

First Financial's Turn (Non-Traded REITs are a Red Flag)

For the 3rd time we were asked to take a look at a potential client's portfolio. We have previously shared what an Edward Jones Broker had done to a client and what a Wells Fargo Broker, to the best of our knowledge, is still doing to a client. In this case, the biggest red flag is a Non-traded REIT, representing 17.5% of the portfolio, assuming it is still worth what she paid for it. She, in this case is 77 years old, and the REIT isn't scheduled to "liquidate" until 2023.

November 3, 2017

Dear G.,

At your request we have analyzed your IRA and provided you with our recommendations:

%	Symbol	Type	Description	Factors (1)	Yield	Risk (2)
First Financial IRA						
11.6	AMLPM	ETF	Domestic MLPs		5.8%	2.4
17.5	.HSTIPXX		Domestic Non-Traded REIT			1.3
15.1	BALCX	OEF	Domestic 50-70% Lg Growth		0.9%	0.6
9.8	YACKX	OEF	Domestic Lg Blend		1.6%	1.0
17.5	JABCX	OEF	Domestic 50-70% Lg Growth		1.2%	0.6
10.3	LDLAX	OEF	Domestic Short-Term Bond		3.1%	0
2.8	PSHAX	OEF	Domestic Ultrashort Bond		1.4%	0
14.9	IBLLX	OEF	Domestic 50-70% Lg Growth		0.4%	0.6
0.6	Cash					0
Weighted Average:						0.9
HCM Recommendation						
40	QMNIX	OEF	Global Long/Short Equity-Lg Blend	V, M, Q	1.4%	0
10	GFMRX	OEF	Global Real Estate		2.7%	1.1
10	XSLV	ETF	Domestic Small Value	S, Q, LV	2.0%	0.8
10	ISCF	ETF	Foreign Small/Mid Blend	V, Q, M, S	2.1%	1.2
15	ANGIX	OEF	Domestic Multisector Bond		5.9%	0.8
15	GIFIX	OEF	Domestic Bank Loan		3.9%	0.4
Weighted Average:						0.5
Notes						
1	V=Value, M=Momentum, Q=Quality, S=Size, LV=Low Volatility					
2	Ratio of average historical Maximum Drawdowns to S&P 500 declines of at least 10%					

In the above chart, **Type** refers to Exchange Traded Fund (ETF) or Open-End Fund (OEF), often referred to as Mutual Funds. **Description** provides the Morningstar Category for each Fund when available. **Factors** and **Risk** are fully explained on our website: <http://www.hughescapitalmanagement.com/>

As noted on our site, Hughes Capital Management (HCM) "applies the academic findings of Behavioral Finance to the management of Individual Investment Accounts A factor is something that explains stock returns, ranging from Insider Buying and Value, to stock price Momentum. The concept of Factors has been

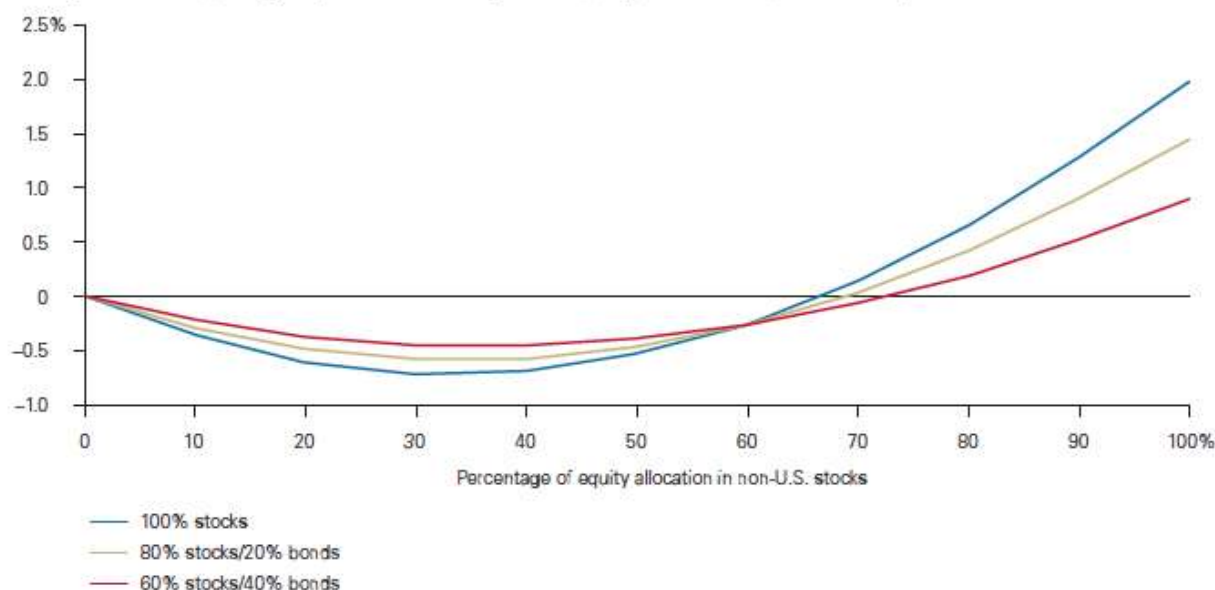
around since Eugene Fama (who won the Nobel Prize in Economics in 2013) and Ken French began developing statistical models to explain stock returns relative to the broader market. Since their initial work, more and more factors have been added, and just in the past few years the idea has exploded in popularity, with so called “Smart Beta” funds (another term for Factor based investing) sprouting up everywhere one looks. Yet despite the newfound popularity and hype for this investing approach, very few of these Factors withstand academic scrutiny." Five of the **Factors** which we consider compelling and apply to Funds we are recommending are shown in **Note 1**.

Again from our website, "Volatility creates Opportunity, but only if the investor has a sufficient Investment Horizon and can keep the inevitable fear during market declines in check. ... Instead of volatility, HCM uses maximum drawdown as its preferred measurement of risk." As described in **Note 2**, we calculate the Maximum Drawdown of each fund relative to the S&P 500 when it declines by at least 10%, since and including the Great Recession's Bear Market, which ended on March 9, 2009. The resulting ratios are then averaged. As we discussed on the phone, given your Risk Profile, our goal was to lower your portfolio's **Risk** to half, **0.5**, of that of the S&P 500.

Before discussing each fund, we need to note our second biggest concern, your portfolio's lack of diversification. From "Wells Fargo's Turn - 12/13/16", under Worth Sharing on our website: "As investing legend John Templeton once observed, **"The only investors who shouldn't diversify are those who are right 100% of the time."** The minimum allocation to International stocks that HCM recommends is 40% (now 30%). International stocks constitute nearly half of the most widely followed global benchmark, the Morgan Stanley Capital International All Country World Index (MSCI ACWI), and two thirds of the world's total market capitalization. ... Academics term this error **Home Bias**, which is defined by Investopedia as "the tendency for

Figure 3. Adding non-U.S. stocks has historically reduced the total volatility of a portfolio

Average annualized change in portfolio volatility when adding non-U.S. stocks to a U.S. portfolio



Notes: U.S. equities represented by MSCI USA Index; non-U.S. equities represented by MSCI World Index ex USA from 1970 through 1987 and MSCI All Country World Index ex USA thereafter. Bond data represented by Salomon High Grade Index from 1970 through 1972, Lehman Long-Term AA Corporate Index from 1973 through 1975, and Barclays U.S. Aggregate Bond Index thereafter. Data through December 31, 2013.

Sources: Vanguard, Thomson Reuters Datastream, and MSCI.

investors to invest in a large amount of domestic equities, despite the purported benefits of diversifying into foreign equities." From International Diversification, Part 2 - 9/10/17: "Our continuing recommendation of a 40% allocation to International Stocks for clients whose primary objective is Capital Appreciation and for whom we are buying individual stocks is at the high end of the range that has historically been most effective in reducing volatility. As noted by Jon Seed in "Passive" Investing: Theory and Practice in a Global Market, "While Vanguard recognizes that the diversification benefits of international equities are real, they suggest that anywhere between 20-40% is "adequate." Vanguard buttresses this conclusion by showing that most of the benefits of international equity diversification dissipates quickly."

Not only is there a complete lack of International Diversification, but your Domestic equity exposure is almost completely Large Growth. Over time, Small beats Large (Size Factor), especially when combined with the Value or Quality Factors, and Value beats Growth. Morningstar's John Rekenthaler from 9-05-17:

"In my experience, growth-stock managers are *optimists*. They believe that the U.S. is the greatest country in which to live, that now is the greatest of all times, and that their companies will do great things. They pay higher stock-price multiples for their purchases than do other investors, in exchange for getting something better. So, they must have faith; if they do not, they would cease to be growth-stock owners.

This faith leads to trust. Much more than value-stock managers, growth-style managers rely on what corporate executives tell them. (Frequently, when interviewing growth managers, I would ask them to discuss why they bought a stock, and they would respond by repeating back to me the company's public-relations message.) ... it does make them extroverts.

