Resisting the Chase: Reimagining Liquidity and Diversification
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Mutual fund bond investors have reached an unwelcome crossroads. With interest rates at historic lows, they have spent much of their post-crisis existence cautiously ascending the risk ladder in search of yield. Over time, each step up has offered less compensation for incremental risk, but investors have been unwilling—or too fearful—to abandon their positions and sacrifice hard-sought, often meager, returns.

The dynamic is an unfortunate, but somewhat desired result of monetary policy set by the Federal Reserve, which has rendered fixed income unattractive and left only a handful of asset classes capable of generating any return. Bonds, for their part, are no longer a trusted source of negative correlation. They once provided a defined, modest cash flow and the ability to manage liquidity needs while offering protection from marketplace pricing whims. Monetary policy has culminated in a dangerous precedent for risk concentration and a lack of diversification as investors have been herded into high-risk assets in the form of public equity, private equity, and high-yield. And it has become exceedingly difficult to liquefy or diversify as banks no longer have the financial capital, nor the intellectual capital, to purchase those assets and remove investors from those positions in an orderly and timely manner thereby reducing the magnitude of losses and market volatility.

These forces have driven mutual fund investors to lurch from asset class to asset class, chasing investments that have most recently generated the highest returns. But they do so in a vacuum, making decisions based on the anxiety of the moment and not on any meaningful macroeconomic forecasts. Such behavior has created an opening for a strategy that reimagines the role of liquidity and diversification, once the domain of traditional fixed income investments.

The Impatient Driver

Let's consider, for a moment, how that investor behavior would play out in a different setting. Consider the proclivities of an impatient driver on a congested highway, darting from one lane to the next, reacting to any sign of movement in bumper-to-bumper traffic. The driver feverishly changes lanes based on the perception that he can reach his destination more quickly by following the kinetic energy. But his decisions are not based on any material knowledge of the road ahead, which is obscured by other vehicles. Ultimately, the driver ends up achieving little - having spent a great deal of physical and mental energy, or worse yet, crashes into another driver or loses any progress he gained.

This is an apt comparison to retail mutual fund investors who chase returns with the same random logic, shifting money from one asset class to the next based on a deceptive psychology of recent price movement. In the end, price-driven investors become unwitting victims of their own naiveté and lack of patience as their transaction costs accumulate and they are rendered helpless in their battle to maintain diversification. Without thoughtful research and in-depth market insights, their frequent asset reallocations inevitably lead to suboptimal performance at best and a portfolio accident at worst.

In the same way an anxious driver can misinterpret road conditions, an unwitting mutual fund investor can overlook the importance of diversification and the role of liquidity in portfolio management. If investors had perfect foresight with respect to future asset returns, then investing would be simple. Investors would concentrate their portfolios into the single asset class known to have the best outcomes. But sadly, investors are not clairvoyant, creating the need for investment diversification to offset the risk of the unknown.

Liquidity is equally important and serves the dual purpose of weathering market turmoil and providing the “dry powder” to seize new investment opportunities. A well-constructed portfolio with appropriate liquidity should have investments that are uncorrelated with other portfolio holdings, ideally eliminating the need to sell holdings at adverse prices in stressed financial markets. In addition to insulating investors from the need to sell those holdings, liquidity should also provide the ability to profit prospectively in distressed markets – by allocating cash when attractive opportunities arise. The well-diversified and liquid portfolio should be capable of thriving, and not crashing, during an adverse event.

Picking a Lane

Traditionally, the fixed income component within a well-diversified portfolio serves three primary purposes: liquidity, negative correlation to risky assets, and potential for moderate income. Today, however, most fixed income investments are unable to provide investors this comprehensive array of traditional benefits. So, where should mutual fund investors turn to satisfy these three objectives?

Many investors have embraced liquid alternatives ("liquid alts"). These products emerged after the 2008 financial crisis as a popular remedy for volatility and quickly proliferated in response to retail investors' craving for diversification and non-correlated returns. Liquid alts generally seek high absolute returns and superficially appear to be an ideal fit for those investors striving to maintain investment returns without inching up the risk ladder. The typical liquid alt fund seeks to replicate a hedge fund strategy—but ultimately implements it in a diluted form, largely as a result of mutual fund regulation.

Like hedge funds, there are liquid alts funds that will perform as advertised and those that will not. Caution must be exercised when evaluating alternatives for investors searching for the three objectives outlined above. A fund touting the typical low-volatility and higher expected return scenario may fail to perform during times of stress when correlations converge to 1.0. Many strategies fail to hedge significant downside exposures, and in many cases, may exacerbate them.

What's ideally missing from the liquid alt fund space is a low-to-moderate returning strategy that seeks a strong negative correlation with the rest of an investor's portfolio – a liquid alt fund that restores the integrity of today's historically risky asset allocation. The beauty of such a fund lies in its potential ability to offer low-to-moderate returns in times of calm, while seeking large payouts in times of volatility. That is, the investor may experience modest returns in the fund when the rest of the client's portfolio probably has higher performance; but, when the rest of the portfolio performs poorly, the fund seeks to generate capital appreciation and income. In this way, the ideal liquid alt fund becomes a potential source of liquidity in the event that cash is needed. If not needed, the portfolio is well-positioned to allocate capital to other low risk, fundamentally-sound, and now higher-yielding assets.

It is precisely that strategy that we at First Principles Capital Management (FPCM) seek to execute in our liquid alt mutual fund, the Context Macro Opportunities Fund, in the form of total return with low correlation to broad financial markets in ordinary markets, but strong negative correlation in periods of market distress. We envision a viable scenario where investors reap modest returns with a positive probability of creating a strong upside return through options strategies when volatility hits. The core of the strategy is to avail mutual fund investors of the same option tools institutional investors have long utilized to manage portfolio downside.

