# Quarterly Newsletter

April 2015

**CAPITAL MARKETS UPDATE** | Global Equities delivered solid returns (+2.3%) for the first quarter in choppy markets. International (+4.9%) and Emerging Market Equities (+2.2%) led the way while U.S. Large Cap Equities lagged (+1.0%). Global Fixed Income posted weak returns (-1.9%) as the US Dollar continued to strengthen relative to other major currencies. Domestic bonds rallied (+1.6%) as yields declined amid tepid economic data and benign expectations for Fed rate increases later in the year. Similarly, Real Estate pushed higher (+4.8%) as investors continued to chase yield. Commodities were the weakest asset class (-5.9%).

**BEHAVIORAL FINANCE** | Traditional economic and financial theory posits that markets are efficient and current prices fully reflect all relevant information. Behavioral finance theorists challenge the traditional thinking and observe that investors routinely make emotional (a.k.a. irrational) financial decisions that produce inefficiencies in market pricing (periods when market prices differ from "fair value" based on the underlying fundamentals). In fact, numerous studies show that cognitive and psychological biases significantly influence investors' decision making. Last quarter, we discussed the large impact investor emotion may have on asset prices and market cycles. This quarter, we will dig a little deeper with emphasis on asset prices and how investors can take advantage of enduring trends.

**WHY DO MARKETS TREND?** | In their Nobel-Prize winning research in the 1970s, cognitive psychologists Daniel Kahneman and Amos Tversky argue that human behavior accounts for the under- and over-reaction that occurs in security prices. Market prices don't immediately fully reflect new information that has changed the fundamental (fair market) value of an asset. Instead, price trends form due to investors' (1) initial ***anchoring*** to old facts and ***under-reaction*** to new information and (2) subsequent ***herding*** behavior and delayed ***over-reaction*** to changes in fundamentals.

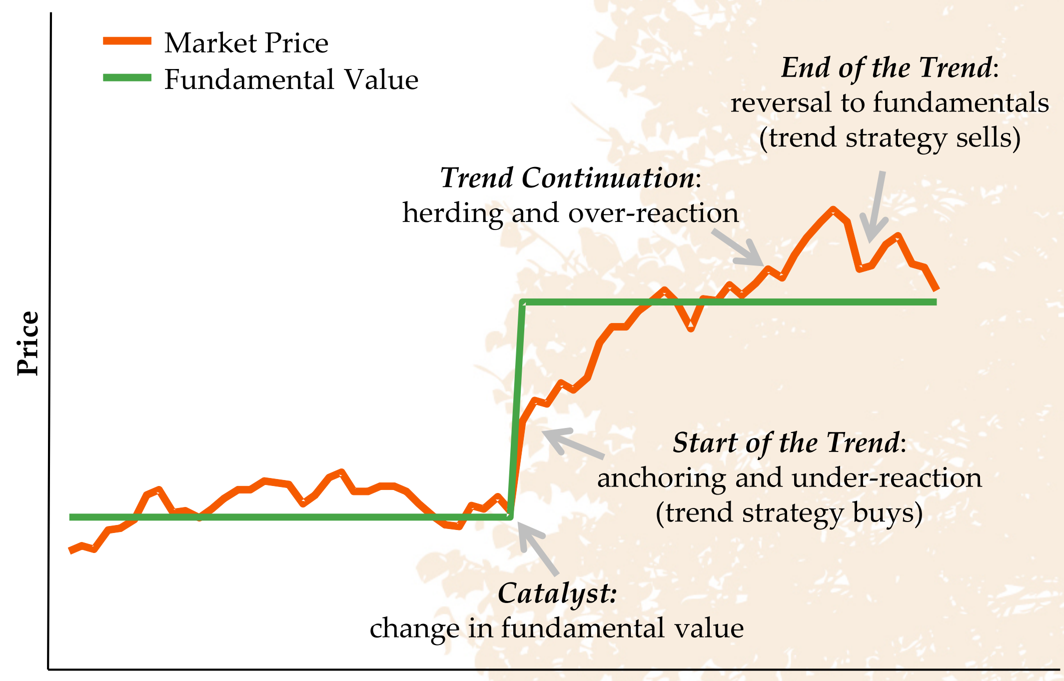
1. Anchoring and Under-reaction—Rational investors rigorously analyze an investment and evaluate its fair market value based on the current fundamentals. This valuation determines a price that becomes a mental reference point. As emotional investors, our psychological tendency is to "anchor" to this initial valuation/price and the initial fundamentals on which it is based. Simply said, we are slow to react to new information and adjust our analysis. The result: investors don't give full credit to the positive (negative) change in fundamentals and the market price undervalues (overvalues) the asset.

2. Herding and Over-reaction—Herd behavior describes the tendency of individuals to follow the crowd. We like to wear what is fashionable, eat what is popular and go to the trendy place. After all, there is comfort in numbers. Investors tend to be especially emotional and competitive—we don't want to miss out while others profit. The result: as investors herd together, chase performance and over-react, the price trend overshoots.

**PROFIT FROM THE CROWD** | Disciplined investors have an opportunity to profit from the irrational decisions (cognitive biases) of emotional investors. Managed Futures is a trend following strategy that seeks to profit from these persistent investor behaviors. The strategy trades contracts to buy or sell a particular asset (stocks, bonds, currencies or commodities) in the future at a set price. The discipline is to buy (sell) contracts for assets that are rising (falling) in price. The Managed Futures investor then profits (loses) from a continuation (reversal) of the current trend.