And yes, I would agree that growth-stock managers tend to be extravagant and impulsive. The first occurs by definition—they do indeed spend more! The second also follows quite directly from the premise. Growth-stock owners invest in the future; they pay high prices now, to receive a high payoff later. They purchase hopes and dreams. They have no choice but to be impulsive, in the sense of making decisions based on incomplete information, because that is what buying the future entails. The task is not for those who require precision.

It would be a stretch to call value managers pessimists, in the attempt to make the contrast between them and growth-stock buyers symmetrical. Pessimists don't buy stocks, for the most part. Rather, value-stock buyers are *skeptics*. They do believe that happy days will come again, thereby boosting the prices of their holdings, but they dampen their expectations. This is not necessarily the best of all possible worlds, and their companies are not necessarily great. Pretty good is enough.

Value managers invest looking backward, not forward. They do not know what the future will bring to their companies, but they do understand how similar investments have fared in the past. They are market historians, and are far, far likelier than growth-stock managers to follow the academic literature. (The next finance professor I meet who is a growth-stock investor will be my first.) Value investors are data-driven.

This means that they don't place much faith in corporate executives. Why would they? If a company has been well managed, and operates in an attractive industry, it almost certainly will cost more than a value manager is willing to pay. Value investors hold businesses that have broken their promises, or which are dragged down by occupying an unprofitable sector. Perhaps those companies' executives can offer useful guidance—but best not to take too much from them. Trust history's odds instead."

AMPLP - Your unrealized 26.3% loss in this benchmark ETF is actually less than half of its 55% Drawdown between 8/29/14 to 2/11/16. The S&P 500's last correction also ended on 2/11/16, but with a 13.3% Drawdown. Given the depressed valuations of mid-stream energy MLPs, the historical **Risk** ratio of 2.4 overstates the current risk. Our 2 newest clients are both focused on Capital Appreciation. We bought AMZA, an actively managed MLP ETF currently yielding 16.7%, for both of them, but at 2% of their portfolios, not 11.6%. We have added the S&P 500 (orange line) to Morningstar's chart for comparison:

Alerian MLP ETF AMLP | ★★★

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Quote **Chart** ETF Analysis Distributions Performance Ratings & Risk Portfolio Fees & Expenses Tax Ownership Filings

Last Price \$10.71	Day Change ↓ -0.03 -0.23%	NAV 10.73	Open Price 10.75	Day Range 10.69-10.77	52-Week Range 10.23-13.31	12-Mo. Yield 5.82%	Total Assets 9.73 bil USD	Expenses 1.42%
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As of Tue 10/31/2017 10:03 AM EST |USD

Intraday Indicative Value
\$10.71 ↓ -0.03 | -0.27%

Prem/Discount 0.04%	Volume 521809	Avg Vol. 9.3 mil	SEC Yield% 10.68	Bid/Ask/Spread 10.70/ 10.71/ 0.09%	Category Energy Limited Partnership
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As of Tue 10/31/2017 9:51 AM EST |USD



.HSTIPXX - This Non-Traded REIT, 17.5% of your portfolio, is our biggest concern. We have used Vanguard REIT ETF (VNQ), at \$34.1 billion in Total Assets the largest equity REIT ETF by far, to calculate a **Risk** ratio of 1.3. This actually understates the volatility of REITs compared to the S&P 500. While the S&P 500 has had 2 corrections (of -17.6% in '11 and -13.3% ending on 2/11/16 as noted) since its last Bear Market, REITs have suffered a Bear Market of -21.3% between 5/31 & 10/3/11, and 3 corrections: -17.6% from 5/21 to 9/5/13, -17.2% from 5/31 to 10/3/11, and -15.2% from 8/1 to 11/10/16.

Non-Traded REITs are by their nature illiquid and opaque. While this Texas REIT may be an exception, Non-Traded REITs have the reputation of being sold to the public at very high commission rates. While we have looked at its most recent 10-Q, a thorough examination is beyond the scope of this review. This "blind pool"

offering was suppose to be made "only to qualified investors who meet minimum suitability requirements, as well as standards determined by your financial advisor." Given your age and net worth you shouldn't have qualified, and, therefore, should be able to get out before next year if you want to press the issue. From the WSJ:

Basics on Nontraded REITs

By Peter Grant

May 23, 2017

Nontraded real-estate investment trusts are investment products targeted at small investors that have had a roller-coaster history in recent years. Here is a summary of how they work, why they have been controversial and the changes taking place in response to criticism.

What are nontraded REITs?

They are investment vehicles that raise money from small investors and use those funds to purchase office buildings, stores, hotels, warehouses and other commercial real estate. If all goes well, investors receive dividends from the income of those properties and profit when the REIT is liquidated, usually after a few years.

How are nontraded REITs different from traded REITs?

The main difference is that the shares of traded REITs are bought and sold on stock exchanges such as those of other public companies. Some investors like being insulated from stock market volatility.

When did nontraded REITs become popular?

They attracted tens of billions of dollars of investments in the early years of the economic recovery, partly because they offered high dividends in a low-interest-rate environment. But fundraising efforts have been hampered more recently by criticism and regulatory investigations.

Why the criticism?

More than five years ago the Securities and Exchange Commission and the Financial Industry Regulatory Authority increased their scrutiny of the industry because they believed nontraded REITs might not be disclosing risks and costs adequately. Some small investors weren't aware they were paying as much as 15% in upfront fees and that there was a chance they might not get all their principal back.

What was the upshot of that scrutiny?

Finra has adopted new rules designed to improve disclosure. As a result of these rules, most new nontraded REITs have adopted new structures.

How have nontraded REITs performed?

Some have returned only a fraction of investors' principal when they liquidated. But most of the returns have been respectable due partly to the rising value of commercial real estate over the past eight years. The average nontraded REIT has returned to investors 10.5% annually, including dividends, according to Green Street Advisors. But the average traded REIT has returned 13.7% during that same period, Green Street says.

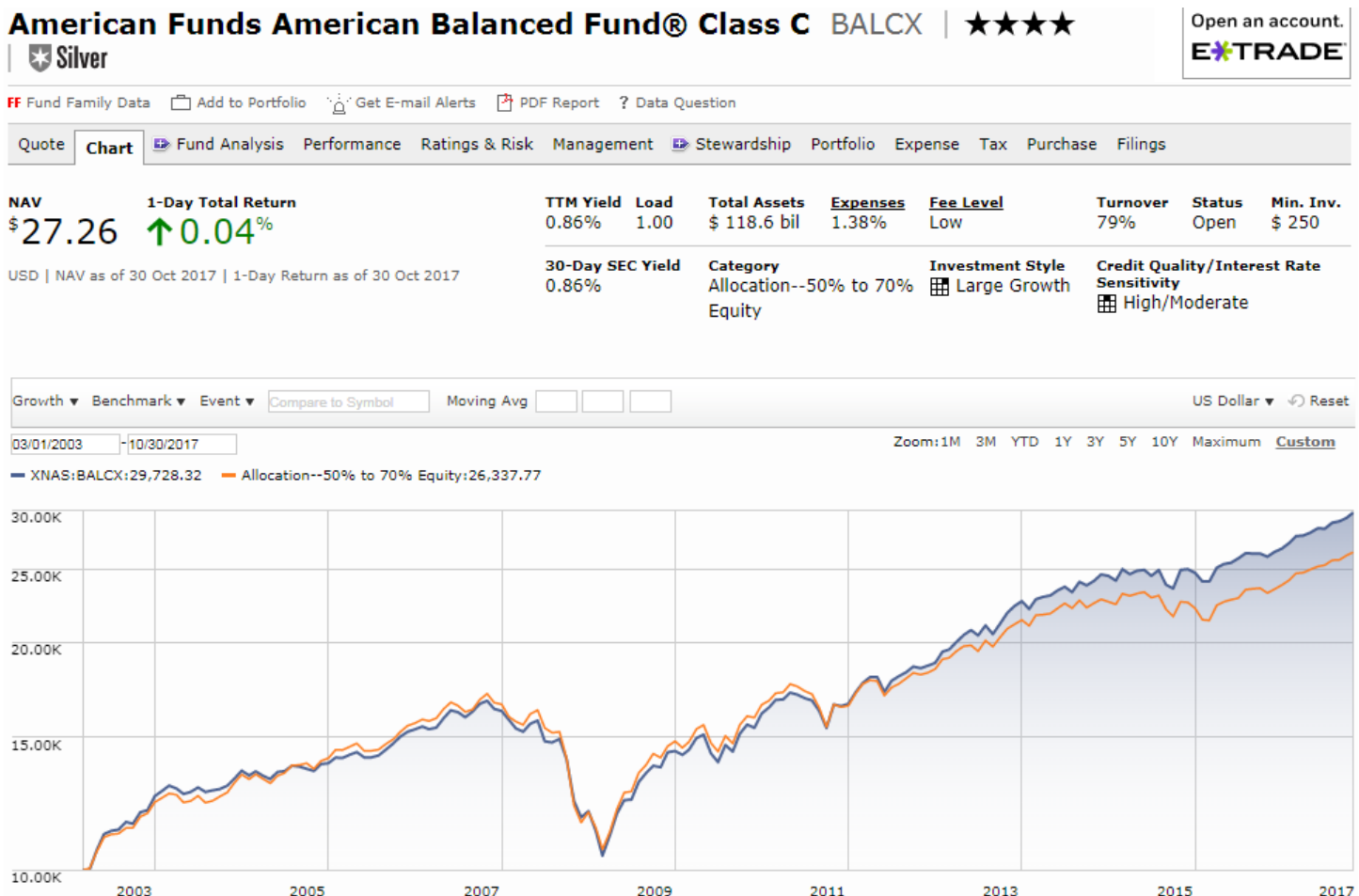
If you go to FINRA's website you will find the following warning:

