PERSONAL FINANCIAL MANAGEMENT

paracle

**PERSPECTIVES**

# Non-Traditional Approach

*"Success is steady progress toward one's personal goals."*

*-Jim Rohn*

**Investors sometimes find themselves asking if it is possible to avoid the downsides and doldrums of stock and bond markets. While one cannot completely avoid the unpredictable movements of financial markets, there are unique investments that can be added to a portfolio to enhance diversification and, hopefully, provide a smoother return pattern.**

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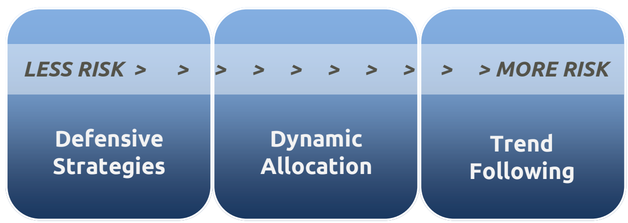
Paracle classifies anything other than conventional stocks or bonds as "non-traditional" investments.  There are a multitude of such investments available in the marketplace, both safe and unsafe, cost-effective and extremely expensive.  We thoughtfully evaluate these opportunities and identify strategies that have potential to help our clients better reach their investment goals without taking on excessive risk or expense.

We recommend non-traditional investments in three specific areas:

- Defensive Strategies
- Dynamic Allocation
- Trend Following

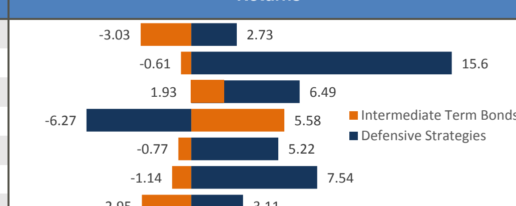



Let's explore each of these areas to better understand what they are and their benefits in a diversified portfolio.

**Defensive Strategies.** Defensive strategies encompass a variety of unique approaches with a common goal of producing modest positive returns regardless of how the bond and stock markets perform.  Often called hedge funds, these strategies are unique in their ability to both buy and sell investment positions at the same time, thereby offsetting the risk of "long" holdings with "short" positions.  Some investor perceive hedge funds to have high risks, which is likely the result of a few well-publicized product implosions by unscrupulous managers who, ironically, did not appropriately hedge risks.  While hedge product structures can indeed be complex, a well-structured hedge position is actually straightforward and has limited downside risk.

Defensive investments have provided similar long-term returns to bonds[1]. While they can be more volatile than bonds at times, they are not closely tied to changes in interest rates, which makes them a good diversifier for bonds. The chart below illustrates this concept.  Furthermore, defensive strategies also have very low net stock exposure, which means they have lower sensitivity to movements in global stock markets. Taken together, the inclusion of defensive strategies in a traditional portfolio helps to dampen the downside.

| Description | 10 Year Rate Rising | Change in Rates (%) | Returns |
|---|---|---|---|
| Fed surprises market with rate hikes | Oct '93 - Nov '94 | 2.51 | |
| Russian default | Oct '98 - Jan '00 | 2.24 | |
| Global growth rebound following tech bubble | Jun '03 - Jun '06 | 1.78 | |
| Global financial crisis | Jan '08 - Dec '09 | 1.60 | |
| Eurozone debt crisis; U.S. credit downgrade | Sep '10 - Mar '11 | 1.00 | |
| Fed announces reduction in quantitative easing (QE) | Aug '12 - Dec '13 | 1.53 | |
| "Trump rally" following elections | Aug '16 - Jan '17 | 0.99 | |




Defensive Strategies: HFRI FOF: Conservative Index; Intermediate Term Bonds: Bloomberg Barclays U.S. Aggregate Bond

Participation in defensive investments can be difficult for the average investor. Top-tier managers are inaccessible due to their high minimums. In contrast, accessible lower-tier managers tend not to provide sufficient performance to justify their management and performance-based fees. Given the concurrent challenges of limited access and high manager fees, Paracle has determined that tracking a diversified index of hedge fund strategies is a good way to participate in the hedge category at a substantially lower cost than traditional hedge funds.