300 South Main Street | Winston-Salem, NC 27101-8724 | Telephone: 336-777-1677
Fax: 888-761-1120 | www.arborinvest.com

The chart below is a hypothetical illustration of how the strategy works. After an initial catalyst (new information that increases the asset's fundamental value), the market price adjusts higher (but not all the way to fundamental value). The fund manager then buys the asset once the upward trend has begun (typically an automated trade based on quantitative algorithms). The purchase price is an attractive entry point (below fundamental value) as the crowd anchors and under-reacts. Investor herding and over-reaction then perpetuate the trend and drive the market price (and profits on the investment) higher. The fund manager finally exits the position once the trend becomes over-extended or reverses.




Source: AQR Capital Management, LLC

GOOD TO HAVE ALTERNATIVES | Alternative Investments are valuable diversifiers if they are truly alternative, i.e., ***different*** from the rest of the portfolio. Careful selection is important—too many strategies claiming to be alternative charge a high fee and have a significant correlation with stocks. J.P. Morgan Asset Management reports that Hedge Funds had a +0.8 (i.e., strong) correlation with Global Equities over the last ten years. Based on that data, the name "Hedge" Funds seems to be a misnomer. Within Alternative Investments, we value strategies with ***low expected correlations*** to traditional stocks and bonds. Managed Futures is especially compelling given its propensity to perform well in strong and weak markets. Over the last five years (the fund's inception was January 2010), the AQR Managed Futures Strategy Fund has delivered attractive returns, modest volatility and a low negative correlation (tends to move in the opposite direction) with Global Equities (-0.2) and Global Fixed Income (-0.1).

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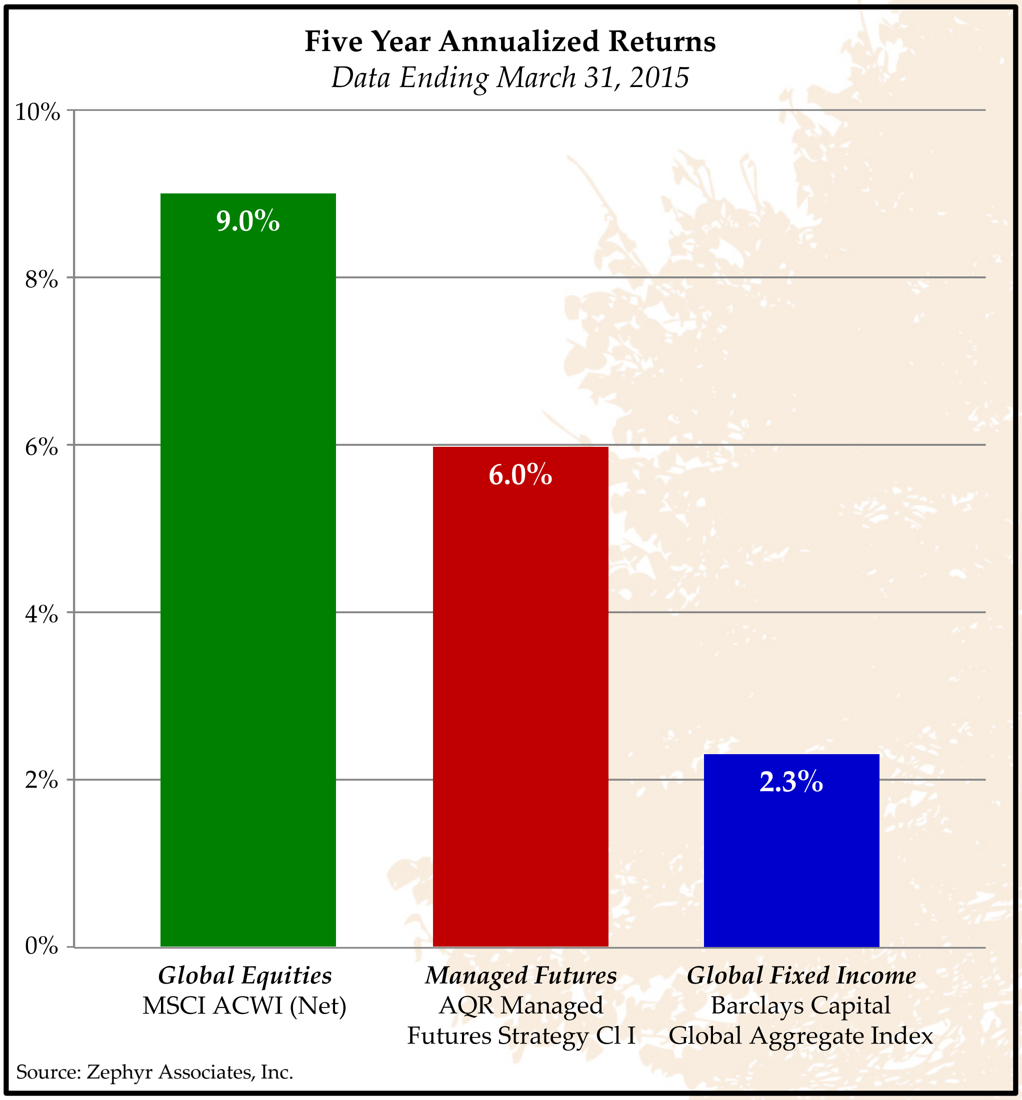


Markets will continue to have cycles in which some assets outperform and others disappoint. History reminds us that maintaining discipline has rewarded long-term investors at the expense of market timers and performance chasers. In fact, some investment strategies are designed to profit from the emotional swings of the crowd. As global interest rates continue to plumb historic lows, it is increasingly important to hold true alternatives to further diversify traditional stock and bond portfolios.

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