Investor Alerts

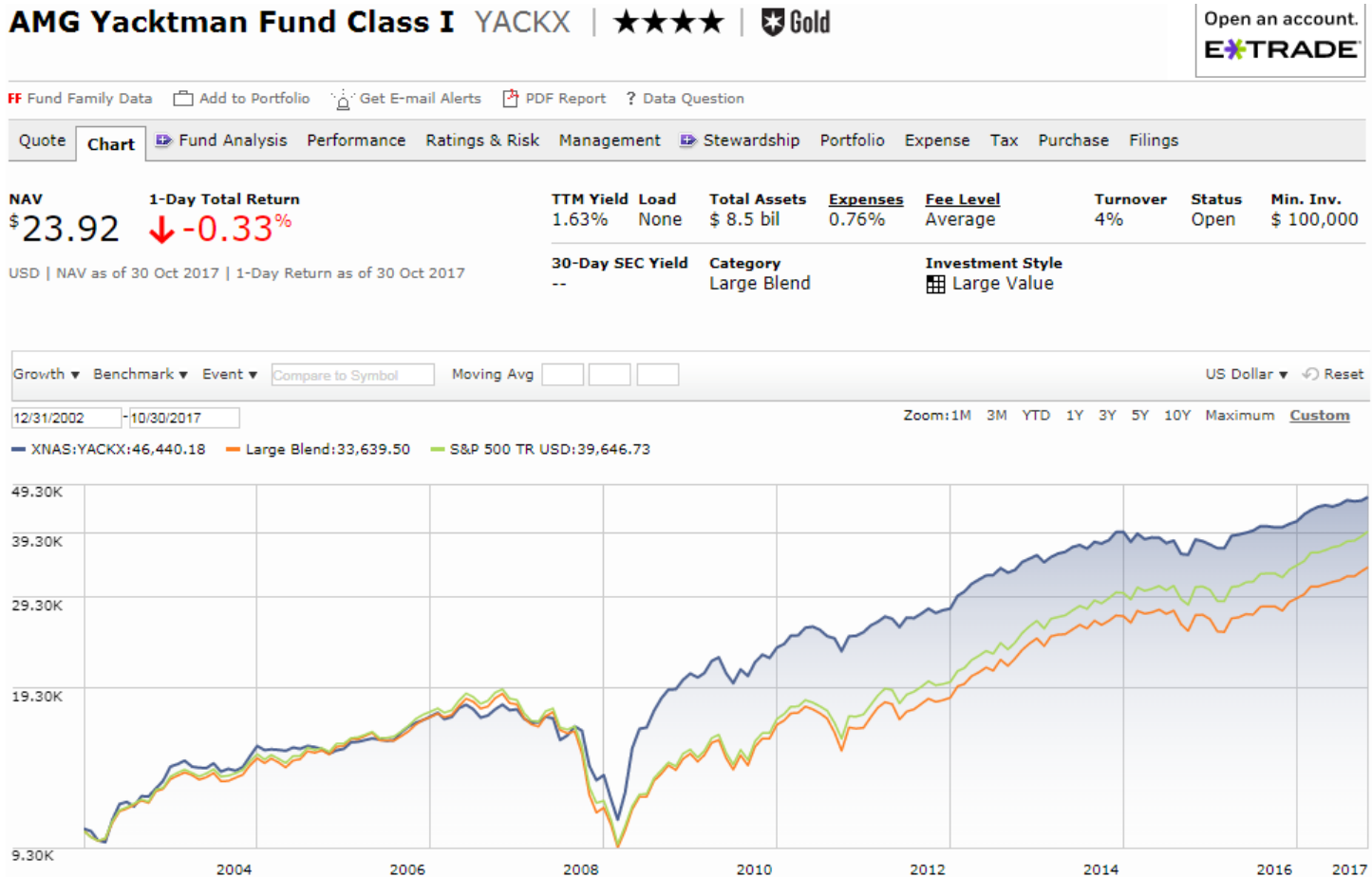
Public Non-Traded REITs—Perform a Careful Review Before Investing

During extended period of low interest rates, investors often seek products offering more attractive yields. One such product is the publicly registered non-exchange traded real estate investment trust (REIT) or "non-traded REIT" for short. While non-traded REITs and exchange-traded REITs share many features in common, they differ in several key respects. Most significantly, as the name implies, shares of non-traded REITs do not trade on a national securities exchange. For this reason, non-traded REITs are generally illiquid, often for periods of eight years or more. Early redemption of shares is often very limited, and fees associated with the sale of these products can be high and erode total return. Furthermore, the periodic distributions that help make these products so appealing can, in some cases, be heavily subsidized by borrowed funds and include a return of investor principal.

BALCX - Unless a Momentum ETF, our Factor based approach precludes both Large Cap and non-Quantitative Growth Funds. That said, American Funds have a good reputation and, as can be seen below, BALCX (blue line) has outperformed its peers (orange line). While we advise clients to never pay a load (sales commission), compared to what we have seen from a Wells Fargo and an Edward Jones Broker, 1% seems relatively benign.



YACKX - As can be seen from its Morningstar ratings (4 out of a potential 5 Stars based on past performance and the analyst's rating of Gold, Morningstar's highest) and chart, this is a solid OEF (blue line). It has outperformed both its peers (orange line) and the S&P 500 (green line). These are the Institutional shares, which HCM always makes available to its clients when possible. No Load and usually better expenses than other classes of shares for the same fund.



JABCX - More Large Growth, this time in a poorly rated OEF. The introduction to Morningstar's 1/9/17 analysis:

Janus Balanced retains a Neutral Morningstar Analyst Rating because of significant 2016 manager changes. ...

The prospects in the equity portion of the fund are not compelling. Pinto has managed all-equity fund Janus Growth & Income to subpar results in his nine-year tenure, and performance has also been so-so thus far in his 3.5-year stint at Janus Twenty JAVLX. Both funds are rated Neutral, and Janus Twenty will soon merge into Janus Forty JDCAX. Finally, Janus' merger with U.K.-based asset manager Henderson Global Investors (slated to close in 2017's second quarter) lends further uncertainty to the fund's prospects.

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Quote **Chart** Fund Analysis Performance Ratings & Risk Management Stewardship Portfolio Expense Tax Purchase Filings

NAV \$32.82	1-Day Total Return ↓ -0.06%	TTM Yield 1.23%	Load 1.00	Total Assets \$ 13.3 bil	Expenses 1.67%	Fee Level Below Average	Turnover 83%	Status Open	Min. Inv. \$ 2,500
USD NAV as of 30 Oct 2017 1-Day Return as of 30 Oct 2017		30-Day SEC Yield 0.71%	Category Allocation--50% to 70% Equity		Investment Style Large Growth	Credit Quality/Interest Rate Sensitivity Mid/Moderate			

Growth Benchmark Event Compare to Symbol Moving Avg US Dollar Reset

05/01/2005 - 10/30/2017 Zoom: 1M 3M YTD 1Y 3Y 5Y 10Y Maximum Custom



LDLAX - With rare exceptions, we don't recommend Bond Funds, particularly in a rising interest rate environment. The introduction to Morningstar's 3/31/17 analysis:

"Lord Abbett Short Duration Income has put up some of the best returns in its short-term bond Morningstar Category since its 2007 strategy shift, but it's not without risk. Despite its record and a drop in fees, the fund's credit-sensitive portfolio, significant exposure to structured securities, and rapid asset growth (including \$5 billion of net inflows in the trailing 12 months through February 2017) contribute to its Morningstar Analyst Rating of Neutral.

One of the positives for this fund is its relatively cheap fees, which have come down as assets have grown. Comanagers Robert Lee and Andrew O'Brien are also experienced. Lee joined the fund as a manager in 1998, O'Brien in 2007, and the two of them helped to oversee the strategy's transition in 2007 and 2008. Lord Abbett has also recently made a push to build out its analyst group, especially on the structured credit front, where this fund has a significant allocation.

For many years, the fund was run as a short-term government-bond fund, but in December 2007 it adopted a broader approach with a focus on credit-sensitive assets, including investment-grade and junk-rated corporate bonds, and asset-backed securities. As a result, the fund's allocations to high-yield bonds and structured credit, including commercial mortgage-backed securities and ABS, tend to be well above many of its short-term bond peers.

This turn toward yield came just as yields on riskier assets ballooned in the wake of the 2008 financial crisis. High-yield bonds and structured credit have performed well for much of the period following the crash. However, the fund has also suffered losses during credit market downdrafts. For example, a relatively large allocation to credit-sensitive bonds (including a typical double-digit stake in junk bonds and bank loans) derailed returns in the back half of 2015. The fund's 1.2% loss from June 2015 through February 2016 landed among the worst-performing decile of its peer group. Investors who have flocked to this fund in recent years should take note of these risks and be aware that the fund could struggle during longer periods of volatility."