**Dynamic Allocation.** Paracle utilizes dynamic allocation strategies to expand portfolio diversification beyond traditional stocks and bonds. Dynamic allocation strategies provide diversifying exposure to specialized asset categories such as high yield bonds, bank loans, emerging market bonds, foreign currencies, real estate, and commodities. Managers of dynamic strategies attempt to capitalize on the natural tendency of these specialized categories to cycle in and out of favor. The embedded chart demonstrates this cycle.

| 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 25.55 | 45.58 | 32.67 | 4.40 | 58.21 | 26.93 | 6.05 | 40.88 | 7.44 | 27.24 | 2.14 | 17.13 |
| 17.44 | 35.50 | 18.11 | -5.22 | 51.62 | 17.23 | 4.98 | 18.93 | 5.29 | 3.43 | -0.69 | 11.37 |
| 9.64 | 15.22 | 11.03 | -26.16 | 47.54 | 15.68 | 4.36 | 16.76 | 4.35 | 2.45 | -1.77 | 10.16 |
| 6.27 | 11.85 | 2.08 | -29.10 | 30.81 | 15.12 | 1.52 | 15.81 | 1.77 | 1.60 | -4.47 | 9.94 |
| 5.06 | 8.16 | 1.91 | -40.07 | 21.98 | 10.13 | -1.18 | 9.66 | -1.22 | -3.08 | -6.02 | 7.56 |
| 2.74 | 6.74 | 1.87 | -46.49 | 13.48 | 9.03 | -1.75 | 4.09 | -3.08 | -5.72 | -14.92 | 2.02 |
| -8.65 | -15.09 | -18.15 | -52.98 | 7.53 | 4.95 | -16.01 | 0.08 | -8.98 | -33.06 | -32.86 | 1.49 |

Floating Rate Loans
High Yield Bonds
Emerging Market Bonds
International Real Estate
US REITs
Commodities
International Bonds

Oftentimes dynamic strategies are "contrarian" in nature, attempting to profit by investing in a manner that differs from conventional wisdom when the consensus opinion is extreme. They purchase greater amounts of an asset category when valuation discounts are prominent and sell a category when valuations reach historically high levels. It is important to have a long-term perspective when pursuing such strategies, since contrarian positioning may take time to pay off.

**Trend Following**. Trend following strategies capitalize on the impulsive "herd mentality" moves of investors over short periods of time ranging from days to one year. These strategies work best when market volatility and corresponding fear or greed emotions are high. Strong trends occur in both up and down market environments, so trend following can perform well at times when traditional investments are struggling (demonstrated in the chart below).

| Description of Crisis | Period | Returns | |
|---|---|---|---|
| | | Stock Returns | Trend Following Returns |
| Black Monday | Sep - Nov 1987 | -29.7 | 8.5 |
| Iraq invades Kuwait | Jul - Oct 1990 | -14.1 | 13.5 |
| Russian default and hedge fund crisis | Jul - Aug 1998 | -15.4 | 5.4 |
| Lead up to 9/11 attacks | Jul - Sep 2001 | -14.7 | 4.1 |
| Enron and WorldCom; End of tech bubble | Apr - Sep 2002 | -28.4 | 18.7 |
| Global financial crisis | Jun - Feb '08-'09 | -46.4 | 7.2 |
| Eurozone debt crisis; US credit downgrade | May - Sep 2011 | -16.3 | -2.1 |
| Chinese currency crisis | Aug - Sep 2015 | -8.4 | -0.2 |
| First Fed hike since 2006 | Dec - Jan '15-'16 | -6.5 | 1.3 |

Stock Returns: S&P 500; Trend Following Returns: Barclays BTOP 50 Index

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| Category | Maximum Drawdown |
|---|---|
| Trend Following | -17.7 |
| Global Stocks | -54.8 |

Source: Morningstar Direct. Trend Following - SG Trend Index; Global Stocks - MSCI ACWI IMI. Max Drawdown Peak Dates: Global Stocks - 11/2007; Trend Following - 2/2000

Since trend following performance often comes at different times than the performance of traditional stock investments, trend following is an effective way to diversify a global stock portfolio. A key feature of trend following strategies is that risk exposures can be tightly controlled. Although trend following performance is variable from year to year, the maximum drawdowns in difficult market conditions have been lower for trend following strategies than for stocks.

It is important to distinguish that trend following is not predictive. Rather, trend followers merely participate in already-existing movements in the hope that they will extend further. Trend following strategies make money on trends that extend and lose money when trends don't extend or when trends are mixed.

Well diversified trend following strategies include exposure to trends in stocks, interest rates, currencies, and commodities. Most diversified strategies cover 70 – 80 unique markets.

**In Summary**

Non-traditional investments complement a well-diversified traditional stock and bond portfolio since they tend to provide returns at different times than traditional investments. Non-traditional investments cover a broad spectrum in terms of potential return and downside risks. On the safe side of the spectrum, defensive strategies play a risk-reducing role in the non-traditional asset class, similar to how bonds reduce risk in traditional asset classes. On the other end of the spectrum, dynamic allocation and trend following strategies offer higher returns if one is willing to accept higher variability as well. When balanced together thoughtfully, non-traditional investments can help stabilize overall portfolio returns. This serves to achieve one of our primary investment objectives, helping the families we serve achieve their goals as smoothly as possible.

Source:
1. Time period: 1/1/1990—7/31/2017. Bloomberg Barclays U.S. Aggregate Bond index return: 6.1%; HFRI Fund of Funds: Conservative index return: 5.8%





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