Unhappy with or skeptical of TAA?

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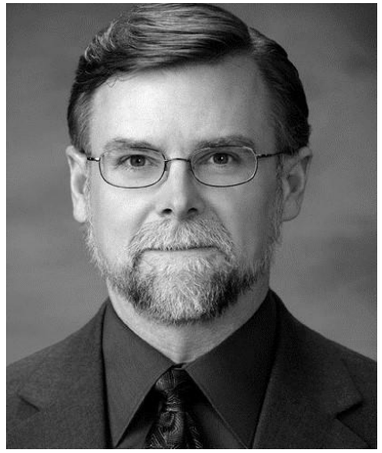

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TAA stands out among investment strategies

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- TAA has a larger percentage of consistent detractors than most other strategies

- Why?

- Two primary reasons
- Failure to first set . . . and then maintain . . . appropriate expectations
- Blackbox approaches . . . and those who make it sound more complex than it really is

Sources of unhappiness or skepticism

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- Expectations
  - Taxes
  - Optics
  - Tracking
  - Destination versus journey
  - Measuring success
  - Exaggeration

- Blackboxes or complexity

Expectations - Taxes

Terribly tax inefficient

TAA is tax inefficient

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- TAA is all about generating short-term capital gains instead of long-term capital gains
- If TAA generates a long-term capital gain, then something is wrong with the strategy

- Set and maintain appropriate expectations

- But, don't . . . mistakenly jump to the incorrect conclusion that TAA should not be used in taxable accounts

Expectations - Optics

The average experience over time . . . versus an instant in time

Two aspects to the optics challenge

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- There two separate and distinct issues here
- Visibility versus invisibility
- Inappropriate asset mix

- Both . . . are optical problems and NOT investment problems

Visibility versus invisibility

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- For some clients, seeing what they are holding with too much specificity, can be disturbing
- Often generating emotional reactions
- For example
  - I don’t want to hold China
  - Everyone knows long bonds are dangerous
  - Technology is too dangerous for me to hold
  - Everyone knows that small cap should be part of every prudent portfolio
  - I don’t want to hold so much outside the U.S
  - Everyone knows that real estate is a bad exposure to hold right now
  - I don’t want to hold energy, they pollute
  - Everyone knows that the portfolio should be 30% to 50% bonds

Inappropriate asset mix

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- An inappropriate asset mix results from . . . exposing oneself to too high a probability of significant failure
- This results from holding too LARGE of a bet for too LONG a period of time
- At any instant in time, a TAA portfolio will reflect significant tilts or bets
- But, on average over the long span of time . . . a TAA portfolio's average asset mix will be no different from a passive ultra-diversified portfolio
- The very short time period with which TAA portfolios expose themselves to specific bets . . . means that over suitably long time periods, TAA portfolios are no more risky (and are probably less risky) than more traditional ultra-diversified solutions

Expectations - Tracking

It won’t track a benchmark . . . and this makes life really difficult

Lack of tracking

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- This is one of the two biggest sources of disappointment with TAA
- Essentially . . . the S&P 500 is up and my TAA portfolio is down

Consider a specific example

- A simple generic example of TAA that I discussed during prior Friday discussions

Step 5 - Identifying the data set and quantitative rule

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- Monthly returns spanning the time period Jan 1919 through Feb 2020

- 29 asset categories
  - 7 - U.S. stocks
  - 9 - international stocks
  - 6 - U.S. Treasuries (maturities from 90-days to 30-years)
  - 2 - U.S. investment grade corporate bonds
  - 1 - International government bonds
  - 1 - broad-based diversified commodities
  - 3 - precious metals

Slide from prior Friday discussion

- Quantitative rule
  - Once each month select the 7 assets that are trending the most strongly and equal weight them

Step 5 - Identifying the data set and quantitative rule, continued

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- Quantitative rule
  - Once each month select the 7 assets that are trending the most strongly and equal weight them

