NAV / 1-Day Return	Total Assets	Adj. Expense Ratio	Expense Ratio	Fee Level	Longest Manager Tenure
10.37 / ↑0.01 %	6.6 Bil	0.950%	1.120%	High	7.93 years
Category	**Credit Quality / Interest Rate Sensitivity**	**Min. Initial Investment**	**Status**	**TTM Yield**	**Effective Duration**
Multisector Bond	Low / Limited	1,000,000	Open	4.43%	2.43 years

Incremental improvements, but plenty of risks in this mortgage-heavy strategy.

Summary | by Brian Moriarty Aug 27, 2020

Angel Oak Multi-Strategy Income is an aggressive mortgage-focused strategy. Its management has a solid foundation, but risks and weaknesses remain. It earns a Morningstar Analyst Rating of Neutral across all share classes.

Angel Oak was originally founded as a manager of private funds in 2008 investing in beaten-down nonagency mortgages but has since grown into a combined boutique asset manager, mortgage lender, and securitization business. This strategy is managed by firm co-founder Sreeni Prabhu and a bevy of comanagers: Berkin Kologlu has expertise in collateralized mortgage obligations; Sam Dunlap in both mortgages and interest-rate hedges; Kin Lee in commercial mortgages; and Colin McBurnette has a varied background that includes distressed debt and risk management. Clayton Triick, the team's asset-backed securities lead, was added to the roster in September 2019.

The team is experienced, and the members' knowledge of the securitized market is impressive, but its analyst team is not as robust as some competitors. Additionally, co-founder and longtime manager Brad Friedlander retired in July 2019. The team is strong enough to absorb his departure, but he was an important part of the fund's early success. Overall though, we would like to see them work together for longer and manage through a variety of environments.

The bulk of fund assets (more than 50%) are held in nonagency mortgages, but the managers also invest in CLOs (5%-20%), asset-backed securities (single digits), and commercial mortgage-backed securities (8%-20%), some of which have carried lower credit ratings. The managers have plenty of experience in the securitized credit markets, but they have courted above-average risk, including periodically leveraging the fund and holding less liquid assets such as whole loans and lower-rated CLOs. While the strategy struggled in the late 2015 sell-off, the team handled March 2020 more successfully, which is a positive sign. This remains a unique offering with a balance of pluses and minuses.

Process | Average

The team has demonstrated nuanced knowledge of structured credit markets, though it continues to court notable risks. The strategy earns an Average Process Pillar rating.

This is a team-managed strategy that invests predominantly in nonagency mortgages but will also hold sizable stakes in a variety of other securitized sectors, including CLOs, ABS, and CMBS. The managers take a comparatively conservative approach to the nonagency mortgage component of the portfolio. But they court above-average risk in other ways, and the portfolio has gone through evolutions and adjustments since its 2011 inception.

Monthly investment committee meetings set the strategy's basic allocation, while daily and weekly meetings address sector- and subsector-level investment themes. The group's fundamental analysis is robust; the team models each security through dozens of scenarios to understand how it will behave, and they dig deeply into the underlying collateral. However, the managers also periodically introduce leverage by keeping their line of credit partially drawn. This is slightly offset by their preference to hold those assets in cash and other liquid securities, but it can be dangerous when combined with holdings that court significant liquidity risk, such as whole loans, CRTs, and lower-rated CLOs. That risk tempers our enthusiasm.

As of June 2020, the bulk of assets here (69%) resided in nonagency mortgages. This number is almost unchanged from one year prior, as these securities have been the strategy's bread-and-butter since inception. Most of that allocation has been in legacy securities--typically Alt-A and Prime--but also a notable allocation to postcrisis nonagency mortgages, which accounted for one third of the total nonagency bucket. This includes nonqualified mortgages, reperforming loans, and credit risk transfer securities, all of which carry elevated risk compared with agency mortgages. The postcrisis mortgage market has grown in recent years, but its fragmentation has made it a research-intensive sector.

