July 2021

While our benchmark, MSCI's "flagship global equity index", was up 0.4% last month, it was down 1.4% if you exclude American stocks. The S&P 500 (+2.3%), Nasdaq (+1.2%), and Dow (+1.3%) set all time highs during the month, but the Small Cap Russell 2000 (-3.6%) finished the month 5.7% below its March 15th record close.

Inflation remains our primary concern. The $1 trillion bipartisan infrastructure bill, which the Administration will attempt to follow with a $3.5 trillion social, health and environmental bill via reconciliation, is nearing completion. From today's The Daily 202:

Since the outset of bipartisan infrastructure negotiations, lawmakers have wanted to accomplish three things that are very hard to do simultaneously: Pay for a major new spending program, not raise new taxes, and claim their plan does not increase the federal deficit.

These constraints were political, not economic.

Republican opposition made new taxes on the rich or corporations impossible. The White House quickly ruled out a gas tax, fearing it could hit drivers, as well as other levies on Americans earning under $400,000, in line with President Biden’s campaign promise. Spending cuts were also off the table.

Accommodating those conflicting demands has produced some creative accounting that only became more strained as negotiations unfolded.

Initially, the group discussed increasing Internal Revenue Service enforcement of tax cheats, since that would at least in the abstract not amount to a tax increase. The provision was estimated to raise more than $100 billion in new revenue. But that plan fell through amid GOP opposition and an intense opposition campaign from well-funded conservative groups, depriving lawmakers of a key revenue source.

The most important offset in the deal involves repurposing more than $260 billion in coronavirus relief aid previously approved by Congress.

However, experts say much of the savings from coronavirus aid appear to derive from the difference between a program’s initial estimated cost and what was ultimately spent. That lower cost, when compared to what was first projected, is then claimed by the bipartisan lawmakers to represent savings that pay for the infrastructure package, even though those savings would materialize regardless of new legislation. While some coronavirus relief provisions ended up costing less than projected, others — not mentioned by the bill's authors — ended up costing more.

The Congressional Budget Office, Congress’s nonpartisan scorekeeper, is expected to within days issue a report with a much more modest view of the impact of the proposed saving measures.

Goldwein, of CFPB, estimated the deal only saves $50 billion in repurposed coronavirus aid, a fourth of what the proponents say. Donald Schneider, who served as chief economist to Republicans on the House Ways and Means Committee, has estimated roughly $41 billion in unused coronavirus relief funds will be counted toward the overall savings. While negotiators say their plan raises as much as $540 billion, Schneider estimated it would raise $208 billion — less than half of what’s claimed. ...

The bipartisan negotiators and White House officials have also defended their math.

A White House official, speaking on the condition of anonymity to reflect internal dynamics, said there was agreement within the bipartisan group to not judge the cost of the measure by the forthcoming CBO score, although Democrats routinely cited the agency when denouncing President Donald Trump's 2017 tax cuts. Sen. Mark R. Warner (D-Va.) told my colleague Tony Romm that "people who want to vote for this know that it's paid for."

From Global Investment Strategy's Jul. 23rd report:

Investors Are Asking The Wrong Question About Inflation

Investors keep asking whether the recent increase in US inflation is transitory. However, this is the wrong question to ask. Annualized core CPI inflation reached 10.6% in the second quarter. There is little doubt that inflation will fall from such elevated levels. The key question that investors should be asking is whether inflation will decline more or less than what the market is discounting. The widely watched 5-year/5-year forward TIPS inflation breakeven rate has sunk to 2.11%, below the Fed's "comfort zone" of 2.3%-to-2.5%. Thus, the market already expects a substantial decline in inflation. Our sense is that US inflation will come down fast enough to allow the Fed to maintain a highly dovish policy stance, but not as fast as market expectations currently imply. As inflation surprises on the upside, long-term bond yields will rise. This should revive bank shares and other reflationary plays. The combination of a weaker US dollar, faster sequential Chinese growth, increased vaccine supplies, and favorable valuations should all help EM stocks later this year. Go long the Vanguard FTSE Emerging Markets ETF (VWO) versus the Vanguard S&P 500 ETF (VOO).

While we agree with the above premise, our oft repeated concerns about most EMs remains, including, once again, China, to which VWO has 40% exposure. From the WP:

Wall Street is finally waking up to the reality of China

Josh Rogin July 8, 2021|

This week, Xi Jinping dealt a humiliating blow to Wall Street, crushing a major Chinese tech firm shortly after U.S. investors had handed it billions. It's a watershed moment that has even the most die-hard Wall Street China boosters finally admitting that the game has fundamentally changed. Investing Americans' futures in Chinese companies is no longer a risk Wall Street can calculate, much less defend.

On July 2, just two days after Goldman Sachs, J.P. Morgan and Morgan Stanley launched an initial public offering for the Chinese ride-hailing app Didi on the New York Stock Exchange, Chinese regulators cracked down on the company hard. Citing data privacy concerns, the Chinese government ordered the removal of Didi's app from app stores, pending an opaque national security review process. As a result, the stock has lost 30 percent of its value since shortly after its IPO, when investors, most of them from the United States, put $4.4 billion into the company. Shamelessly, the Wall Street firms that set up the Didi IPO collected millions of dollars in fees regardless.

Some Wall Street pundits — perhaps for the first time — realized they had been acting as useful idiots by encouraging Americans to throw money into the Chinese tech firm. CNBC host Jim Cramer said just last week about Didi, “I would try to get as many shares as you can … I doubt they’ll have much trouble with the regulators.”

This week he’s singing a different tune. “You’re a moron if you buy a Chinese deal after this. You’re a moron. I don’t care if it pops,” Cramer said Tuesday. “Why do you need to put your capital at risk after this?”

Cramer, the new China skeptic, is now echoing the concerns national security types in Washington have been screaming in Wall Street’s direction for the past several years. Chinese companies raising capital in the United States can’t be audited. And now that Beijing is determined to increase its control over all Chinese industries, these companies can’t credibly claim to be independent from the Chinese government.

Of course, there were plenty of signs that Beijing was cracking down on its tech giants (and even setting their sights directly on Didi). But rather than heed those warnings, the New York financial gurus told their audiences and themselves that investing in China was a sure bet. Now, the financial consequences will fall not on those gatekeepers at the top of the financial industry, but on their clients — millions of unwitting U.S. investors.

As U.S.-China tensions have worsened, Wall Street financial service firms, asset managers and hedge funds have been racing to increase their holdings in Chinese companies of all kinds, including those Washington was trying to sanction for complicity in human rights atrocities or links to the Chinese military.

Seduced by the lucrative Chinese market, Wall Street firms and U.S. regulators have eagerly helped a flurry of Chinese companies raise money from U.S. investors, who then find themselves holding these risky assets because their savings are tied up in pension funds or other vehicles they don’t personally manage.

Until now, many in the financial world wanted to believe the Chinese Communist Party was fundamentally pragmatic. They insisted that Beijing would never risk its economic development by killing its Wall Street cash cow, and that investors could always count on rational decision-making and solid returns. None of that is defensible anymore. With the Didi move, Xi has put an end to business as usual.