Slide from prior Friday discussion

			Simple quantitative rule	
Alternative investment time periods	**Intended to serve client needs located this far in the future**	**Comparative performance benchmark**	**Intermediate-term, investment grade, U.S. corporate bonds**	**The 7 asset classes that are trending most strongly, equal-weighted**
7 ½ years	5 to 10 years	25%/75% stocks/bonds	30%	70%
12 ½ years	10 to 15 years	50%/50% stocks/bonds	20%	80%
17 ½ years	15 to 20 years	75%/25% stocks/bonds	10%	90%
22 ½ years	21 years and greater	100% stocks	0%	100%

Step 5 - Identifying the data set and quantitative rule, continued

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Correlations between TAA and S&P 500

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- These correlations mean that it is extremely likely that the S&P 500 will be up and your TAA portfolio will be down

	1 month	3 months	6 months	1 year	3 years	5 years
Correlation between the S&P 500 and the TAA portfolio	0.59	0.61	0.61	0.57	0.54	0.48

Expectations - Destination versus Journey

The investment industry's greatest dysfunction

The investment industry delivers “Journey Portfolios”

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- Their motivation is commercial . . . and therefore practical and logical
- It is easier to sell “journey product”
- Since it is all about assembling short-term relative performance track records
  - 1-year
  - 3-years
  - 5-years
  - 7-years
- Just incubate a whole bunch of these
- Then sell the heck out of the few that worked
- Keep developing more in the backroom, to replace the ones you went live with that failed

Journey portfolio

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Benefit

Experience a smoother, more pleasing Journey

. . . instead of

Cost

Unfortunately, your Journey portfolio might lead you to this Destination

Destination portfolio

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Benefit

Reach a more favorable Destination

. . . instead of

Cost

Unfortunately, your Destination portfolio might take you on this type of Journey

Is a destination portfolio an absolute return portfolio?

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- NO !

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PERSPECTIVES

The Myth of the Absolute-Return Investor

M. Barton Waring and Laurence B. Siegel

In meetings with clients and colleagues in the past few years, we have noticed that many otherwise hardheaded and clear-eyed investors are excited about "absolute return" investing. The notion is spreading like wildfire. Many institutional investors have already added, or are planning to add, an absolute-return "asset class" to their policy mix. At a time when pension funds, foundations, and endowments are under

both sensible and true to the sense of the term eluded us. That experience further piqued our interest in the idea.

So, let us explore the term a bit. It is widely used, and because words are chosen to a purpose, one can find some of that purpose by observing the context in which a term is used.

One important bit of context is that the word pair "absolute return" has been used most by those

Is a destination portfolio an absolute return portfolio?

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- NO !
- TAA portfolios have no ability, and make no attempt to generate a positive return all of the time
- Instead . . . their objective is that of a “Destination Portfolio”
- To maximize the probability of earning at least X% at some future date Y-years in the future

Step 5 - Identifying the data set and quantitative rule, continued

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- Quantitative rule
  - Once each month select the 7 assets that are trending the most strongly and equal weight them

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TAA vs S&P 500 - giving it the time it needs to mature

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	1 month		3 months		6 months		1 year		2 years		3 years		5 years		7 1/2 years	
	TAA	S&P	TAA	S&P	TAA	S&P	TAA	S&P	TAA	S&P	TAA	S&P	TAA	S&P	TAA	S&P
99% chance of earning MORE than this return	-6.2	-13.9	-9.9	-25.2	-10.4	-34.0	-13.7	-43.4	-6.7	-33.6	-3.6	-28.9	2.7	-13.6	4.8	-3.8
10% chance of earning LESS than this return	-2.1	-5.0	-2.9	-7.6	-2.7	-9.6	-1.6	-12.4	1.5	-7.1	4.5	-4.6	5.7	-1.0	8.4	2.0

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TAA vs a 25/75 stock/bond benchmark