Lord Abbett Short Duration Income Fund Class C **LDLAX** | ★★★★★

Neutral

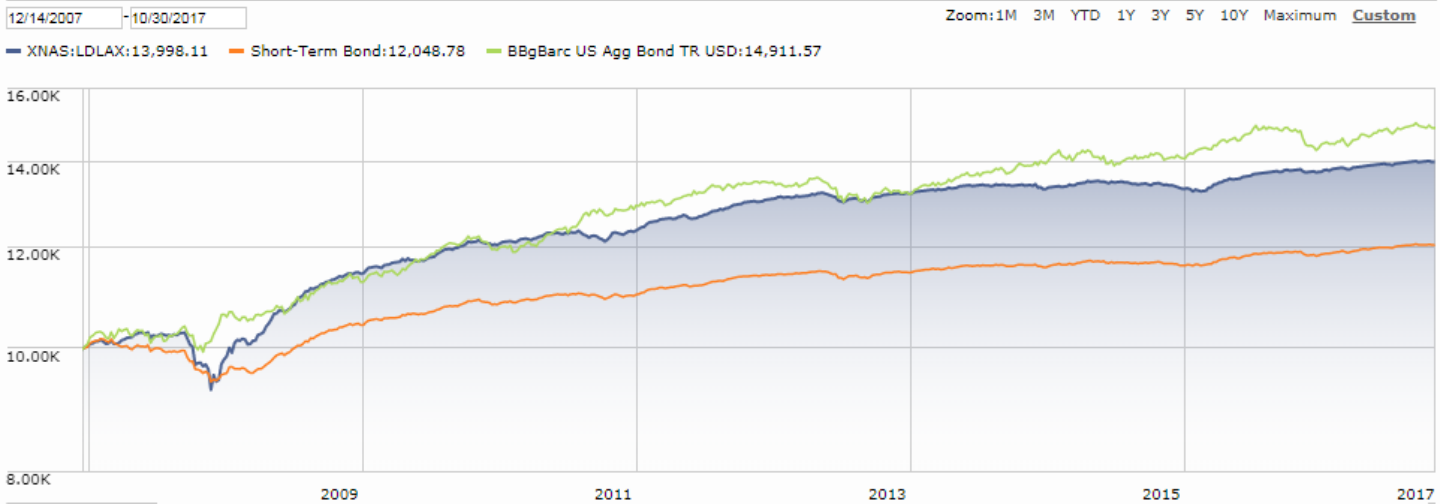
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Quote **Chart** Fund Analysis Performance Ratings & Risk Management Stewardship Portfolio Expense Tax Purchase Filings

NAV \$4.30	1-Day Total Return ↑0.01%	TTM Yield 3.13%	Load 1.00	Total Assets \$ 42.6 bil	Expenses 1.24%	Fee Level Below Average	Turnover 50%	Status Open	Min. Inv. \$ 1,500
USD NAV as of 30 Oct 2017 1-Day Return as of 30 Oct 2017		30-Day SEC Yield 1.44%	Category Short-Term Bond		Credit Quality/Interest Rate Sensitivity Mid/Limited				

Growth ▼ Benchmark ▼ Event ▼ Compare to Symbol Moving Avg [] [] [] US Dollar ▼ Reset



PSHAX - While this is a highly rated Bond OEF as shown below, it is impossible to justify paying a 2.25% Load to earn 1.4% a year.

PIMCO Short-Term Fund Class A PSHAX | ★★★★★ | Silver PIMCO

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Quote **Chart** Fund Analysis Performance Ratings & Risk Management Stewardship Portfolio Expense Tax Purchase Filings

NAV \$9.88	1-Day Total Return ↓ -0.10%	TTM Yield 1.43%	Load 2.25	Total Assets \$ 13.4 bil	Expenses 0.70%	Fee Level Average	Turnover 324%	Status Open	Min. Inv. \$ 1,000
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USD | NAV as of 30 Oct 2017 | 1-Day Return as of 30 Oct 2017

30-Day SEC Yield
1.21%

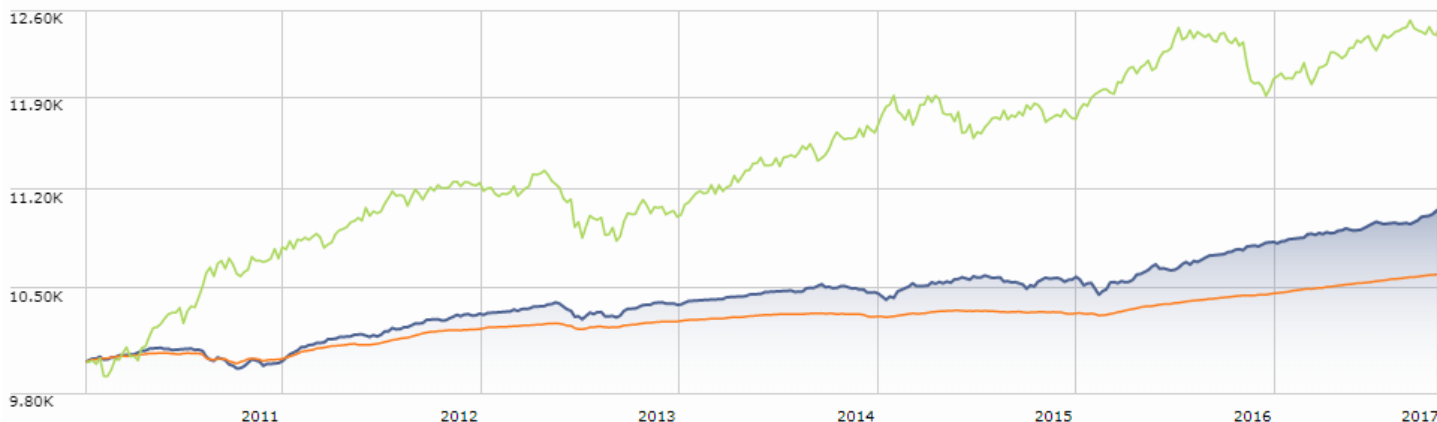
Category
Ultrashort Bond

Credit Quality/Interest Rate Sensitivity
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Growth Benchmark Event Compare to Symbol Moving Avg US Dollar Reset

01/01/2011 10/30/2017 Zoom: 1M 3M YTD 1Y 3Y 5Y 10Y Maximum Custom

■ XNAS:PSHAX:11,038.13 ■ Ultrashort Bond:10,595.04 ■ BBgBarc US Agg Bond TR USD:12,431.76



IBLLX - The last of your Large Growth OEFs. The introduction to Morningstar's 8/29/17 analysis:

Transamerica Multi-Managed Balanced features a different subadvisor on the equity and fixed-income sleeves: JPMorgan and Aegon Investment Management, respectively. The fund targets a 60/40 split between stocks and bonds, using strategies that attempt to add value through modest deviations from their respective benchmarks. As expected, the fund's results have largely been in line with the fund's custom benchmark, which consists of 60% S&P 500 and 40% Bloomberg Barclays U.S. Aggregate Bond indexes. However, the fund comes with an average price tag, raising the hurdle for a strategy with limited potential for outperformance. Furthermore, turnover within the underlying subadvisors teams warrants caution. The fund earns a Morningstar Analyst Rating of Neutral. ...

The underlying strategies are reasonable but fail to demonstrate an edge. Plus, both subadvisors have experienced recent manager turnover: Three managers have departed from JPMorgan's Disciplined Equity team since 2014, while two managers have left the Aegon team since 2015.

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Quote **Chart** Fund Analysis Performance Ratings & Risk Management Stewardship Portfolio Expense Tax Purchase Filings

NAV \$27.39	1-Day Total Return ↓ -0.07%	TTM Yield 0.44%	Load 1.00	Total Assets \$ 1.1 bil	Expenses 1.81%	Fee Level Average	Turnover 35%	Status Open	Min. Inv. \$ 1,000
USD NAV as of 30 Oct 2017 1-Day Return as of 30 Oct 2017		30-Day SEC Yield 0.23%	Category Allocation--50% to 70% Equity		Investment Style Large Growth	Credit Quality/Interest Rate Sensitivity Low/Moderate			



Our Recommended Portfolio

QMNX - We have added the S&P 500 (yellow line) to Morningstar's chart of our favorite OEF for reducing **Risk** and included their Analyst Report:

AQR's systematic approach to market-neutral investing.

by [Patricia Oey](#) 09/01/2017

AQR conducts rigorous research into the sources of long-term investment performance. AQR Equity Market Neutral seeks to generate returns via a systematic stock-selection process that harnesses the output of this research. This well-designed process has manifested itself in a strong, albeit short, track record. The fund earns an initial Morningstar Rating of Bronze.

