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PORTFOLIO WATCH

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Fee Only

Choosing the Right Container

As we enter 2017 and reflect on 2016 (even though there are probably parts of it we would probably rather forget), college students everywhere, and most Oakland Raider fans, are mourning the loss of Robert Hulseman, the inventor of the red Solo cup. Besides being necessary sporting equipment for Beer Pong, red Solo cups are great as paint containers, catching bugs, and holding Coors Light. You probably wouldn't want to use them, however, as a container for a Chateau Montelena Estate Cabernet Sauvignon (unless you're a 49ers fan). Sometimes, the right container is pretty important.

Investment Containers

Most people don't think about the "containers" they use for investments. For most investors, everything fits into the same container: a mutual fund. These are the red Solo cups of investing. They are very easy to purchase or sell, they are usually cheap, and they have daily liquidity. At any moment you can decide you don't want to own a mutual fund, and at the end of the trading day you're out. Exchange Traded Funds (ETFs) are even more liquid because they trade like stocks. Of course, if you can decide at any time that you want to sell so can everybody else, and this can create a problem. Where does the cash come from if a bunch of people want their money back at the same time? All funds keep some amount of cash on hand to deal with redemptions, but what if the redemption requests exceed the cash? Obviously, something needs to be sold, and this is why matching the container to the investment is so important.

Mis-matched Containers

Early in 2016, the most popular high-yield bond ETF (HYG) was down over 17% from the previous year. Another high-yield bond fund (HYLD) with more

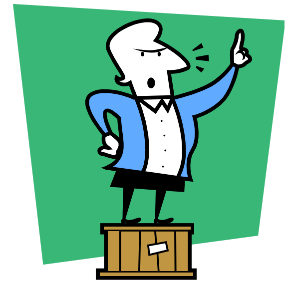
energy exposure was down 28%. The bonds these funds were holding didn't default, so what was the problem? The problem was that too many investors were worried about rising interest rates and oil companies (which have a lot of high-yield debt), and decided they wanted out at the same time. High-yield bonds, which used to be called "junk bonds," are difficult to sell. They're illiquid. When you hold illiquid assets in a highly-liquid container, problems arise. The funds had to sell assets that no one wanted to buy, so the prices collapsed. This is called a *liquidity crunch*, and can easily happen when using the wrong container.

Correct Containers

If you are a trader and plan to get in and out of stocks, then a container with daily liquidity is an obvious choice. But most sane investors don't hold illusions of beating the market by rapid trading, and so a container with a little less liquidity can be an advantage. For investments like real estate or high-yield private debt, it is very important to use vehicles that prevent selling due to mass hysteria or the latest tweet from Donald Trump. This is why I use private partnerships that are illiquid for several years for these types of assets. A relatively new type of container has emerged in the last few years called an "interval fund." These are purchased just like a mutual fund, but they can only be sold during a one-week window each quarter, and there is a limit to how much can be sold each quarter. These provide most of the benefits of a mutual fund, but avoid the possibility of a liquidity crunch. Perhaps this could turn into the next red Solo cup of investing.

Veripax News

This is the 125th edition of Portfolio Watch. I wrote four newsletters in 2006 and one every month since then. I still have fun with them, although it gets harder and harder not to repeat myself…too often. Just a little trivia, since I've never counted them up before.



Market Comments

So far, the stock market has really liked the idea of a Trump presidency. We're going to have lower corporate taxes, companies are going to move their manufacturing plants back to the United States, small businesses will be able to hire more people, Mexico is going to pay us for building them a beautiful wall, and Russia will love us as we jointly defeat terrorism throughout the world. This seems to be what the market is expecting, or at least hoping for, and it has driven stock prices to all-time highs. Remember that stock prices and Price-to-Earnings ratios tend to reflect what is expected to happen, so there is a lot of optimism being priced into the market. I tend to think there is some risk associated with a Trump presidency that is not being factored in yet.

There is another explanation for the market responding to the outcome of the election in exactly the opposite way that the "experts" were predicting. It's safe to say that the election was a risky event from an investing standpoint. Therefore, every advisor and money manager who pays attention to risk and worries about protecting capital probably had some extra cash on the books. When the market suddenly reversed direction and took off, anyone holding cash started to look dumb (see last month's newsletter) and needed to look for an opportunity to jump back in. Typically, a good "opportunity" would be a pullback, but after several days with no pullback, money managers got worried. At that point, the wait for a pullback gets abandoned and managers just wait for a day or two pause. Every time the market paused for a day or two, money managers would start to buy again and drive the market higher. This is known as a "melt up," and it can drive investors into making very risky choices.

What's next for 2017? Well, the market could go up, or it could go down, or… You've heard that before, and I try not to make decisions based on guessing. Anything can happen in the short-term, but we're entering 2017 with historically high stock valuations (by some measures, only 2000 and 1929 were higher). Historically, these valuations would suggest that long-term returns for the market (7-12 years) would be either relatively flat or even negative. If Trump can accomplish all or most of what he says he can from an economic standpoint, maybe we won't see a return-to-the-mean from a valuation standpoint. On the other hand, we probably won't have the U.S. Treasury printing $4.3T like we had over the last 8 years. I don't plan on abandoning risk management anytime soon.

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