JULEX CAPITAL

	1 month		3 months		6 months		1 year		2 years		3 years		5 years		7 1/2 years	
	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75
99% chance of earning MORE than this return	-6.2	-4.5	-9.9	-8.9	-10.4	-12.8	-13.7	-18.6	-6.7	-11.1	-3.6	-5.8	2.7	-2.0	4.8	0.3
10% chance of earning LESS than this return	-2.1	-1.3	-2.9	-2.0	-2.7	-1.7	-1.6	-1.7	1.5	-0.1	4.5	0.3	5.7	1.4	8.4	2.5

TAA vs a 25/75 stock/bond benchmark

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	1 month		3 months		6 months		1 year		2 years		3 years		5 years		7 1/2 years	
	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75
99% chance of earning MORE than this return	-6.2	-4.5	-9.9	-8.9	-10.4	-12.8	-13.7	-18.6	-6.7	-11.1	-3.6	-5.8	2.7	-2.0	4.8	0.3
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All successful investments are “destination portfolios”

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- Successful investments are like agricultural crops

- Plant
- Sprout
- Grow
- Mature
- Ripen
- Harvest

- If you harvest before the crop’s destination . . . you end up with disappointment

- Example . . . think of venture capital, or LBOs, or the new Opportunity Zone Funds

All successful investments are “destination portfolios”

JULEX CAPITAL

- Successful investments are like agricultural crops

- Plant
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The journey

- If you harvest before the crop’s destination . . . you end up with disappointment

- Example . . . think of venture capital, or LBOs, or the new Opportunity Zone Funds

All successful investments are “destination portfolios”

JULEX CAPITAL

- Successful investments are like agricultural crops

- Plant
- Sprout
- Grow
- Mature
- Ripen
- Harvest ⬅ **The destination**

- If you harvest before the crop’s destination . . . you end up with disappointment

- Example . . . think of venture capital, or LBOs, or the new Opportunity Zone Funds

TAA vs a 25/75 stock/bond benchmark

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	1 month		3 months		6 months		1 year		2 years		3 years		5 years		7 1/2 years	
	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75
99% chance of earning MORE than this return	-6.2	-4.5	-9.9	-8.9	-10.4	-12.8	-13.7	-18.6	-6.7	-11.1	-3.6	-5.8	2.7	-2.0	4.8	0.3
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TAA vs a 25/75 stock/bond benchmark

JULEX CAPITAL

	1 month		3 months		6 months		1 year		2 years		3 years		5 years		7 1/2 years	
	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75	TAA	25/75
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Expectations - Measuring success

How do I know that I remain on track . . . how do I know it’s working?

Correlations

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	1 month	3 months	6 months	1 year	3 years	5 years
Correlation between the S&P 500 and the TAA portfolio	0.59	0.61	0.61	0.57	0.54	0.48

	1 month	3 months	6 months	1 year	3 years	5 years
Correlation between the 25/75 stock/bond benchmark and the TAA portfolio	0.63	0.60	0.59	0.62	0.50	0.39

Conclusion

- You cannot benchmark to any published index benchmark
- None . . . absolutely none
- This is incredibly unsatisfying . . . but remains true