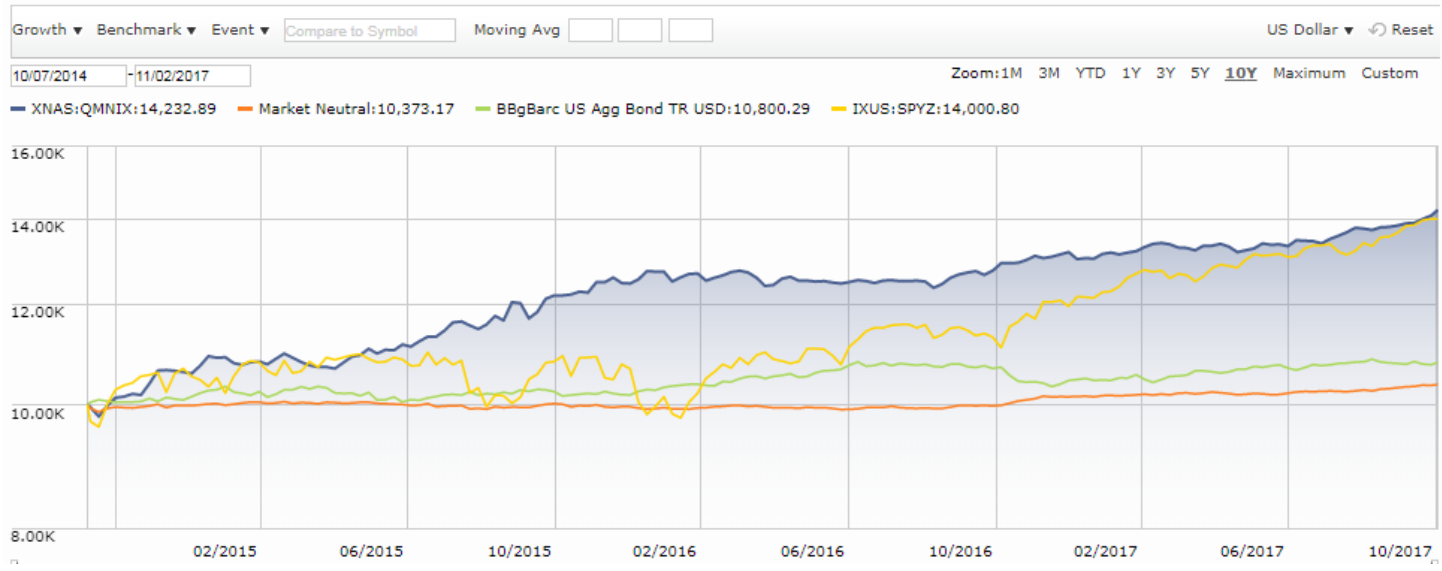
The stock-selection process employs a quantitative model to rank stocks from the MSCI World Index using well-established factors such as value and momentum and less quantifiable factors such as investor sentiment, which may use a metric (among others) such as change in percentage of shares shorted. High-ranking stocks are held in a long portfolio, low-ranking stocks are sold short, and the portfolio is structured to be market-neutral with no sector or country bets.

Since the fund's October 2014 inception through July 2017, its annualized gain of 10.8% trounced the market-neutral Morningstar Category average's 1.1% return. However, the fund's benchmark--three-month Treasuries--

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Quote **Chart** Fund Analysis Performance Ratings & Risk Management Stewardship Portfolio Expense Tax Purchase Filings

NAV \$12.92	1-Day Total Return ↑0.23%	TTM Yield 1.41%	Load None	Total Assets \$ 2.2 bil	Expenses 1.39%	Fee Level Average	Turnover 227%	Status Limited	Min. Inv. \$ 5.0 mil
USD NAV as of 02 Nov 2017 1-Day Return as of 02 Nov 2017		30-Day SEC Yield --	Category Market Neutral	Investment Style Large Blend	Credit Quality/Interest Rate Sensitivity --				



suggests that AQR's return expectations are much more modest relative to recent performance. Indeed, much of the fund's outperformance since its launch occurred in 2015, when it had a much smaller asset base and held more concentrated portfolios relative to current positioning. Outperformance has moderated, but the fund continues to outshine its category peers. As an indication of the fund's capacity constraints, AQR closed this fund to new investors in June 2017 when assets under management for this fund and AQR Long-Short Equity QLEIX, which employs the same stock-selection process, was \$5.9 billion.

Investors here face a few risks: The stock-selection model may become less effective as computing power and big data become more pervasive. Also, the fund uses derivatives, such as total return basket swaps and currency forwards, which come with counterparty and liquidity risks, especially during periods of market stress.

But overall, this fund is a solid liquid alternative option for those who have access to it.

Process Pillar: Positive | Patricia Oey 09/01/2017

This fund's research-driven systematic stock-selection process is based on AQR's extensive research on equity factors, which helps it earn a Positive Process rating.

Harnessing the research and experience of its 45-person global stock-selection team, Friedman and his group have built a systematic model that scores the 1,600 companies from the MSCI World Index using about 200 signals that can be grouped into one of the following categories: valuation, momentum, stability, earnings quality, investor sentiment, and management signaling. Well-established factors, such as value, are screened using common ratios such as price/earnings. Earnings quality may use a measure such as the change in accounts

receivable. Others are proprietary ideas based on in-house research and lesser-known data sources. Friedman's team is always testing new ideas, and a few new signals are added to the model every year.

The model ranks stocks using these signals relative to peers within and across industries and countries. High-ranking stocks are held long, while low-ranking stocks are shorted. These portfolios are structured to create a market-neutral portfolio with the help of an optimizer, which also seeks to minimize transaction costs while maintaining the portfolio's key traits. Trading is done in-house, where traders and portfolio managers work closely together to facilitate efficient execution.

The managers seek to create a very diversified long and short market-neutral portfolio, with about 800-900 holdings on each side. For exposure to these securities, the fund may take long or short positions in individual stocks or use a custom total return basket swap. The long portfolio tends to be higher-quality and lower-beta relative to the short portfolio, so the fund generally tilts toward the long portfolio, in dollar terms, to achieve a market-neutral positioning. As assets have grown, the fund's average portfolio market cap has trended higher. This bears monitoring, as it may affect future performance. Annual turnover in the past two years has averaged around 300%.

Derivatives add leverage to this portfolio. As of June 2017, it had a long exposure of 150% and short exposure of 130%, for a total gross exposure of 280%. The fund's leverage is adjusted in order to achieve a targeted volatility of 6%.

Leverage here is higher than most market-neutral mutual fund peers, which generally don't use derivatives. Leverage can be a source of risk; however, the fund's diversified portfolio (of hundreds of stocks) mitigates the impact of a single stock going the wrong way. The fund's counterparties for its derivative transactions are five large, global banks. There is always the risk that the banks may not be able to honor these derivative contract, particularly during periods of market stress.

Performance Pillar: Positive | Patricia Oey 09/01/2017

Strong absolute and risk-adjusted returns since inception earn this fund a Positive Performance rating.

From inception in October 2014 through July 2017, this fund has returned 10.8% annualized, a blistering performance for a market-neutral fund. The category average during the same period was 1.1%. In the first and second quarters of 2015, the fund generated healthy returns of 2.6% and 1.8%, respectively. But the fund hit it out of the park during the very volatile third quarter of 2015, when it returned 10.1% versus the category average of negative 0.3%. AQR attributed these returns to the performance of stocks with a strong momentum signal.

The fund's 2015 performance may be partly attributable to the fund's small asset base, which was only \$266 million by year-end. With a low asset base, the fund's portfolios were more concentrated, with fewer holdings, and a lower market-cap average, relative to the fund's current portfolios. Performance in 2017 through July was much more moderate, at 1.9%. With three-month Treasuries as a benchmark, it is likely that AQR does not expect to sustain the fund's early category-topping performance.

Since inception, the fund has remained slightly below its volatility target of 6.0%, with a Sharpe ratio of 1.8, which is significantly higher than the category average of 0.6. This Sharpe ratio may also revert to a lower long-term average.

People Pillar: Positive | Patricia Oey 09/01/2017

Of this fund's four managers, Jacques Friedman and Andrea Frazzini have been on the roster since the fund's inception in July 2013. Ronen Israel and Michele Aghassi were added in March 2016, when Lars Nielsen stepped down to become AQR's chief risk officer.

Friedman has been at AQR since its founding in 1998 and is currently head of the global stock-selection team, a group of 45 individuals who research and test potential new signals/factors for the stock-selection model. He is a named comanager for the 30 AQR strategies that employ this model (AQR has a total of 37 mutual funds). Prior to AQR, he developed quantitative stock-selection strategies at Goldman Sachs Asset Management, where he worked alongside Cliff Asness and the other AQR founders. The other three named managers all have Ph.D.s and have worked at AQR for about 10 years. Frazzini has only worked at AQR, Aghassi worked at DE Shaw as a quant analyst prior to grad school, and Israel worked at Quantitative Financial Strategies as a senior analyst from 1996 to 1999. Many of the senior members of the 45-person stock-selection team also have doctoral degrees and similar work experience.

Manager investment is reasonable; the portfolio managers invest in this fund and other AQR funds that employ the stock-selection model. Overall, this highly credentialed and experienced team earns the fund a Positive People rating.

Parent Pillar: Positive | 02/01/2017

AQR boasts a strong quantitative research culture, competitive fees, and high manager retention, warranting a Positive Parent Pillar rating. Quantitative research underpins all of the firm's strategies. It offers traditional equity and alternative strategies in both hedge fund and mutual fund formats. The firm puts a strong emphasis on infrastructure and efficient execution. Minor compliance gaffes over the past few years are not a cause for concern.