The situation is getting worse, not better. Chinese tech firms like Alibaba and Tencent are facing huge fines for various alleged offenses. The Chinese government is going after more Chinese firms that have raised money in the U.S. markets. Realizing that some U.S.-China decoupling is certain, Xi may want to manage the process on his own terms, bringing Chinese companies back home to help bolster the country’s own capital markets.

“The Communist Party is busy asserting tighter control of Chinese tech companies in an effort not only to break any sense of independence among China’s technology leaders but also to ensure that they are acting in line with Beijing’s strategic goals,” said Jonathan D.T. Ward, author of “China’s Vision of Victory.”

But there is a silver lining to the Didi IPO debacle. No more can Wall Street pundits, asset managers, lawyers and lobbyists argue with a straight face that Chinese firms are anything but under the effective control of the CCP. That means admitting Beijing can squash them or pilfer their coffers at any time — for any reason. Wall Street must now acknowledge that the risk of investing in these companies can’t be known, much less disclosed. Therefore, U.S. investors shouldn’t be trusting their futures to China Inc.

Admitting you have a problem is just the first step. Now the Wall Street clique must change its behavior to acknowledge that funneling Americans' money into Chinese companies that have zero transparency, zero accountability and zero independence from the CCP is both bad for investors and bad for America.

From the front page of last weekend's WSJ:

Investors Rethink China Bets

By Juliet Chung, Justin Baer and Dawn Lim

American investors are asking whether China Inc. is still worth the risk following a widening series of regulatory crackdowns that have wiped some $400 billion off the value of U.S.-listed Chinese companies.

Investors ... are rethinking their portfolios following Beijing's decision last week to curtail the operations of China's for-profit tutoring industry along with its ongoing campaign to rein in tech companies. The moves fueled large declines across sectors of China's stock markets and hammered Asia-focused funds stateside. ...

It was the latest of regulatory crackdowns that have hit the value of Chinese firms as large as Tencent Holdings, even as U.S. indexes have risen to records. Earlier regulatory moves that had rattled companies such as, its unlisted sister company Ant Group and Didi Global, which is considering going private again to placate authorities, had already caused concern among western investors.

U.S. regulators also added new pressure to stocks on Friday when U.S. Securities and Exchange Commission Chairman Gary Gensler said the agency would require additional disclosures from Chinese companies before allowing them to sell shares.

So far this month, China ADRs have lost more than $407 billion dollars in aggregate, according to FactSet, more than double their losses in March 2020 when the U.S. market plummeted at the beginning of the Covid-19 pandemic.

China this week tried to reassure global financial firms that it wasn't trying to decouple from U.S. markets. A top securities regulator told representatives of global banks and investment firms that Chinese authorities in the future would carefully consider the market impact of policy changes before making them.

Over the last decade, U.S. investors have been drawn to China because of its huge population, growing economy and booming tech industry. Despite tension between the Chinese and American governments, U.S. investors continued to see strong returns. Yet, the deteriorating political relationship between the two countries has bled into the markets.

The Trump administration blacklisted some Chinese companies from U.S. investments last winter and paved the way for several Chinese companies to be delisted in the U.S. The Biden administration is maintaining some of the Trump White House stances against Beijing. ...

Many U.S. investors remain bullish on China's long-term prospects despite what skeptics say is the difficulty of anticipating Chinese President Xi Jinping's moves. They say they can't afford to miss out on the growth of an economy some investors think is on track this decade to overtake the U.S. as the world's biggest. Many on Wall

Street think a country so intertwined with global supply chains and the financial markets is, for better or worse, too big to ignore. ...

Some U.S. managers said the recent episodes served as a harsh reminder that China remains an emerging market, where sometimes sudden policy decisions can matter more to a stock's performance than that company's growth prospects or its annual profits. ...

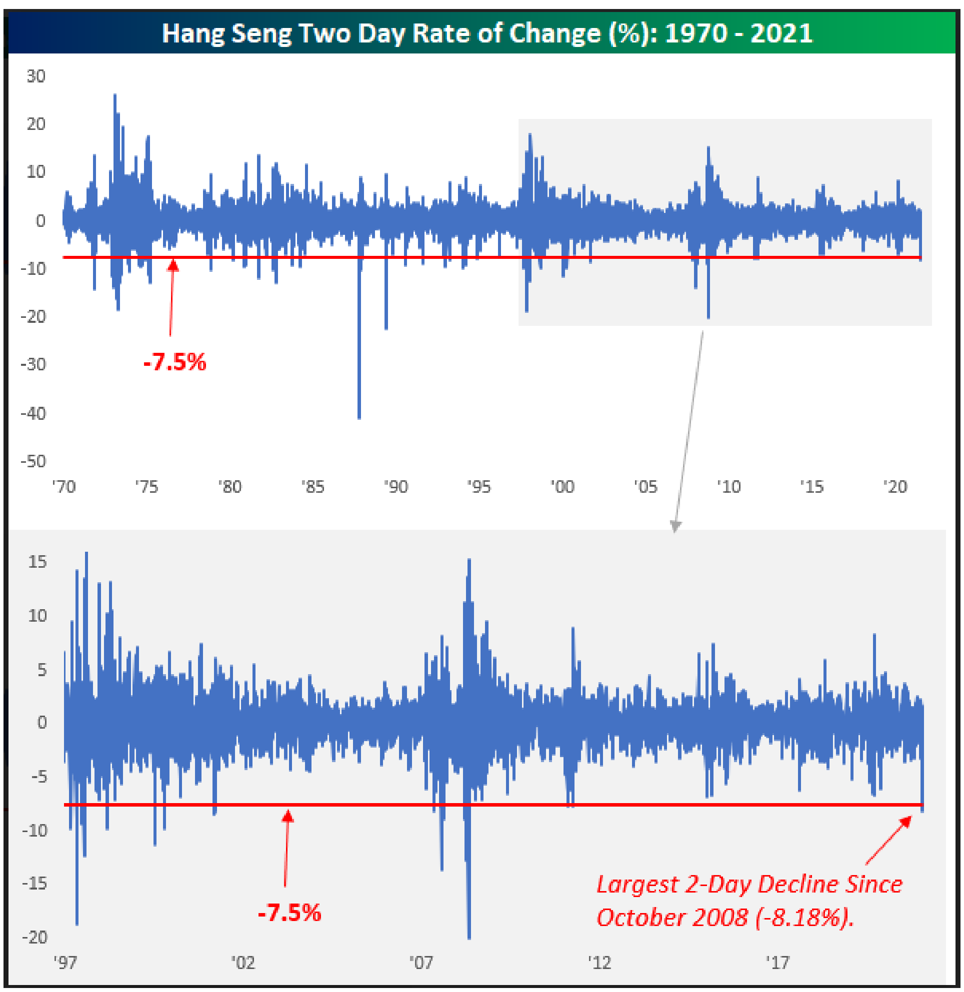
Liqian Ren, a quantitative investment specialist at ETF firm WisdomTree Investments, said investors needed to recognize that being in emerging markets like China always comes with political risks.