The portfolio also had exposure to CMBS (4%), CLOs (6%), corporate bonds (6%), and ABS (9%) in June 2020. After a roughly 14% stake in lower-rated CLOs caused a rough patch in late 2015, the firm put a 20% prospectus limit on the sector and began shifting the allocation into higher-quality securities. But the strategy still courts quite a bit of risk: 36% of assets were rated below B, and whole loans--which court more liquidity risk than many other securities--remain a presence. To be sure, the team was cautious entering March 2020 and worked hard to protect the portfolio during the sell-off, to the benefit of investors. This shows improvement and evolution.

People | Average

The team here has laid a capable foundation that's nonetheless on the small side. It earns a Neutral People Pillar rating.

Angel Oak uses a team-based approach, with six portfolio managers sharing responsibilities here. Those managers are Sreeni Prabhu, Berkin Kologlu, Sam Dunlap, Kin Lee, Colin McBurnette, and Clayton Triick. Prabhu is Angel Oak's co-founder, co-CEO, and CIO, and has a long history running mortgage portfolios; Kologlu has an expertise in CLOs; Dunlap has a background in both mortgages and interest-rate hedging; and Lee is the resident CMBS expert. McBurnette has a varied background that includes distressed debt investing and risk management, while Triick leads the team's ABS efforts. They are supported by a handful of analysts, many newer to the firm.

While each manager has notable experience, most has been gained working on private vehicles and many are still newer to managing an open-end product. Their performance in March 2020 bodes well: the portfolio had plenty of liquidity and losses were in line with category peers. But the firm is still settling in after a period of rapid growth, and the analyst team remains small. The departure of Brad Friedlander remains relatively fresh as well; a co-founder and the original manager on this strategy, he retired in July 2019 to pursue endeavors outside of the asset management industry.

Parent | Average Aug 28, 2019

Angel Oak Capital Advisors is the asset-management arm of the Angel Oak family of companies. The Atlanta-based firm was founded in 2008 to invest in distressed nonagency mortgages through private vehicles. In 2011, it launched its first mutual fund, Angel Oak Multi-Strategy Income ANGLX, which has rapidly grown to over $7 billion in assets; the firm's total assets under management was roughly $10 billion in mid-2019 and, in addition to Multi-Strategy Income, included four other open-end funds and a variety of private vehicles.

The broader Angel Oak family of companies has grown rapidly as well and now includes commercial and residential mortgage lenders and a capital markets business that securitizes new mortgages. These businesses give the investment team unique insights into the securitized credit markets and are kept functionally separate, though they could present potential conflicts of interest in the future.

The investment team, which is led by co-founder Sreeni Prabhu, has grown along with assets. However, this is the first time running open-end vehicles for many on the team, and personal investment in the funds they manage is low. Co-founder Brad Friedlander recently retired, and he played an important role in the firm's early success. The firm has its strengths but needs to continue maturing as it transitions from startup to established. It earns a Neutral Parent rating.

Performance

The strategy hit a rough patch in 2020, which has weighed on its longer-term returns. From May 2013 through July 2020, the strategy’s institutional share class returned 2.7% annualized and trailed 80% of distinct peers in the multisector bond Morningstar Category. But that drag has more to do with a slow rebound rather than above-average losses, suggesting the team managed through the crisis relatively well given the preference of many liquidity-challenged sectors. For instance, from Feb. 20, to March 23, 2020, it lost 13.8% - dramatic in absolute terms, but almost exactly matching the peer median loss for that stretch. But from March 24 through July 2020, the strategy’s 8.6% recovery still lagged just over 80% of peers. Some of the portfolio’s less liquid CLO and CMBS holdings struggled to recover, but the strategy was also less exposed to securities that saw the wildest swings in performance, for better and worse.

More generally, the strategy is likely to do well in stress periods where most of the pressure is on either corporate credit or interest rates. For example, it outperformed during the interest rate shocks of both 2016 and early 2018, as well as when corporate credit sold off in late 2018. But the focus on the structured credit market leaves it vulnerable to the consumer markets as well as heightened liquidity risk, particularly in lower rated or more esoteric securities.

Price

It’s critical to evaluate expenses, as they come directly out of returns. The share class on this report levies a fee that ranks in its Morningstar category’s middle quintile. That’s not great, and based on our assessment of the fund’s People, Process and Parent pillars in the context of these fees, we don’t think this share class will be able to deliver positive alpha relative to the category benchmark index, explaining its Morningstar Analyst Rating of Neutral.