The leadership team has close ties to academia. In fact, 11 of the firm's 26 principals have doctorate degrees, and five are current or former professors. The principals own most of the firm, and the three remaining founding principals have final decision-making authority. Equity ownership and attractive compensation have promoted high manager retention (99% over the past five years).

While AQR does many things well, manager investment appears a little low. According to regulatory filings, only 2.7% of the firm's mutual fund assets are invested in funds where a manager has more than \$500,000 invested. The firm has kept fees generally reasonable with three quarters of its share classes featuring below-average fees for their distribution channels. Even though AQR has been attentive to capacity in the face of rapid asset growth in its liquid alternative products, capacity concerns may be an obstacle for return generation in the future.

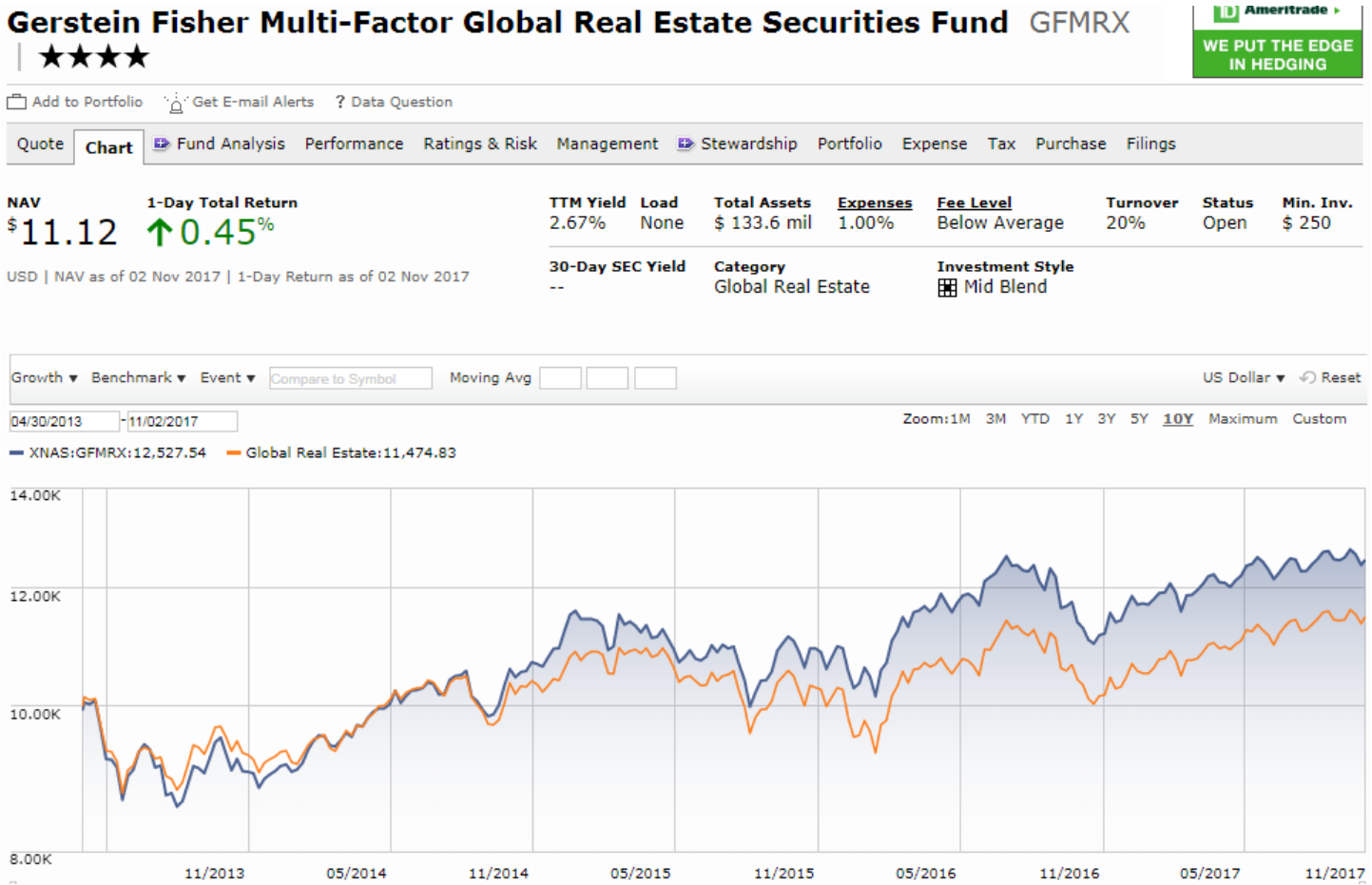
Price Pillar: Neutral | Patricia Oey 09/01/2017

On average, the fund's share classes are not cheap relative to similarly distributed peers. This fund earns a Neutral Price rating.

About 75% of the fund's assets are in the institutionally distributed shares. The I shares have an annual report net expense ratio of 1.28%, which carries an Average Morningstar Fee Level. The other share classes carry an Average or Above Average ranking.

In April 2017, AQR announced that it would close the fund to new investors as of July 1, 2017. Even though the fund's asset base of \$1.7 billion (as of June 2017) does not seem large, AQR Long-Short Equity QLEIX, which has \$4.2 billion, holds similar portfolios. In addition, the stock-selection model is used in some form across most of AQR's equity products.

GFMRX - This Quantitative, unleveraged OEF outperforms its Peers (orange line), and has a **Risk** ratio relative to the S&P 500 of 1.1, which is low for Real Estate Funds. While it remains our favorite Fund for Global Real Estate, we recommend only investing in it once you are out of your Non-Traded REIT.



In our "REITs & Rates - 11/21/16" Worth Sharing we wrote: "Whether your objective is Capital Appreciation or Income, Real Estate is an Asset Class we recommend, and publically traded REITs are the best way to gain exposure. However, valuations matter."

As shown in a recent report from Cohen & Steers, as of September 30, 2017 REITs had underperformed stocks over the past 5 Years, but outperformed over the past 20 Years.

Market Performance Review Total Annualized Returns
(% in US\$)

	5 Years	20 Years
	Total Return (Annualized)	Total Return (Annualized)
Real Estate Securities Indexes⁽¹⁾		
Global	6.7	7.4
United States	9.7	9.4
Broad Stock Indexes⁽²⁾		
Global	11.0	6.3
U.S.	14.2	7.4
Real Estate Securities Indexes vs. Broad Stock Indexes⁽³⁾		
Global	-4.3	+1.1
U.S.	-4.5	+2.2

Cumulative five-year relative returns of global and U.S. real estate versus stocks have been -30% and -36% respectively.

As a result, REITs are relatively undervalued when compared to stocks.

Equity Earnings Multiples Have Expanded to Near Cycle Highs versus Stable Multiples for Real Estate

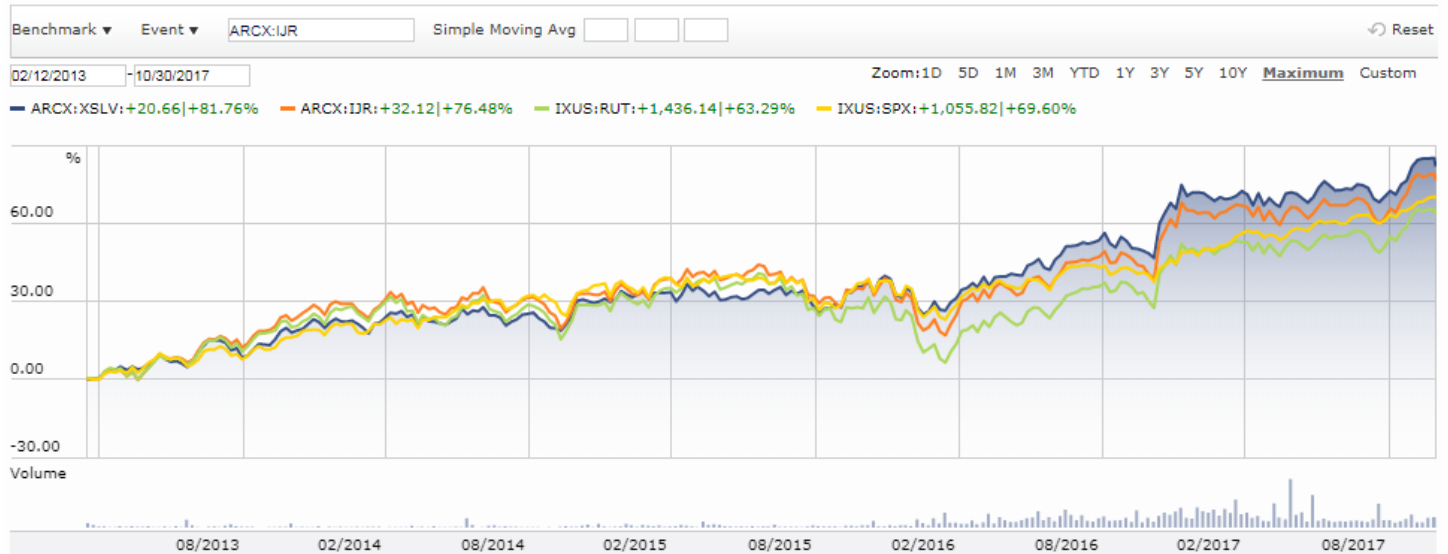


XSLV - We have previously shared with clients how the S&P SmallCap 600 (orange line) outperforms the commonly quoted Small Cap Russell 2000 (green line) benchmark due to its Quality Factor screening. Adding the Low Volatility Factor results in XSLV, which has a historical **Risk** ratio of **.8** to the S&P 500 based on Maximum Drawdown.