"If a private company makes a lot of money, is very profitable and operates in a sector the government feels in need to be the main service provider, regulators will pay attention," she said. ...

For hardened emerging-markets investors, sudden policy decisions have long been par for the course. "Whenever there are periods of stress in the market, it's the tourists who sell first," said Anh Lu, a senior T. Rowe money manager who focuses on Asia-Pacific markets.

From Saturday's Bespoke:

It was a rocky start to the week as crackdowns by the Chinese government on companies in the tech sector caused volatility. Stocks in Hong Kong were among the hardest hit falling over 8% in two days for the largest two-day decline since the financial crisis.



Follow-ups

The Benefits of Sin Stocks

By Larry Swedroe | July 29th, 2021

While environmental, social, and governance (ESG) investing continues to gain in popularity, economic theory suggests the share prices of "sin" businesses (typically those involved in the gambling, tobacco, alcohol, guns, and defense industries) will become depressed if a large enough proportion of investors choose to avoid them—the "shunned-stock hypothesis." Such stocks would have a higher cost of capital because they would trade at a lower price-to-earnings (P/E) ratio—providing investors with higher expected returns. Some investors may view those higher expected returns as compensation for the emotional cost of exposure to offensive companies. On the other hand, socially conscious investors may be willing to accept less-than-optimal returns while gaining peace of mind knowing they are not promoting activities they believe are detrimental to society and/or one's health. [1]

The evidence from research papers such as 2009's "The Price of Sin: The Effects of Social Norms on Markets," the 2017 papers "Fewer Reasons to Sin: A Five-Factor Investigation of Vice Stocks" and "Sin Stocks Revisited: Resolving the Sin Stock Anomaly," and the 2020 study "The Underpricing of Sin Stocks" has found:

- Sin stocks have provided abnormal risk-adjusted returns due to neglect by institutional and retail investors, who lean toward the side of ESG.
- The abnormal return to sin stocks occurred because they are more profitable and less wasteful with investment than the average corporation.
- Sin stocks tend to be low-beta stocks and have highly statistically significant loadings on the betting-against-beta (BAB) factor.
- Sin firm IPOs are more underpriced (22.3%) than non-sin firm IPOs.

Greg Richey contributes to the literature on sin investing with his study "Is It Good to Sin When Times Are Bad? An Investigation of the Defensive Nature of Sin Stocks," published in the October 2020 issue of The Journal of Investing. Richey analyzed the defensive nature of individual sin industries against the market portfolio. His database covered the period 1980 to 2019 (providing 480 monthly observations) and 106 firms from four sin-related industries—alcohol, tobacco, gambling, and defense. He constructed a sin fund portfolio as well as one portfolio for each industry (a booze fund, a smoke fund, a game fund, and a boom fund).

Following is a summary of his findings:

- Sin stocks have had higher returns and Sharpe ratios than the market portfolio, and sin industry funds' returns have been less correlated with each other than they have been with the market portfolio.
- The betas of the sin portfolios were less than one, indicating they have less systematic risk than the market portfolio (they are more defensive).
- Bad news events have a lesser impact on sin stock return volatility than do good news events.

As the following table demonstrates, the returns on the sin portfolios outperformed the market portfolio (S&P 500) over the sample period, both in percentage (mean) return and in risk-adjusted (Sharpe) return. They also outperformed the BAB factor portfolio.

	Mean Return	Std. Dev.	Skewness	Kurtosis	Beta	Sharpe
SinFund	1.295	4.743	–0.473	6.087	0.79	0.199
BoozeFund	1.268	4.922	–0.084	5.877	0.68	0.187
SmokeFund	1.592	7.023	1.105	9.051	0.73	0.176
BoomFund	1.529	6.938	0.923	4.754	0.83	0.169
GameFund	1.146	5.804	–0.181	8.042	0.91	0.137
S&P	1.078	4.397	–0.741	5.375	1	0.166
BAB	0.951	3.636	–0.552	6.764	–0.15	0.165
T-Bill	0.35	0.295	0.812	3.51	0	0

The results are hypothetical results and are NOT an indicator of future results and do NOT represent returns that any investor actually attained. Indexes are unmanaged, do not reflect management or trading fees, and one cannot invest directly in an index.

Summary

As the shunned-stock hypothesis suggests, sin stocks have not only provided higher returns than the market portfolio but higher risk-adjusted returns as well. In addition, Richey's study demonstrates that sin stocks provide the added benefit of being defensive in nature, reducing the tail risk of investing in equities. Risk-averse investors may conclude that, for them, sin investing is a good choice.

From Morningstar:

What the Last Year Taught Us About Low-Volatility ETFs

Are they living up to expectations?

Daniel Sotiroff
Jul 27, 2021

The past year has been a reality check for investors holding low-volatility exchange-traded funds. While most of the global market sprinted back from the depths of the coronavirus-driven sell-off, low-volatility strategies chugged along at a slow jog. They appreciated in value but failed to keep pace with the market's aggressive tempo.

The numbers paint a pretty stark picture. IShares MSCI USA Minimum Volatility Factor ETF (USMV), which has a Morningstar Analyst Rating of Silver, trailed the S&P 500 by 25.9 percentage points over the 14 months from April 2020 through May 2021. Similar deficits were observed for other low-volatility strategies focused on foreign developed and emerging markets.

Over the long run, low-volatility strategies have proved effective at cutting back on statistical measures of risk. But they differ from many other strategies in that they aren't designed to beat the market. Instead, the expectation is marketlike total returns with less risk, which sets them up for better risk-adjusted performance. ...

There's No Free Lunch

Low-volatility strategies underreact to market movements, be they large upward moves or deep drawdowns. They typically provide some downside protection when the market goes through a downturn. ... USMV, which tracks the MSCI USA Minimum Volatility Index, has largely delivered on that expectation. It beat the market when the dot-com bubble burst in mid-2000 and again eight years later when the market collapsed during the 2008 global financial crisis.

There is a price to pay for that benefit. Low-volatility strategies typically underperform during bull markets. USMV's benchmark lagged the market during the dot-com bubble of the late 1990s, the first two years of the recovery from the global financial crisis, and most recently during the rebound from the coronavirus-driven sell-off.

That pattern isn't limited to the United States. The same expectations and performance apply to low-volatility strategies targeting foreign stocks. Two examples on the menu of Morningstar Medalists are Silver-rated iShares MSCI EAFE Minimum Volatility Factor ETF (EFAV) and Silver-rated iShares MSCI Emerging Markets Minimum Volatility Factor ETF (EEMV). Like USMV, their target indexes held up better during the financial crisis and underperformed during the rebound.

Those trade-offs are the main way that low-volatility funds differ from their respective market, and the pattern is reflected in the historical statistics for these strategies. Exhibit 1 shows that standard deviations have been lower and drawdowns, on average, have been shallower.