Solutions

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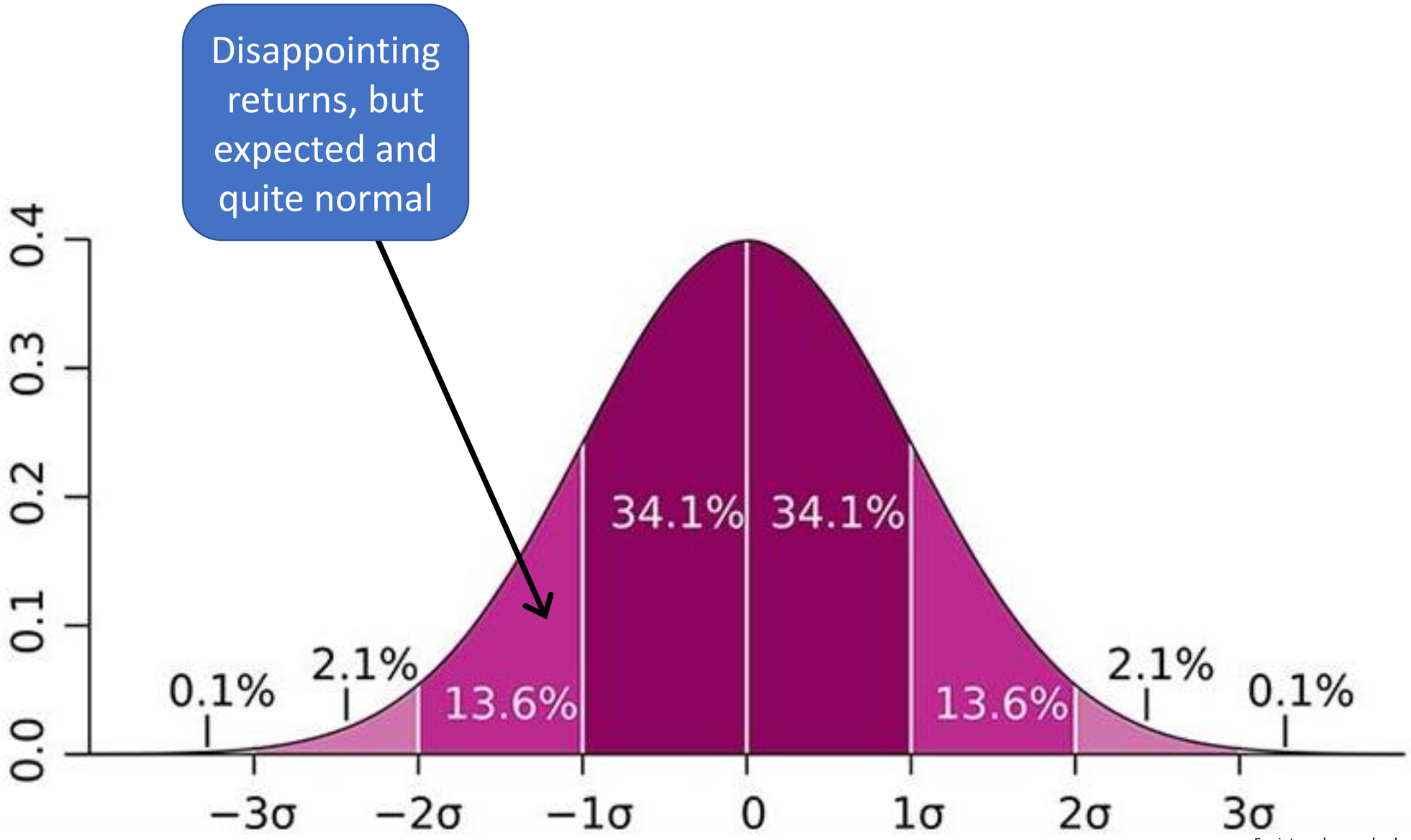
- Partial solutions
- Set reasonable expectations
  - If you're using a TAA portfolio with a 7 ½ year destination, then don't expect it to deliver as high a return as 100% equities . . . over the long-run
- Compare to a universe of other TAA managers
  - Challenging . . . your universe must be very carefully constructed
- Two-step process
  - First, confirm that the TAA manager is following their process and has not changed or over-ridden the process
  - Second, confirm that recent performance is solidly within the probability distribution of returns for this strategy