Add to Portfolio Get E-mail Alerts ? Data Question

Quote **Chart** ETF Analysis Distributions Performance Ratings & Risk Portfolio Fees & Expenses Tax Ownership Filings

Last Price \$45.93	Day Change ↓ -0.83 -1.77%	NAV 45.95	Open Price 46.68	Day Range 45.78-46.68	52-Week Range 36.89-47.00	12-Mo. Yield 1.95%	Total Assets 1.07 bil USD	Expenses 0.25%
As of Mon 10/30/2017 8:00 PM EST USD		Prem/Discount -0.05%		Volume 129044	Avg Vol. 156,757	SEC Yield% —	Bid/Ask/Spread 45.66/ 53.57/ 15.94%	Category Small Value
Intraday Indicative Value ⓘ \$45.95 ↓ -0.82 -1.74%		As of Mon 10/30/2017 4:29 PM EST USD						



Morningstar's Analyst Report, with our parenthetical notes in red:

Potent exposure to small stocks with low volatility.

by Alex Bryan, CFA

2/28/2017

Suitability

PowerShares S&P SmallCap Low Volatility ETF XSLV aggressively pursues small-cap stocks with low volatility. It should offer a smoother ride and better risk/reward profile than the S&P SmallCap 600 and most of its peers. But it can make concentrated industry bets at times and may require high turnover. And it has a limited record. These considerations limit its Morningstar Analyst Rating to Bronze.

Each quarter, the fund targets the 120 least volatile members of the S&P SmallCap 600 Index over the past 12 months and weights them by the inverse of their volatilities, so that the least volatile stocks receive the largest weightings in the portfolio. This strategy implicitly assumes that recent relative volatility will persist in the short term, which has historically held. It does not consider how stocks in the portfolio interact with each other.

Stocks that make the cut tend to enjoy more stable cash flows than the average small-cap firm. This should allow the fund to weather market downturns better than most of its peers but may cause it to lag in stronger

market environments. Because there are no limits on sector weightings, the fund can end up with large sector bets. But these tilts can shift over time. For example, at the end of January 2017, real estate stocks represented 16% of the portfolio, down from 26% a year earlier (20.8% as of 10/25/17).

While small-cap stocks tend to be more volatile than their larger counterparts, the performance advantage from tilting toward low-volatility stocks has historically been the largest among the smallest stocks. A big part of this edge has come from avoiding the riskiest small-cap stocks, which tend to trade at high valuations and have poor profitability, two characteristics that have historically been associated with lackluster performance.

So far, the fund's approach has worked well. From its inception in February 2013 through January 2017, the fund exhibited about 13% less volatility and about 24% less market sensitivity than its parent index. It also beat the benchmark by 203 basis points annualized during that time, largely because of more-favorable stock exposure in the financial-services industry (27.2% as of 10/25/17).

Fundamental View

Investors can always reduce risk by allocating a greater portion of their portfolios to less risky assets like cash or bonds. But this strategy will likely offer better returns than a market-cap-weighted stock/bond portfolio of comparable volatility, albeit with smaller diversification benefits.

Historically, less-volatile stocks have offered better risk-adjusted returns than their riskier counterparts, and this effect has tended to increase as market capitalization decreases. Robert Novy-Marx, a professor at the University of Rochester, attributes low-volatility stocks' attractive performance from 1968 to 2013 to their low average valuations and high profitability in his paper, "Understanding Defensive Equity." He argues that investors would be better off targeting stocks with value and profitability characteristics directly because there is no guarantee that low-volatility stocks will always have these characteristics. For example, although the fund is in the small-value Morningstar Category, it does not currently have a pronounced value tilt.

While low valuations and high profitability likely contributed to low-volatility stocks' attractive historical performance, there is probably more to the story. Many investors care about benchmark-relative returns, which may cause them to favor riskier stocks that have higher expected returns in bull markets, reducing their expected returns relative to their risk. Similarly, neglected lower-risk stocks can become undervalued relative to their risk. This is not necessarily the same as the traditional value effect, as many of these stocks often trade at comparable or even higher valuations than the market. Andrea Frazzini and Lasse Pedersen, two principals from AQR, develop this argument in their paper, "Betting Against Beta."

There may also be an element of behavior-induced mispricing behind the low-volatility effect, where investors may overpay for volatile stocks that offer a low probability of a high payoff. Much of the low-volatility performance benefit has come from simply avoiding the most volatile stocks (including many small biotech firms and junior miners), which tend to have low profitability and high valuations and may be mispriced.

The fund's narrow focus on recent volatility and frequent rebalancing allow it to effectively capture the low-volatility effect documented in the academic literature. But it can also lead to high turnover and introduce some indirect bets that investors may not anticipate. Turnover exceeded 50% in each of the past two years. In addition to large and fluid sector tilts, the fund's exposure to value stocks may change over time.

The fund has greater exposure to the financial-services (a plus in a moderately rising interest rate environment), utilities, and real estate sectors than the S&P SmallCap 600 Index, and less exposure to technology, consumer

cyclical, and healthcare stocks. While the fund often takes large sector bets, it effectively diversifies firm-specific risk. It tends to favor profitable firms with conservative asset growth, which can translate into attractive free cash flows **(this results from the S&P SmallCap 600's Quality Factor)**.

Portfolio Construction

The fund employs full replication to track the S&P SmallCap 600 Low Volatility Index. It earns a Positive Process rating because it offers pure exposure to stocks with low volatility, which have historically offered superior risk-adjusted performance and should continue to do so. Each quarter, S&P ranks the constituents in the S&P SmallCap 600 by their volatility over the past 12 months and selects the least volatile 120 for inclusion in the index. It then weights these constituents by the inverse of their volatility, so that less-volatile stocks receive larger weightings in the portfolio. This approach is laudably transparent, and it offers clean exposure to the low-volatility effect. But because there are no constraints on sector weightings or turnover, the fund can end up with large sector tilts that change over time. And because it does not consider valuations in its selection process, the fund can drift across the Morningstar Style Box. It currently nets out in small-blend territory but has exhibited a greater value tilt in the past. Unlike some of its peers, the fund does not consider correlations among stocks, which can affect how the portfolio behaves.

Fees

PowerShares charges a low 0.25% expense ratio for this offering, which is reasonable for this strategy and low relative to the small-value category, supporting the Positive Price Pillar rating. Over the trailing three years through January 2017, the fund lagged its benchmark by 31 basis points annualized, slightly more than the amount of its expense ratio. This was likely due to transaction costs.

Alternatives

SPDR SSGA US Small Cap Low Volatility ETF SMLV is the cheapest alternative (0.12% expense ratio). At the end of December 2016, this fund switched to the SSGA US Small Cap Low Volatility Index from the Russell 2000 Low Volatility Index. It now targets stocks representing the least volatile 30% of each sector in the eligible universe and weights its holdings by the inverse of their volatility. This sector-relative approach keeps the fund's sector weightings more in line with the broader small-cap market. SMLV also measures volatility over a longer period (five years) than XSLV, which means it will be slower to adjust as volatility changes. **(XSLV, which includes the Quality Factor, is better designed, and has superior performance.)**

iShares Edge MSCI Minimum Volatility USA Small-Cap ETF SMMV (0.20% expense ratio) takes a more holistic approach to reduce volatility. It attempts to construct the least volatile portfolio possible with stocks from the MSCI USA Small Cap Index. To do this, it uses an optimizer that takes into account each stock's volatility, factor exposures, how stocks interact with each other, as well as several constraints. These include limiting sector tilts and turnover. **(While this relatively new ETF, 9/9/16, is on our Watch List, its lack of liquidity, just under 10 mil. Total Assets, precludes it from consideration for now despite its performance, which has been nearly as good as XSLV with even less volatility.)**

Actively managed Royce Special Equity RYSEX (1.15% expense ratio) may also be worth considering. This fund carries a Morningstar Analyst Rating of Silver. Managers Charlie Dreifus and Steven McBoyle target highly profitable small-cap businesses with attractive valuations and conservatively stated financials. They hold a compact portfolio that has exhibited lower volatility than the S&P SmallCap 600 Index over the past decade.

More importantly, the fund has distinguished itself during market downturns and will likely continue to do so in the future. (The much cheaper XSLV has significantly outperformed since inception. RYSEX is another example of active management not adding value.)