Exhibit 1 Low-Volatility ETFs Have Generally Performed as Advertised

ETF/Index	Total Return (%)	Std Dev (%)	Sharpe Ratio	Avg. Drawdown (%)
United States				
S&P 500	16.01	13.13	1.15	–7.10
iShares MSCI USA Min Vol Factor ETF USMV	13.48	10.68	1.18	–5.40
Invesco S&P 500 Low Volatility ETF SPLV	12.13	11.07	1.03	–5.73
Foreign Developed Markets				
MSCI EAFE	8.42	14.31	0.59	–10.37
iShares MSCI EAFE Min Vol Factor ETF EFAV	7.67	10.55	0.69	–6.95
Emerging Markets				
MSCI Emerging Markets	6.92	16.55	0.45	–13.08
iShares MSCI Emrg Mkts Min Vol Factor ETF EEMV	5.30	12.51	0.42	–9.55

Source: Morningstar Direct. Data from January 2012 through May 2021.

Low Risk Doesn't Mean No Risk

Long-term averages indicate these strategies have lived up to their billing. However, they are far from perfect, and long-term averages may hide short periods of undesirable performance that investors should expect but would no doubt prefer to avoid.

One such instance occurred during the pandemic sell-off. Low-volatility strategies should have provided some downside protection, but Invesco S&P 500 Low Volatility ETF (SPLV) and USMV did not. The S&P 500 declined by 33.8 percentage points between Feb. 6 and March 23, 2020. USMV shed 33.2 percentage points, while SPLV lost more than 36. Both failed to deliver when it mattered most.

Even when they successfully provide downside protection, low-volatility funds are still subject to substantial declines. For example, the S&P 500 lost 51% between October 2007 and February 2009, as the financial crisis put the global economy on ice. The index that USMV tracks declined 41% over that same period. It outperformed the market but still incurred a fairly sizable drawdown.

Circumstances like that are a reminder that USMV, SPLV, and their overseas counterparts are still fully invested in stocks. By design, they take some risk off the table, but they are still quite volatile .... Exhibit 2 shows the standard deviations of the S&P 500, USMV, SPLV, and Vanguard Total Bond Market ETF (BND) over the past 10 years. USMV and SPLV had lower standard deviations than the market, but they were nearer to the market than a broad basket of investment-grade bonds.

Exhibit 2 No Substitute for Bonds

ETF/Index	Total Return (%)	Std Dev (%)	Sharpe Ratio	Max Draw-down (%)	Correlation with S&P 500
S&P 500	16.01	13.13	1.15	–19.60	1.00
iShares MSCI USA Min Vol Factor ETF USMV	13.48	10.68	1.18	–19.08	0.89
Invesco S&P 500 Low Volatility ETF SPLV	12.13	11.07	1.03	–21.38	0.81
Vanguard Total Bond Market ETF BND	2.94	3.16	0.74	–3.83	-0.03

Source: Morningstar Direct. Data from January 2012 through May 2021.

Rare Events With Big Consequences

Low-volatility ETFs hummed along as expected for years leading up to the coronavirus pandemic. Periods of outperformance aligned with market dips, while lackluster returns were tethered to strong rallies.

Long-term total returns were almost too good to be true. USMV, EFAV, and EEMV earned better total returns than their respective markets from their launch in October 2011 through March 2020. USMV beat the S&P 500 by 11 basis points per year, EEMV outperformed the MSCI Emerging Markets Index by 61 basis points annually, and EFAV led the MSCI EAFE Index by a whopping 1.9 percentage points annualized. The advantage was greater overseas because foreign markets were volatile and performed poorly by historical standards.

But eventually, all good things come to an end. Starting in April 2020, most global markets went on a tear. The S&P 500 turned in one of its strongest 12-month total returns over the ensuing year. Low-volatility ETFs, with their preference for sluggish stocks, were left in the dust.

The fallout has been nothing short of incredible. USMV, EFAV, and EEMV underperformed their respective markets so severely that their long-term outperformance reversed to a deficit. USMV was among the hardest hit.

Over the 14 months from April 2020 through May 2021, its 11-basis-point-per-year advantage decayed to a 2.2-percentage-point annualized performance shortfall.

The relative growth chart in Exhibit 3 illustrates their tremendous fall from grace. It plots the growth of four low-volatility ETFs relative to their respective markets. An upward-sloping line indicates an ETF is beating its market, while a downward slope represents underperformance. All four experienced modest episodes of over- and underperformance during their first eight years.

Exhibit 3 Right Tail Risk Has Stung Low Volatility ETFs

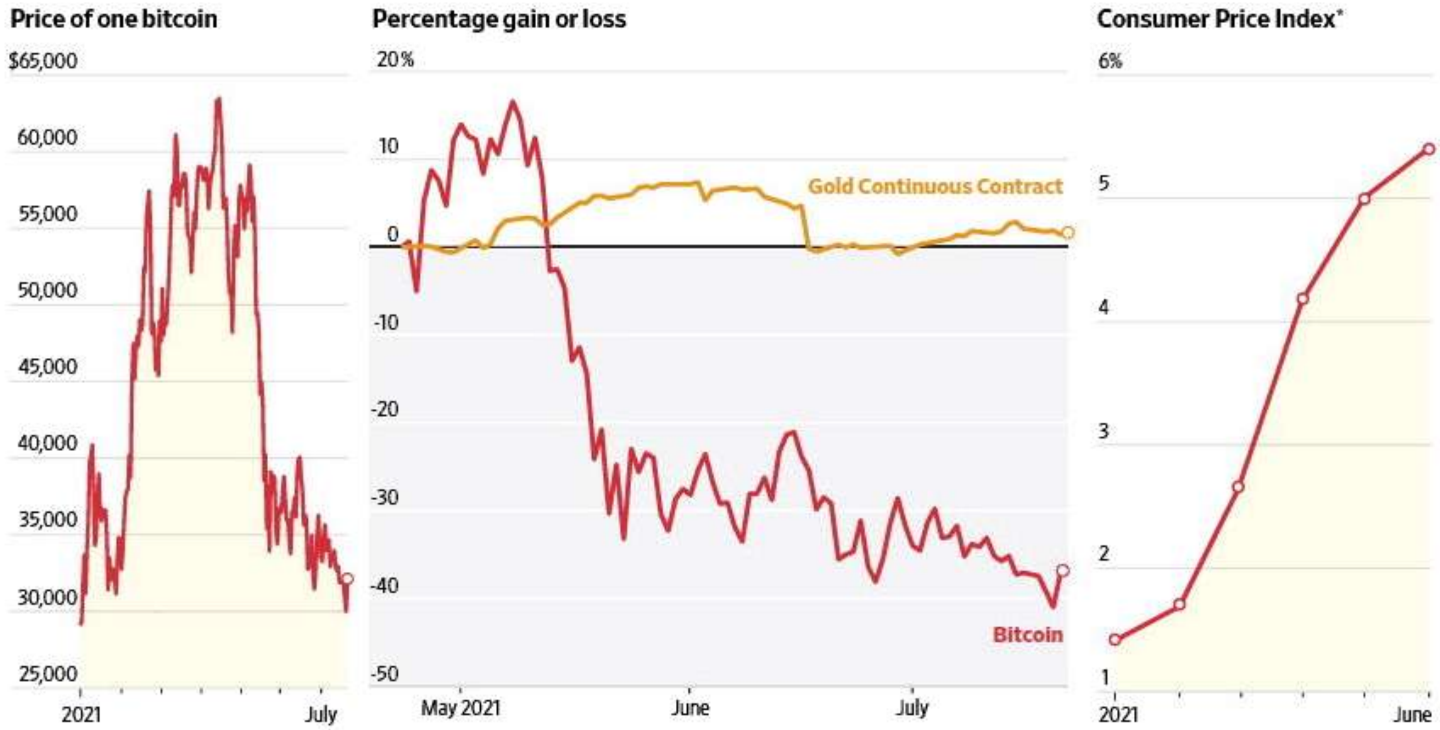
Source: Morningstar Direct and author's calculations. Data from October 2011 through May 2021.

