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New Alternative Investments

In our bulletin last month on defensive maneuvers, we told you that we would be eliminating your exposure to the commodities in the “alternative investments” portion of your portfolio. We explained that commodities had not exhibited the diversification benefits that they had in previous times, and were moving too much in lockstep with stocks for our satisfaction. We also said that we would hold the proceeds in cash until we were ready to invest in the replacement vehicles.

The exit is largely complete (we have been doing this in stages for those holdings that would otherwise have been subject to short-term redemption charges), and we will begin introducing the new investments into your portfolio shortly, in roughly the same amount as the original investments they are replacing (i.e., approximately 10% of your total portfolio).

What are these new investments? They are more sophisticated commodity-based strategies that have more consistently low correlations to stocks. The potential for our original commodity investments to see their diversification benefit erode was known at the outset, and we have been monitoring the equity-commodity relationship for such signs. You have already seen us respond in the past by decreasing the allocation to direct commodity investments and adding “managed futures” (momentum-based) commodity investments. The research we have done on the sector rotation strategy that is incorporated in our mutual fund provided us with more insight into momentum-based strategies in general, and prompted us to search for more sophisticated investments. Meanwhile, a number of innovative strategies have recently become available. After reviewing and testing dozens of candidate strategies, we have identified three that have the properties we desire. As was the case for our original commodity investments, we will be monitoring these to gauge their ongoing diversification benefits while continuing to research their potential replacements should those benefits erode over time. If you are interested in more specific information on these new investments, let us know and we can have a detailed discussion and provide a technical description of each.

Why the delay in introducing them? Two reasons. First, these strategies have only recently become available to retail investors, and we wanted to fully complete our due diligence, analysis, modeling, and testing. We were more comfortable temporarily being out of commodities in the interim than continuing to hold the original investments. Second, these new strategies are currently available only via structured notes. The benefits of structured notes include being able to have access to sophisticated strategies such as these that would not otherwise be available to you. The drawback of all structured notes is counterparty risk — the risk that the issuing bank(s) may not be able to pay when the note is redeemed. You are already exposed to counterparty risk by virtue of the EMERALD- and ASTRO-based notes within the mutual fund. While we consider the counterparty risk presented by these current structured notes, as well as that introduced by the new notes, to be prudent to take in each case given the expected benefit, we would prefer that those risks not both exist at the same time. In that light, we are pleased to report that we are now very close to substantially reducing the counterparty risk within the mutual fund.

How are we reducing the counterparty risk inside the mutual fund? As we mentioned when we first launched our mutual fund, one advantage to moving the EMERALD- and ASTRO-based notes inside the fund was to eventually replace them with more efficient investment vehicles that provide the same protection. These vehicles — typically available only to institutional investors (which our fund is now effectively considered) — carry only a small fraction of the counterparty risk of the corresponding notes. Additionally, we have negotiated for these arrangements to be largely collateralized by the banks, i.e., as the banks’ obligation to you grows, cash supporting that obligation will be posted by the banks and held at our fund’s custodian. None of this was possible without the fund.

The process of instituting these arrangements within the fund is a long and tedious one, subject to lots of negotiation, paperwork, and review by our attorneys, custodian, and fund administrator. We are now very near the end of this months-long process — near enough that we are comfortable to soon begin purchasing the new commodity-based notes for the “alternative investments” portion of your portfolio, outside the fund.

These new commodity-based notes — just like the notes you are used to — would have daily liquidity, meaning we could sell the notes for you on a day’s notice if necessary, and you would receive that days’ market value less a bank transaction charge of approximately one-half percent. The market values would be transparent since they are based on indexes that are calculated and published daily. And they will be visible in your portfolio as individual holdings. Just as with the prior notes, we will be continually monitoring the credit quality of the issuing banks, which are the same two banks — Deutsche Bank and Barclays Capital — that we have had good experience with to date. Again, if you are technically inclined, more details are available on request.

As always, please let us know if you have any questions.

Jerry A. Miccolis, CFA®, CFP®, FCAS, MAAA
Principal, Senior Financial Advisor, and Chief Investment Officer.