A Clear Vision

In retrospect, the recent financial crisis has taught investors the value of diversification and patience. Revisiting our driving analogy, while the erratic driver wound up crashing and had to pull over to the side of the road to assess damage, the patient driver, who committed to one lane, passed the accident when congestion cleared. This driver is analogous to the investor who remained committed during the financial crisis and times of significant loss. Not only was this investor able to recover losses, but he managed to realize significant levels of return while those who frenetically shifted between asset classes more than likely fared less well.

However, there is another twist to this story line. Investors often develop a comfort for historical precedent, and have a propensity to make decisions by extrapolating experiences from the most recent cycle. Predicating an investment strategy on the expectation of a government response to a future crisis similar to the policy actions during the Great Recession, could be a strategic folly. Investors who reaped significant returns did so primarily as a result of an extraordinary and unprecedented event in the form of a $700 billion government bailout plus $4 trillion of financial support from the Federal Reserve. They might be ill-advised to expect that same level of taxpayer capital to be poured into the financial markets again.

The "If" and "When" Risks of Investing

A gambler drops coins into a slot machine knowing with perfect certainty that money will pour out of the machine. He knows that because it's regulated to do so. The problem is, he doesn't know when. He may, however, collect data by watching what other gamblers have put into the machines while evaluating how many coins he has left in his pocket before he decides to step up to a machine to begin to play. It is a careful study of the environment, all in an attempt to maximize the expectation of the machine lighting up and ejecting a payout from the hopper before exhausting his supply of coins.

Similarly, there's no way to know with certainty when a market crisis will unfold and volatility will spike. The question of when to rely on historical precedent can be nuanced. While we can confidently expect that an adverse event will happen, it's difficult to know when, or what ultimately will be the trigger. What we can do is manage a portfolio based on that reality. Certainly no one wants to see equity markets implode, but to ignore the possibility that it could happen is fanciful. While there is little doubt "if" that day will come, "when" it will occur is highly uncertain.

Scoring the goal

To bring this strategy home, we visit the scene of a child's soccer game. Here, we frequently witness a crowd of young children hovering over the ball, succumbing to an urge to chase the ball at all costs. This would suggest that the desire to "be where the action is" may be a genetic trait and overcoming this innate behavior requires diligent coaching and years of practice. Yet, on occasion you observe one lone child, the outlier, who resists temptation and positions herself away from the crowd and simply waits patiently. She shuts out the roar of goading parents and watches as her teammates hover around the ball. In a fleeting moment, the ball randomly pops out of the scrum toward her, and she scores an easy goal. In the world of investments, that soccer player who steps away from the pack is the one who best personifies diversification—in contrast to the investors crowding around the same ball of high-risk assets. She seizes the moment when the risk is low.

The predicament of today's mutual fund investor is not unique; institutional investors are experiencing the same challenges and similar risks. With monetary policy pushing everyone toward the same asset allocation, both have slipped into a pattern and their portfolios have started to look alike. As they've all crowded around a single focus, they've headed down a collectively risky path. What's needed is a coach to guide mutual fund investors through diversification, a fixed income manager with deep institutional expertise who knows how to deploy capital before a crisis occurs and how to redeploy it once the crisis has hit. And one who knows how to resist the inherent desire to be where the action is.

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Important information:

Before investing you should carefully consider the Context Macro Opportunities Fund's investment objectives, risks, charges and expenses. This and other information about the Fund is in the prospectus, a copy of which may be obtained by calling 1-844-511-9653. Please read the prospectus carefully before you invest.

Diversification does not assure a profit or protect against a loss in a declining market.

An investment in the Fund is subject to risk, including the possible loss of principal amount invested. Risks are detail in the prospectus and include, but are not limited to, the following: **Asset-backed and mortgage-backed securities** are subject to risk of prepayment. **Credit default swap agreements** involve special risks because they may be difficult to value, are highly susceptible to liquidity and credit risk, and generally pay a return only in the event of an actual default by the issuer of the underlying. The prices of **futures** can be highly volatile, using futures can lower total return and the potential loss from futures can exceed the Fund's initial investment. The Fund's **derivative investments** have risks, including the imperfect correlation between the value of such instruments and the underlying assets of the Fund. The risk of investing in **foreign companies** involves certain risks not generally associated with investments in the securities of U.S. companies. In addition, individual international country economies may differ favorably or unfavorably from the U.S. economy in such respects as growth of gross domestic product, rates of inflation, capital reinvestment, resources, self-sufficiency and balance of payments position. **Emerging markets** investments are subject to greater political and economic uncertainties as well as a relative lack of information about companies in such markets.

Hedging is a strategy in which the Fund uses a derivative to offset the risks associated with other Fund holdings. There can be no assurance that the Fund's hedging strategy will reduce risk or that hedging transactions will be either available or cost effective. The use of **leverage** has the risk of capital losses that exceed the net assets of the Fund. Leverage may involve the creation of a liability that requires the Fund to pay interest. The Fund may experience difficulty in selling **illiquid** investments in a timely manner at the price that it believes the investments are worth. In addition, market conditions may cause the Fund to experience temporary mark-to-market losses, especially in less liquid positions, even in the absence of any selling of investments by the Fund. The Fund is "**non-diversified**", investing in fewer securities at any one time than a diversified fund. A decline in the value of or default by a single issuer makes the Fund more susceptible to financial, economic or market events impacting such issuer. **Short selling** involves unlimited risk including the possibility that losses to the Fund may exceed the original amount it invested. Investments in **small and medium capitalization companies** may be less liquid and their securities' prices may fluctuate more than those of larger, more established companies. **Newly organized** Funds have no assurance that active trading markets will be developed or maintained.

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