All Is Not Lost

There is still a lot to like about low-volatility strategies, so long as expectations are understood and they are used with a long-term perspective in mind. The long-term risk-adjusted performance of these strategies is where they shine brightest and underpin USMV, EFAV, and EEMV's Silver ratings.

Risk and return are often linked in financial markets, but the connection between the two isn't defined by rigid law. These strategies should continue to eliminate a decent chunk of risk from the market without sacrificing too much return. Investors will have to deal with lagging when the market is doing well. That's the price for cutting back on risk.

From the WSJ on 7/23:



*Percentage change from a year ago
Sources: CoinDesk (bitcoin); FactSet (gold); Labor Department via St. Louis Fed (Consumer Price Index)

Bitcoin's Sharp Drop Undercuts Its Position as Inflation Hedge

BY PAUL VIGNA

Bitcoin's steep selloff is undercutting the argument made by the digital currency's proponents that it is an inflation hedge.

The original cryptocurrency has lost about half of its value since mid-April, fizzling after a spectacular rally that saw it surge above $60,000 from around $7,000 at the start of 2020. It traded Thursday afternoon at $32,256 and got a small boost after Tesla's Elon Musk said he has personal holdings of the crypto-currency, as does his space company SpaceX.

Bitcoin's supporters for years have touted it as an inflation hedge like gold, mainly because the bitcoin network has a set limit on the number of units that can be created: 21 million.

Their argument hadn't previously been tested, however, because inflation has largely been under the Federal Reserve's 2% target since bitcoin's 2009 launch.

Now for the first time in years, shortages of semiconductors, lumber and workers are putting pressure on consumer prices, sparking worries about inflation. At the same time, governments and central banks have been forced to spend trillions to prop up their economies, potentially sapping the purchasing power of their currencies.

The consumer-price index rose to 5.4% in June, its fastest pacein13years. And inflation measures in 49 countries have all been rising since the beginning of the year, according to the Center for Financial Stability, a New York based nonprofit think tank.

Bitcoin is going in the other direction. The digital currency has fallen in five of the past eight days and is down 6.7% in July, extending its months long selloff. It is now up 11% in 2021.

“Bitcoin’s price swings seem to be largely disconnected from macroeconomic fundamentals, including inflation,” said Eswar Prasad, a professor of trade policy at Cornell University who has written extensively about currencies. “At the moment it is hard to see people buying bitcoin as an inflation hedge.”

Other markets are also bucking traditional patterns during inflationary periods. Gold is down 4.8% this year and 12% from August’s record. Government-bond yields have declined in recent weeks as well, suggesting investors are more concerned about slowing economic growth prospects than a surge in inflation.

Many investors have largely dismissed the gains in inflation, seeing them as skewed by short-term supply disruptions related to the reopening of the economy. Federal Reserve Chairman Jerome Powell and other policy makers have also maintained that they expect such gains to be transitory.

In bitcoin’s case, scarcity itself isn’t a stable source of value, Mr. Prasad said. Bitcoin, in fact, is more sensitive to regulatory changes and tweets from influential users than it is from inflation, he said.

“It’s a good asset if gotten at the right time as with any speculative boom,” Mr. Prasad said.

Many investors agree that speculation still appears to be the main driver of bitcoin’s price—people buy cryptocurrency because they believe they can sell it at a higher price in dollars later.

“It’s just like buying a lottery ticket,” said Leonard Kostovetsky, an assistant professor of economics at Boston College Carroll School of Management, of bitcoin. “Inflation is probably there for some people, but it’s way down the list” of reasons to buy.

The speculative drive can be seen in the volume of derivatives trading, in which traders aren’t taking physical possession of the underlying asset but are instead just betting on price.

The volume of trading in the crypto derivatives market is anywhere from five to 20 times higher than the volume of spot trading on a given day, a study from Carnegie Mellon University’s CyLab research group said.

The volumes are so large that the moves in the derivatives market to a large extent have driven the overall price action, the study concluded. ...

From Morningstar:

Liquid Alternatives Funds: Is There Any Hope?

Considering the future of a fund-industry flop.

John Rekenthaler
Jul 22, 2021

Square One

Let's define terms. "Liquid alternatives" funds are publicly available investments, typically mutual funds and exchange-traded funds. They are "liquid" because they may be traded more frequently than their forebearers, hedge funds, and they are "alternative" because they invest atypically, acting like neither stocks nor bonds.

These are the seven liquid alternatives Morningstar Categories:

- Equity Market Neutral
- Event Driven (As shown below, we do utilize BILPX for a client focused on Income/Capital Preservation.)
- Macro Trading
- Multistrategy
- Options Trading
- Relative Value Arbitrage
- Systematic Trend

Almost all liquid alternatives funds are new, created after the 2008 global financial crisis. They were, quite literally, an afterthought--a reaction to the stock market's tumble. The pitch: These funds would protect everyday investors' portfolios, just as hedge funds did for institutions and wealthy individuals.

Protect they did--from investment profits. During the 2010s, liquid alternatives funds averaged an annualized gain of 1.66%, which placed them behind every fund category save for a few specialty groups, such as energy, precious metals, and Latin American stock funds, and three flavors of short-term bond funds. The results weren't disastrous, but neither did they justify such funds' existence.

The market environment provides no excuse. True, the stock-market boom hurt the relative performance for liquid alternatives. But relative returns are not the issue. That a hedge lagged during a bull market is both understandable and acceptable. The concern lies when the hedged investment trails high-quality bonds, as has been the case with liquid alternatives funds. In that case, why bother with trickery? You could just hold Treasuries instead.

The Performance Problem

Liquid alternative funds can't ride investment tailwinds. To use the vernacular, stocks and bonds have betas. (Textbooks define beta as an investment statistic, but in practice investment professionals generally use the word to mean "something that possesses expected returns.") Buy a basket of stocks, and over time you should make money; ditto for bonds. Profiting from betas requires no investment skill.