ISCF - The iShares Edge MSCI Multifactor Intl Small-Cap ETF seeks to track the investment results of an index composed of global developed market small-capitalization stocks, excluding the U.S., that have favorable exposure to the Value, Quality, and Momentum Factors. We have added EFA (orange line) as an appropriate benchmark. EFA tracks the market-cap-weighted MSCI EAFE Index, which covers more than 900 stocks listed in developed markets overseas, and is, at \$82.3 billion, the largest non-USA developed market ETF.

iShares Edge MSCI Multifactor Intl Small-Cap ETF ISCF

Morningstar
ETFInvestor
Free Download.

Add to Portfolio Get E-mail Alerts Data Question

Quote Chart ETF Analysis Distributions Performance Ratings & Risk Portfolio Fees & Expenses Tax Ownership Filings

Last Price \$31.71	Day Change ↓ -0.05 -0.16%	NAV 31.44 USD	Open Price 31.62	Day Range 31.60-31.71	52-Week Range 23.60-31.79	12-Mo. Yield 2.10%	Total Assets 22.00 mil USD	Expenses 0.40%
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As of Thu 11/02/2017 3:58 PM EST |USD

Intraday Indicative Value
\$31.39 ↓ -0.09 | -0.30%

Prem/Discount 1.00%	Volume 2363	Avg Vol. 4,294	SEC Yield% —	Bid/Ask/Spread 30.22/ 47.75/ 44.97%	Category Foreign Small/Mid Blend
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As of Thu 11/02/2017 4:29 PM EST |USD



ANGIX - For clients whose primary objective is Capital Preservation, the actively managed ANGIX, which outperforms both its Peers (orange line) and Benchmark (green line), is a rare exception to our distaste for Bonds. From Angel Oak's website:

"The Fund seeks the best risk-adjusted opportunities in fixed income that offer the potential for both stable, monthly dividends and price appreciation. The Fund employs a top-down strategy to identify relative valuation opportunities within the structured credit markets and a bottom-up credit selection process to selecting

individual issues. The managers will invest opportunistically across a wide range of credits and issuer types based on relative value within fixed income. Specifically, the Fund targets opportunities in:

- Non-Agency Residential Mortgage-Backed Securities (NA RMBS)
- Commercial Mortgage-Backed Securities (CMBS)
- Collateralized Loan Obligations (CLO)
- Asset-Backed Securities (ABS)
- Agency Residential Mortgage-Backed Securities (RMBS)

Currently, the Fund has a bias towards credit and low duration assets to manage interest rate risk. This bias is not set for the long-term and may change over time as the managers' view on the global economy, interest rates and capital market conditions change. The team does not manage the portfolio's asset allocation to resemble the Fund's benchmark in a relative sense, but instead positions the portfolio with a focus on absolute return."

Angel Oak Multi-Strategy Income Fund Institutional Shares ANGIX

Open an account.
E*TRADE

★★★★

FF Fund Family Data Add to Portfolio Get E-mail Alerts ? Data Question

Quote Chart Fund Analysis Performance Ratings & Risk Management Stewardship Portfolio Expense Tax Purchase Filings

NAV
\$11.32 ↑0.04%

1-Day Total Return

TTM Yield 5.86% Load None Total Assets \$ 6.1 bil Expenses 1.00% Fee Level High Turnover 64% Status Open Min. Inv. \$ 1.0 mil

USD | NAV as of 30 Oct 2017 | 1-Day Return as of 30 Oct 2017

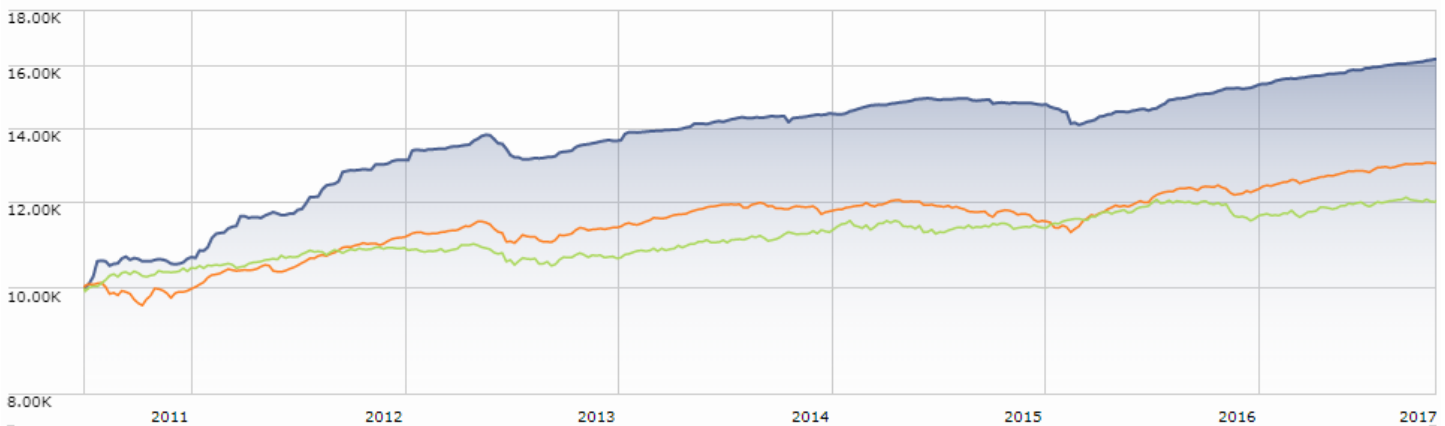
30-Day SEC Yield 4.85% Category Multisector Bond

Credit Quality/Interest Rate Sensitivity
Low/Limited

Growth Benchmark Event Compare to Symbol Moving Avg US Dollar Reset

08/28/2011 10/30/2017 Zoom:1M 3M YTD 1Y 3Y 5Y 10Y Maximum Custom

XNAS:ANGIX:16,220.15 Multisector Bond:13,026.72 BBgBarc US Agg Bond TR USD:12,028.52



GIFIX - Again for clients focused on Capital Preservation, we like Bank Loan Funds in a rising interest rate environment. While our preference would be a Closed-end Fund (CEF) selling at a significant discount to NAV, all of them currently have discounts of less than 10%.

Guggenheim Floating Rate Strategies Fund Institutional Class GIFIX



Morningstar
ETFInvestor
Free Download.

Fund Family Data Add to Portfolio Get E-mail Alerts Data Question

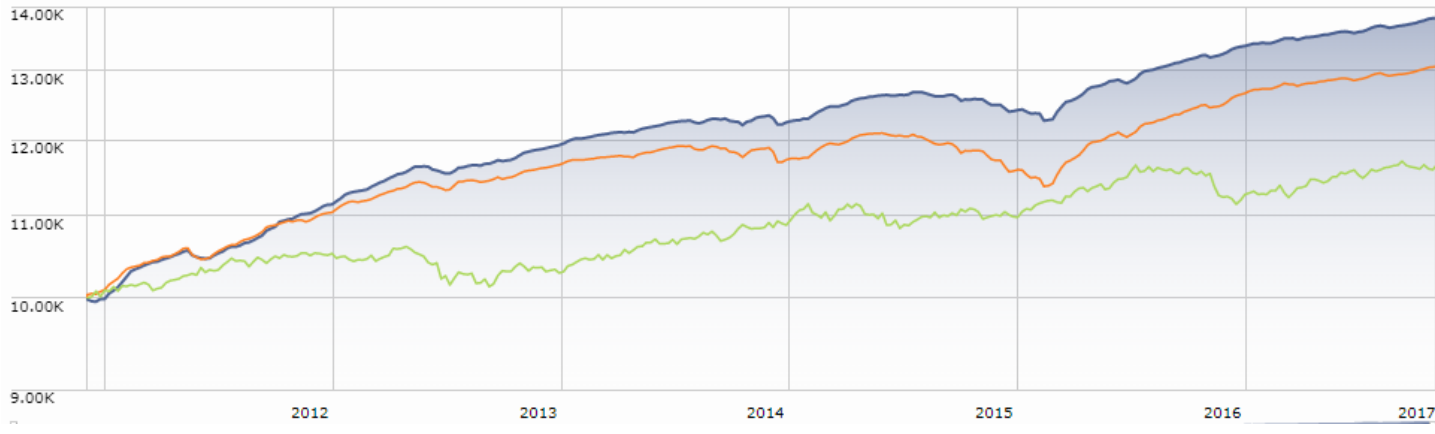
Quote **Chart** Fund Analysis Performance Ratings & Risk Management Stewardship Portfolio Expense Tax Purchase Filings

NAV \$26.09	1-Day Total Return ↑0.01%	TTM Yield 3.85%	Load None	Total Assets \$ 3.7 bil	Expenses 0.79%	Fee Level Above Average	Turnover 35%	Status Open	Min. Inv. \$ 2.0 mil
USD NAV as of 02 Nov 2017 1-Day Return as of 02 Nov 2017		30-Day SEC Yield 4.00%	Category Bank Loan		Credit Quality/Interest Rate Sensitivity Low/Limited				

Growth Benchmark Event Compare to Symbol Moving Avg US Dollar Reset

11/30/2011 - 11/02/2017 Zoom: 1M 3M YTD 1Y 3Y 5Y **10Y** Maximum Custom

XNAS:GIFIX:13,814.30 Bank Loan:13,059.91 BBgBarc US Agg Bond TR USD:11,647.32



Our Best,
Devin