Probability distribution for TAA portfolio returns



Probability distribution for TAA portfolio returns

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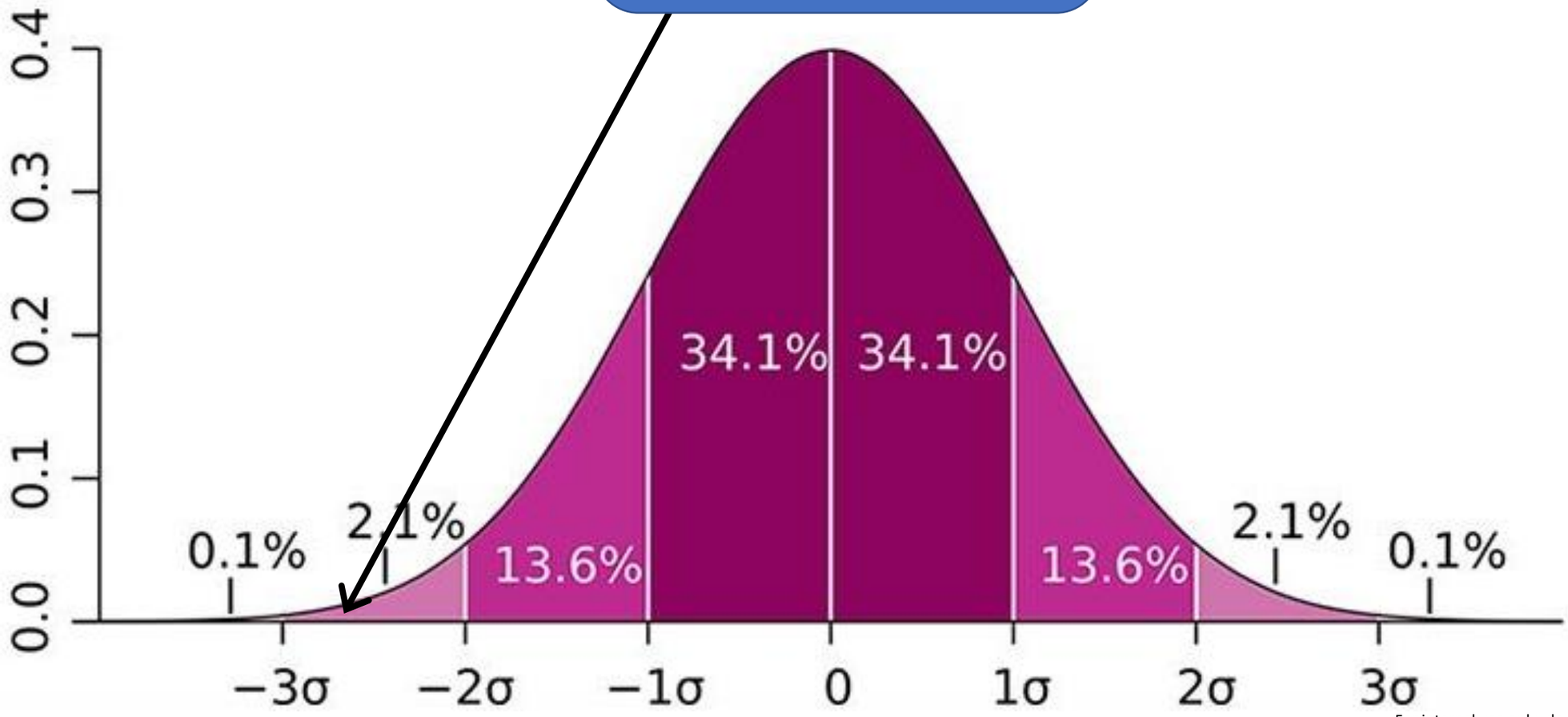
Very disappointing returns, but unexpected and requires clear and sufficient explanation



Expectations - Exaggeration

Overpromising and underdelivering

One of the two most frequent sources of advisor disappointment

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- All too often, TAA is delivered with
  - An overpromise
  - And inevitable resulting disappointment
- The overpromise often goes something like
  - *"We participate on the upside and protect on the downside"*
  - *"Protection and participation"*
  - But what the advisor or client might hear is . . . . *"When the S&P is going up, I'm well in the game, participating handsomely . . . and when the S&P falls, I'm well protected from loss"*

How does this unfold?