In contrast, liquid alternatives funds require insight. Take equity market-neutral funds. For each long stock, a market-neutral fund holds a corresponding short position. The betas cancel each other out. The fund's expected return is therefore 1) the interest collected from the portfolio's cash 2) minus expenses. If the market-neutral fund is to exceed this distressingly low hurdle, it must either cheat with its hedges, or its portfolio manager must make more good decisions than bad.

The same principle applies to other liquid alternatives categories. Event-driven and relative value/arbitrage funds buy and sell stocks, while macro trading, options trading, and systematic trend funds buy other asset classes. Either way, as with market-neutral funds, such funds play a zero-sum game. They can't succeed unless other investors lose. That is, they thrive only if their managers outdo the averages.

From the Report

A recent Morningstar publication, "2021 Global Liquid Alternatives Landscape," by Erol Alitovski, Matias Mottola, Francesco Paganelli, and Simon Scott, highlights several other difficulties. (If you click on the link, don't be dismayed. Once you answer those few questions, the paper will immediately be sent.)

1) *Lineup churn*. If fund companies aren't serious about liquid alternatives funds, then investors probably won't be, either. And fund companies have not been serious. Of the 453 liquid alternatives funds that have been launched since 2009, only 153 exist today. That makes for a 34% survival rate over 12.5 years. Liquid alternatives are the fund industry's mayflies.

2) *Complexity*. The instability comes from both directions. One reason fund companies have shuttered so many liquid alternatives funds is because their investors have been fickle. Liquid alternatives are hard to own. The elaborateness of their strategies makes them unpredictable, which tends to upset shareholders. Losing money is one thing, but losing money unexpectedly, without knowing why, is quite another.

3) *Constraints*. Liquid alternatives funds have been marketed as hedge funds for the masses. That promise has backfired, twice. First, hedge funds have disappointed since liquid alternatives were launched, with the 2010s described as that industry's "lost decade." Second, there is a catch to offering that extra liquidity. Some hedge fund investment strategies cannot be used by their publicly traded cousins. Liquid alternatives funds emulate hedge funds, but they are not perfect matches.

4) *Fees*. Fortunately, liquid alternatives funds usually cost considerably less than hedge funds. That is a benefit. However, they are costly by mutual fund standards, carrying a median expense ratio of 1.66%. Yes, the same figure as their net annualized return. For each dollar that shareholders have earned, the fund company collects a dollar for itself. A 50/50 split. What could be fairer?

Looking Forward

None of this sounds encouraging. Nor should it. Implicitly, liquid alternatives funds contradict passive investing. Indexers maintain that shareholders should avoid the temptation of chasing manager "alphas," opting instead to buy dirt-cheap betas. Without putting the matter quite so directly, liquid alternatives funds argue the opposite. Pay more, forgo beta, and pocket those manager alphas.

History has very firmly supported the indexers' side of that argument.

Nevertheless, there are three current reasons for considering liquid alternatives funds, despite their drawbacks:

1) *The need for an equity hedge has increased*. Better to protect against a stock-market decline when equity valuations are at record levels than when prices are relatively modest. When liquid alternatives funds came to the marketplace, hedges weren't much needed. Today, they are. Of course, as previously mentioned, that doesn't mean that liquid alternatives funds are *the* correct hedge. But at least their function is required. (That should depend on your Risk Profile.)

2) *The competition has softened*. Ten-year Treasuries yielded 2.5% in January 2009, 3% five years later, and 1.3% today. Cash, of course, pays just about nothing. Admittedly, choosing a liquid alternatives fund over such assets brings additional risk, but it is also likely, over a full market cycle, to bring at least somewhat higher returns.

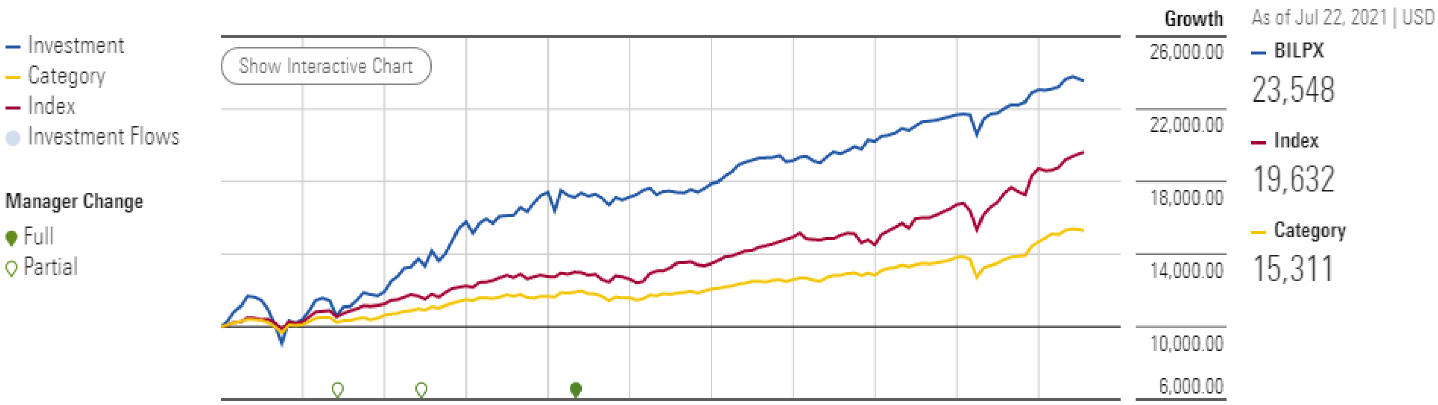
3) *The funds have longer track records now*. Forecasting future winners is a perilous endeavor. Nevertheless, the task does become easier after the evidence accumulates, which is now the case for liquid alternatives funds.

A decade ago, very few liquid alternatives funds possessed five-year track records. Now, 46 funds have 10-year records. It's not a huge number, but enough to justify some tentative conclusions. ...

BlackRock Event Driven Equity Instl BILPX ★★★★ Bronze

NAV / 1-Day Return	Total Assets	Adj. Expense Ratio	Expense Ratio	Fee Level	Longest Manager Tenure
9.94 / ↓0.20 %	8.2 Bil	1.330%	1.360%	Below Average	6.21 years
Category	**Alt Style Correlation / Relative Volatility**	**Min. Initial Investment**	**Status**	**TTM Yield**	**Turnover**
Event Driven	Low / Medium	2,000,000	Open	0.00%	63%

Growth of 10,000



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. 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 Mar 19, 2021

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 Mar 19, 2021

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.

