MAI VIEW

VOL. XVII, NO. XIV | www.macro-allocation.com | MARCH 28, 2017

Self-Serve

"Selfishness is a virtue."

- Ayn Rand

"Selfishness is profitable, but for institutionalized investors it takes courage to be selfish."

- Paul Brodsky

In *Passive Aggressive*, we made the case that ETFs can be useful vehicles for thoughtful active investors. A few people agreed with our self-assessment in the piece that we were being self-serving because we are launching a modestly priced pro-volatility fund that actively manages ETFs. To some this might raise the issue of whether the report was truly objective. It was, and in fact we would argue that opening a fund using the approach endorsed in *Passive Aggressive* shows our high level of conviction towards it. It would be unconscionable were we not to not share an opportunity we see as worthy of opening a business.

Objective analysis is objective because the ideas and conclusions are free of bias, not because the analyst is free of a potential conflict of interest. Full-disclosure separates self-interest from self-dealing.

We have argued recently that US and global output growth are declining fast, Trump's economic initiatives would have little impact (best case), long-duration Treasuries should be bought and high yield credit sold, gold should be owned, US housing and retail sectors should be shorted, as well as other macro trends and applications. Most of our suggestions have been counter-consensus and would benefit from a general increase in economic and market volatility. By discussing the ETF approach within the context of MAI, it is our hope that subscribers value the overall strategy enough to consider acting on it in some measure, whether it is with us, with someone else, or on their own. But enough about that...

Who pursues which investment strategies and why got us thinking about a broader question: *can an alternative-investment style without widespread acceptance have merit, or should it be avoided by practical investors*? The crux of the issue is *when should an investor consider an unconventional approach she has not considered before?* Our answer: *now, at least for a portion of the portfolio.*

A Precarious Setup

On one level, it is satisfying to watch investors migrate to lower-cost passive investment vehicles because higher-cost active management has consistently under-performed. One might say the market for investment intermediation is rational. One might also argue passive investing is not rational at all because it is not forward looking. Rising markets, an unwillingness to acknowledge fat tails (unlikely knowns), and the inability to model Black Swans (*unknown unknowns*) have concentrated popular wealth into a narrowly distributed range of highly vulnerable assets and investment strategies.

The trend towards passive investing implies the preponderance of a type of investment behavior called *reflexivity* - basically, an established trend begets the continuance of it. This mindset is typically embraced by *traders*, but less prevalent among *investors* who generally regard themselves as fundamental long-termers. The irony is that for long-term investors, the broad migration to passive investment vehicles is occurring in full revolt against longer term macroeconomic and commercial fundamentals.

When we step back and look at the broad macroeconomic setup, characterized by aging populations in the world's largest economies, declining overall birth rates among the world's wealth holders, record sovereign and household leverage, the continued economic emphasis of finance over production, the reliance on over-accommodating central banks (even during the Fed's current rate hike phase), historically high equity, bond and real estate prices and record low asset and liability values (in real terms); *<u>we cannot help but conclude that asset prices are generally rising due mostly to inertia, in spite of unreason, and that the most likely outcome will be something unexpected and disappointing</u>*.

Even though it is a rejection of the established secular bull market in assets and the social, economic, political and financial cultures established and tweaked over the span of our career (almost to the day), our heart and mind (not to mention the vast sweep of investment and economic history) tell us structural change is coming. We can use our experience to forecast specific events and new trends that might occur, and we have, but we cannot know exactly what form structural change will take or when it might begin.

Into the Breach

A socialized market framework with implicitly guaranteed perpetual positive returns for all must fail. The best approach is to confront the point of criticality head-on, where "wealth" *seems to be permanent but is not*. Turning popular passive instruments on themselves to take advantage of great market distortions promises to be an aggressive hedge against misguided inertia - an effective portfolio offset that strikes at the belly of the beast. ETFs are here to stay, but their market prices and liquidity profiles are not.

Serve yourself. All investors and trustworthy market professionals should be expected to act selfishly by seeking to identify and profit from unsustainable distortions. If investors must put that in a more virtuous context to satisfy their consciences (or fiduciary charters), then they can make themselves feel better by knowing that helping to close unsustainable distortions is the only way capitalism can survive. Capitalism without failure is like Catholicism without hell. In this case, investors can do well by doing good if/when market hell arrives.

Selfishness is profitable, but for institutionalized investors it takes courage to be selfish.

Paul Brodsky
Macro Allocation Inc.

Property Notice & Disclaimer

The information contained in this document is for general information purposes only. It is provided by Macro Allocation Inc to Subscriber/Members, and, while we endeavor to ensure the information is up-to-date and correct, we make no representations or warranties of any kind, express or implied, about the completeness, accuracy, reliability, suitability or availability with respect to this document or the information, products, services, or related graphics contained in this document for any purpose. Nothing in this document should be taken to constitute professional advice or a formal recommendation, and we exclude all representations and warranties relating to the content and use of this document. Any reliance you place on such information is therefore strictly at your own risk.

In no event will Macro Allocation Inc, its affiliates, and employees be liable for any loss or damage including, without limitation, indirect or consequential loss or damage, or any loss or damage whatsoever arising from loss of data or profits arising out of, or in connection with, the use of this document.

Through this document you may infer that other sources of information mentioned in it could provide suitable analysis related to issues on which you may act and suffer damages. Any mention or reference herein does not necessarily imply a recommendation or endorse the views expressed or implied by it.

Macro Allocation Inc reserves the right to revise and amend this disclaimer notice from time to time and any revised version will be deemed to be applicable from the first date of publication of this document.