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- February 19th through and March 23rd of this year
- The S&P 500 collapsed
- Those who heard and listened to the overpromises . . . wondered why their TAA strategy didn't protect them
- This is an unreasonable and unfounded expectation

Blackboxes or complexity

In truth . . . there really aren’t any “investment secrets”

There are no investment secrets

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- You should expect and demand 100% transparency
- If the investment manager refuses to provide any and every level of granular detail . . . then just run the other way
- The sole exception to this rule . . . resides in the hedge fund arena when managers are harvesting a transitory/temporary finite pricing discrepancy
- Here, they need to keep the opportunity hidden until after they've brought in the harvest

Step 2 - Is the logic supported by voluminous independent research

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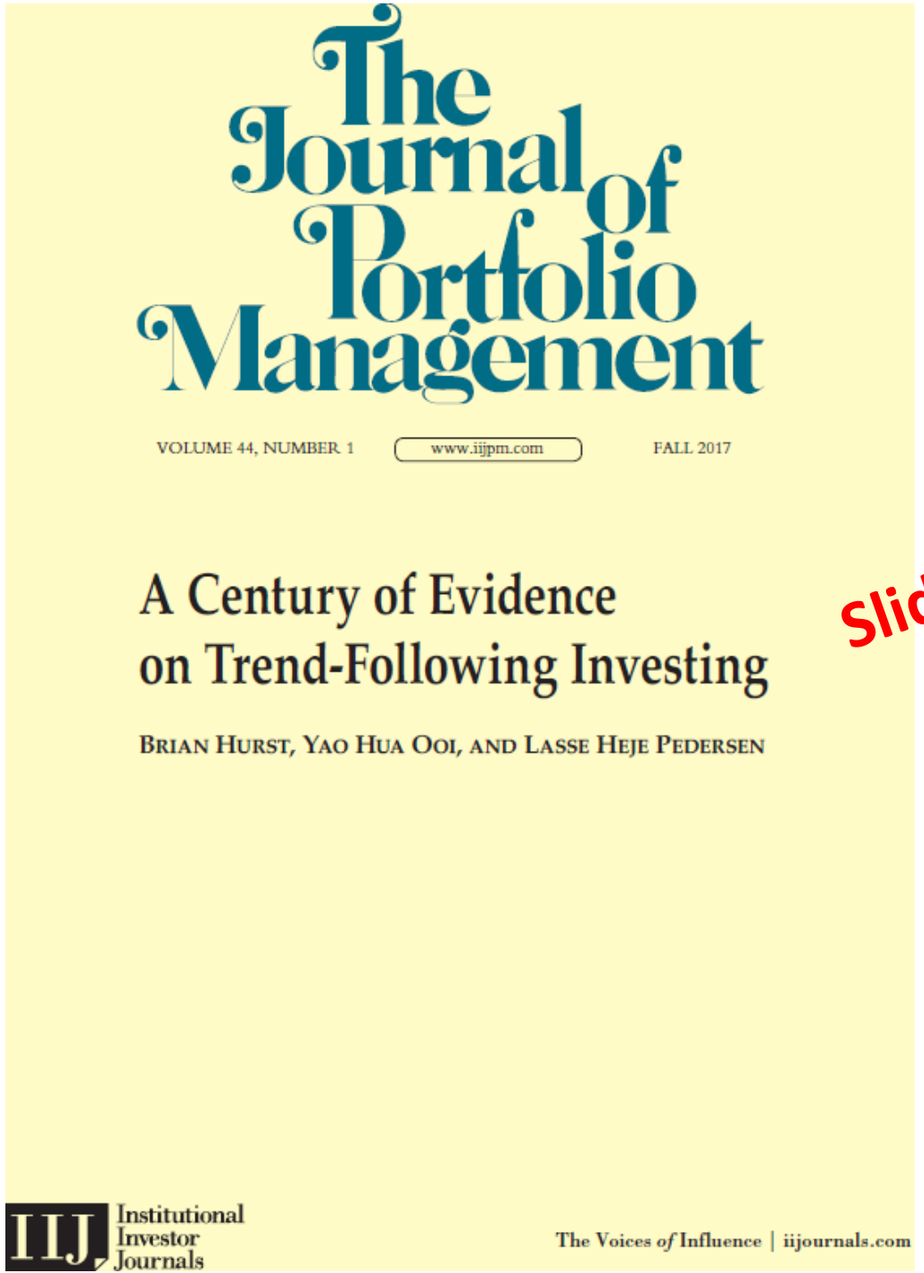