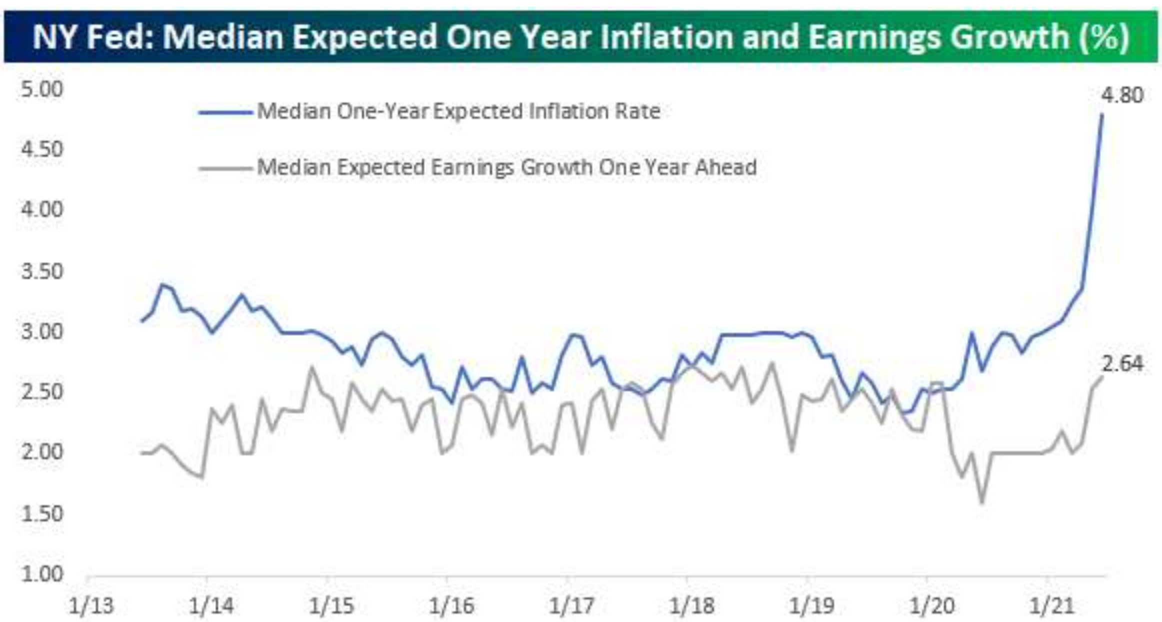
Despite a 5.1% loss in March 2020, the fund posted a solid 6.3% return in 2020. It quickly recovered the March losses, and by June it was positive for the year as deals continued to progress and deal spreads (the discount at which the acquisition company’s stock price trades to the announced purchase 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.

From Bespoke on 7/17:

The NY Fed released its monthly *Consumer Expectations* survey this week, and here again we saw another uptick in inflation expectations that dwarfs any prior readings. At this point, inflation expectations for the next year are running nearly twice that of one-year earnings growth expectations.



From Morningstar:

What's the Future for Bond and Stock Returns?

The outlook for bonds is clearer than that for stocks.

John Rekenthaler
Jul 15, 2021

Unreliable Bonds

The 70-year history of U.S. bond returns can be summarized in three words: bad, then good. From 1950 through the early 1980s, bonds (+2.27% per year) were best avoided. Since that time, they have been outstanding (+8.91% annualized). ... The discrepancy is stark.

Adjusting for inflation doesn't alter the conclusion--it exacerbates it. Not only was inflation higher in the first period than in the second, but the rate of inflation also exceeded the returns from long bonds, meaning that in real terms long bonds were losers. The longer investors held them, the poorer they became. ...

The compounded numbers tell the real story (so to speak). In 1950, placing $10,000 in long government bonds returned only $6,000 over the next three decades (-1.69% per year), after considering inflation. In contrast, those who invested $10,000 into those same securities in 1980 grew their stake to almost $90,000 during the next 40 years (+5.64% annualized). For one generation, long bonds meant penury. For the next, they meant prosperity.

Changing Attitudes

Bonds behaved differently because investors changed. In 1950, Americans needed little encouragement to buy high-quality bonds, which had profited during the Great Depression while stocks collapsed. Consequently, investors were willing to accept modest 2% yields on long bonds, even though inflation had averaged 5.5% through the previous decade. The deal wasn't attractive, but neither were equities, and cash paid 1%. Where else could you go?

By 1980, the appeal of bonds had faded. Thirty years of losing will do that to an asset class. Besides, stocks had begun to look better. Although equities had also struggled during the 1970s, they had outperformed bonds, just as they had done in the two previous decades. Investors therefore demanded more from bonds. No longer would they settle for 2% yields. Long bonds needed to offer more. When the 1970s ended, the yield on 30-year Treasury bonds was 10.3%.

The round trip is now complete: Bond yields are once again at 2%. Much of that decline is attributable to reduced inflation expectations. However, the payout on long bonds has fallen even further than those expectations. Projected inflation for the next 30 years, obtained by comparing the yield on conventional Treasuries to that of inflation-indexed securities, is 2.3%--higher than the 30-year bond yield. Once again, investors are likely to lose with long bonds.

Reliable Stocks

The stock market's history is quite different from that of bonds. With equities, there has been but a single regime. (Since the Great Depression, that is.) They performed well before 1980 (+10.85% per year), and then they performed well after 1980 (+11.81% annualized). Unlike with bonds, dividing equity returns into the two periods offers no new information.

Adjusting the calculation for inflation does create something of a gap, with the second period (+8.48%) outgaining the first (+6.56%) by an annualized 190 basis points, but the margin remains unremarkable. Whereas long bonds behaved dissimilarly during the two eras, the after-inflation gains for equities varied only moderately.

Such consistency can lead one to believe that stock returns are inevitable. With bonds, one period has looked very much unlike another period. Not so with stocks. For 70 years, equity returns have chugged along, reliably reverting to the mean after brief downturns. The lesson for investors has been not to worry about the hiccups, because soon enough stocks will resume their onward march.

The Pessimists

Many, of course, have argued otherwise, stating that although stocks had previously performed well, their jig was up. The corpses of such prognosticators are littered on the street. (Figuratively, of course. Fortunately for stock-market strategists, making incorrect forecasts does not draw blood.) To date, none of their claims have come true:

1) *Low stock yields.* Once upon a time, market observers maintained that the stock-dividend rate should exceed Treasury yields to compensate for equities' higher risk. When that line was at last crossed in 1959, they warned that stocks had become overpriced. Apparently not.

2) *High CAPE ratios.* Robert Shiller's cyclically adjusted price/earnings ratio attempts to put current stock-market valuations into context. When he launched the measure in 1996, Shiller hypothesized that a lofty CAPE ratio implied reduced future stock returns, while a depressed ratio would likely lead to strong results. However, with only brief exceptions, the CAPE ratio has exceeded its historic norm ever since Shiller's introduction. The stock market has not noticed.

3) *Federal Reserve manipulation.* For decades, critics have claimed that the Federal Reserve's interventionalist tactics have artificially propped up stock prices, which at some point would lead to a day of reckoning when the Fed's house of cards came tumbling down. So far, the house remains intact. Such failures have led me to distrust predictions of future stock-market woes. Nor, as previously indicated, can I find evidence of when stocks appear to have been over- or underpriced, as occurred with the history of bonds.

4) *The New Normal.* Rare is the investment expression that spawns a television show (a sitcom, no less.) The term invented by Pimco's Bill Gross to describe the investment markets after the 2008 global financial crisis did just that. However, it was more memorable than accurate. When Gross coined the phrase, he explained that both bond and stock returns would hover near 3%. The latter, obviously, has not occurred.

Wrapping Up

Bond investors have accepted lower future performance. They will not receive what bonds have returned over the past 40 years and surely must know that. The evidence is less forthcoming with stocks. For that reason, one cannot say that equities have run their course. However, it must also be granted, if bond investors have become willing to settle for less, so too may have equity shareholders. The proof is lacking, but the suspicion remains.

John Rekenthaler (john.rekenthaler@morningstar.com) 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.

From July 8th's WSJ:

Small-Caps to Ride Earnings Wave

BY KAREN LANGLEY

Small-capitalization stocks have been on a tear since last fall, and some investors expect them to keep booming.

The **Russell 2000** index of small-cap stocks ended June with its ninth consecutive month of gains, its longest monthly winning streak since at least December 1986, according to Dow Jones Market Data.

The index has advanced 49% since the end of September 2020, when promising Covid-19 vaccine trials inspired confidence that the economic future was bright. The **S& P 500** benchmark of large-cap U.S. companies has risen 30% during that time. ...

The small-cap index includes the same business sectors as the S& P 500, but is weighted more heavily toward several segments that tend to be sensitive to the state of the economy, such as financial and industrial companies, according to data from Refinitiv.

As the U.S. economy continues its recovery, analysts are forecasting a dramatic revival in the profits of smaller companies. Analysts expect companies in the Russell 2000 to report their earnings have more than tripled in the just-ended second quarter from a year earlier, according to Refinitiv.

Due to pandemic shutdowns, many companies struggled in last year's second quarter. S& P 500 earnings, by comparison, are projected to have grown about 65%.

So far in 2021, small-caps are up 14%, trailing the S& P 500's 16% gain. They have lagged behind the large-cap index in recent months. ...

The outsize earnings growth by small-caps is expected to continue throughout the year, with Russell 2000 profits projected to more than quadruple from a year earlier in the third quarter, while S&P 500 earnings rise about 25%.

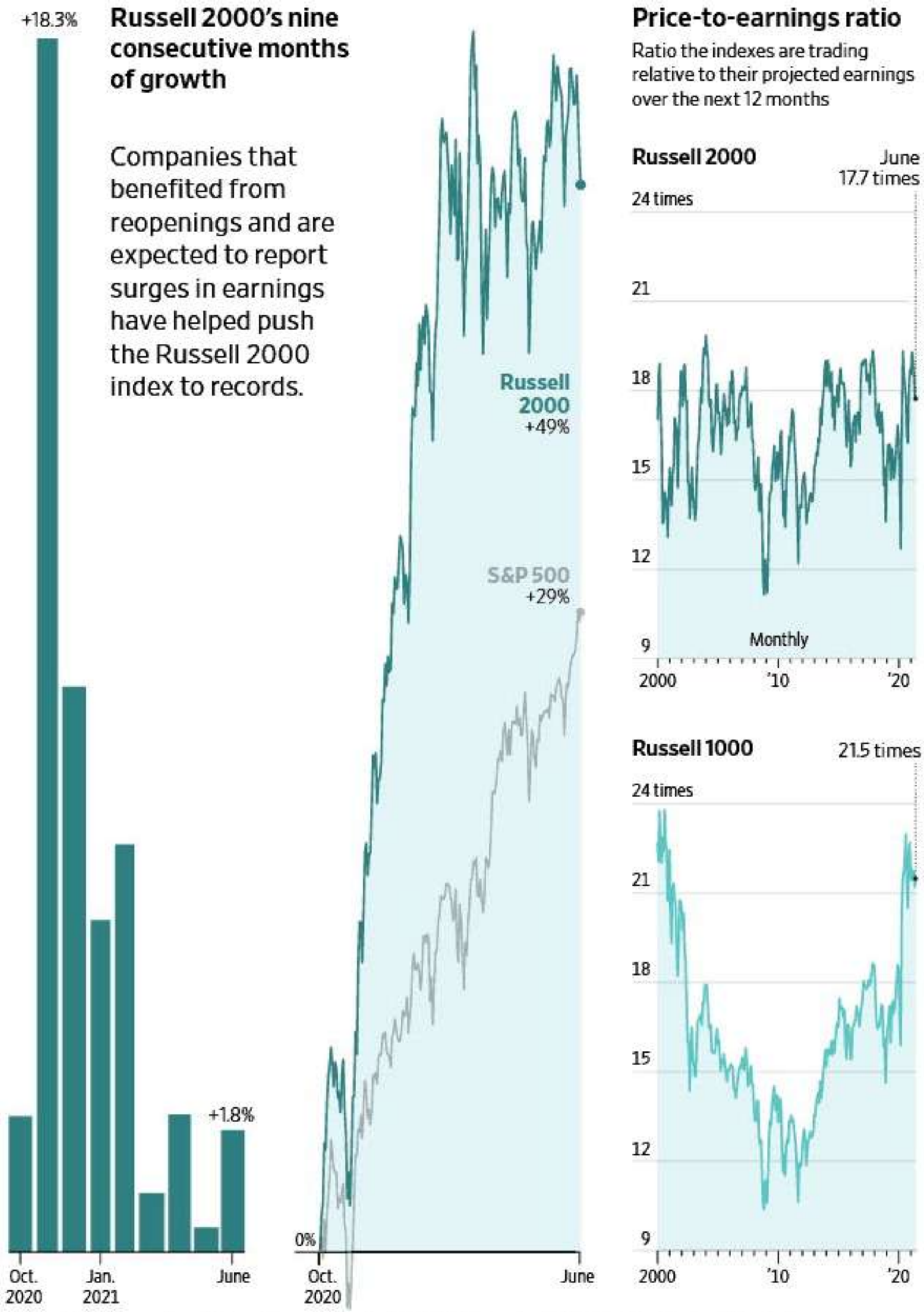
Believers in a further advance for small-caps point to how the group's valuations compare with those of large-cap stocks. ...

The Russell 2000 traded at the end of June at 17.7 times its projected earnings over the next 12 months, compared with 21.5 times for the Russell 1000 large-cap index, according to BofA Global Research. ...

Analysts at RBC Capital Markets said in a recent research report that small-cap stocks have tended to outperform large-caps when economic growth is above its long-term average. That is expected to be the case this year and next, but potentially not in 2023, they wrote. Bountiful government spending, effective Covid-19 vaccines and the fact that comparisons will be drawn against a period of severe slowdown fueled expectations for standout growth numbers—but ones that aren't expected to last in perpetuity.

Small-cap companies often have a less diversified range of business and more volatile earnings than their larger peers. Companies in the Russell 2000 index have an average market capitalization of $3.4 billion, compared with about $76 billion for companies in the S& P 500, according to data from the index providers.

"Small-caps being more sensitive to economic acceleration, as that slows down, I think the relative attractiveness of small-caps will subside a little bit," said David Joy, chief market strategist at Ameriprise Financial Inc.



Sources: FactSet (share-price and index performance, P/E ratios); BofA Global Research - U.S. Equity & Quant Strategy (P/E ratios)