The Journal of Portfolio Management

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A Century of Evidence on Trend-Following Investing

BRIAN HURST, YAO HUA OOI, AND LASSE HEJE PEDERSEN

IIJ Institutional Investor Journals

The Voices *of* Influence | iijournals.com

Slide from prior Friday discussion

Step 2 - Is the logic supported by voluminous independent research

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CONCLUSION

Trend-following investing has performed well in each decade for more than a century, as far back as we can get reliable return data for several markets. Our analysis provides significant out-of-sample evidence across markets and asset classes beyond the substantial

FALL 2017

Slide from prior Friday discussion

Step 3 - Why do markets trend

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- Why markets trend - winners keep winning and losers keep losing
- Investment markets trend because it takes time for new information to first develop, next be disseminated and analyzed, and finally acted upon and consequently, reflected in market prices
- The length of time for this entire process varies considerably from one investor to the next and is therefore spread over many months or more

Slide from prior Friday discussion

Developed → Disseminated → Noticed → Data collected and evaluated → Decisions formulated → Portfolios updated

But it’s worth it

The juice is well worth the squeeze

Step 5 - Identifying the data set and quantitative rule

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- Monthly returns spanning the time period Jan 1919 through Feb 2020

- 29 asset categories
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Slide from prior Friday discussion

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Step 6 - time periods of 7 ½ years

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Average returns	Benchmark	Quant rule
Geometric mean return over the entire 101.1 years	5.6%	12.2%
Median (for investment periods of 7.5 years)	5.5%	12.7%
Mean (for investment periods of 7.5 years)	5.9%	13.0%

Performance during 7.5-year investment time windows by percentile outcome		
Percentile	Benchmark	Quant rule
99th	0.3%	4.8%
98th	0.4%	5.6%
97th	0.7%	6.1%
96th	0.8%	6.6%
95th	0.9%	7.0%
94th	1.4%	7.5%
93rd	1.6%	7.8%
92nd	2.0%	8.0%
91st	2.3%	8.2%
90th	2.5%	8.4%

Five worst 7.5-year investment periods ever experienced (out of the last 101.1 years)	
Benchmark	Quant rule
0.0%	3.5%
0.0%	3.9%
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0.1%	4.1%
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Slide from prior Friday discussion

1,114 investment time periods of 7 ½ years in length

Step 6 - time periods of 7 ½ years

JULEX CAPITAL

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1,114 investment time periods of 7 ½ years in length

For more information contact

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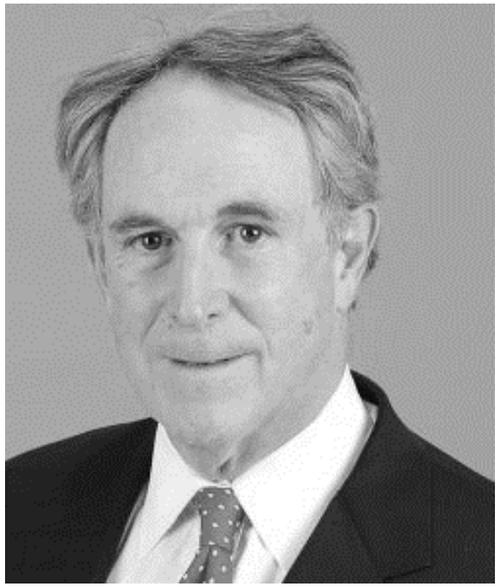

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