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CLIENT NEWSLETTER

"An investment in knowledge always pays the best interest."

—Author unknown, commonly attributed to Benjamin Franklin

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THE VALUE OF AN APOLOGY

On August 1, Elon Musk made what one analyst deemed "maybe the most valuable apology of all time."

A few months ago, on Tesla Corporation's quarterly conference call with Wall Street analysts, Musk, Tesla's rock star CEO and co-founder, was a bit testy, at one point blasting "boring, bonehead questions." Following that call, the price of Tesla stock plunged.

Fast forward three months to the August call, and Musk struck a more conciliatory tone. "My apologies for not being polite on the prior call," Musk said. The analysts seemed satisfied, and shares of Tesla spiked more than 16% the next day. My back-of-the-envelope calculation says that move added about $8.2 billion to the company's value. **$8.2 billion!** With that kind of money, you could build five-and-a-half Yankee Stadiums (but for the love of God, why would you?).

The purported purpose of a quarterly conference call is for a company to talk with analysts about their business results (you know, trivial stuff like whether they made money or lost it), explain how the company is doing and what to expect in the future. That's why it's generally referred to as the earnings and guidance call.

On Tesla's August call, the earnings and guidance portion of the call seemed no different than every other Tesla quarterly call. The company announced a worse loss than expected ($3.06 per share vs. expectations of $2.92), and then proclaimed they would soon turn a profit (something Tesla has **never done**).

What drove Tesla stock from $300 per share to almost $350 then? Must've been that apology. KeyBank analyst Brad Erickson said: "Elon Musk apologized multiple times for his inappropriate behavior on last quarter's call … and the CEO worked to restore faith and credibility with investors that he can be a plus to the investment narrative, not a minus." Erickson is the analyst who called it "maybe the most valuable apology of all time." In monetary terms, it's hard to argue, with the company increasing in value in one day by more than the entire GDP of Moldova.

Vitaliy Katsenelson of Advisor Perspectives maybe isn't as impressed with the value of Musk's contrition. In an article published the next day (which I concede may have been written and submitted before the August 1 call), he said Tesla stockholders should be asking these questions:

1. **How sound is Tesla's balance sheet?** Katsenelson points out that Tesla loses billions of dollars every year, and has incurred a lot of debt. Tesla's recent attempt to squeeze its suppliers to lower its costs was seemingly a recognition of its financial jeopardy.

2. **What happened to 345,000 reservations?** Katsenelson says 400,000 people paid $1,000 a piece to reserve a place in line for Tesla's new Model 3, which was to be offered at $35,000. He estimates that to date Tesla has delivered 55,000 cars, but the price ended up starting at $49,000, not $35,000. Now, Katsenelson has learned, Tesla is advertising that the Model 3 is available in the U.S. with no reservation. With current production at less than 3,000 units per week, Tesla would need about 2 years or a miracle to fulfill all of those prior orders, unless a whole lot of people cancelled their reservations (and drained the company's balance sheet of upwards of $345 million in interest-free deposits).
3. **How effective is Musk at running Tesla?** While respectful of Musk's many talents and accomplishments, Katsenelson lists some recent confidence-destroying erratic behavior from Musk (and didn't even mention the previous quarter's conference call). He threatened a lawsuit against an investor who published negative research, and called a diver who helped rescue the cave-trapped Thai soccer team a "pedo" (shorthand for pedophile, we assume) after the diver criticized him.

Katsenelson believes Tesla's value (and stock price) should be based on the company's fundamentals: its balance sheet, sales (and cancelled sales) numbers, strength of management. And here are some other people who believe that: everyone who has ever taken a basic class in economics. So that would include, for example, me.

If short-term capital markets actually adhered to some basic rules of logic, there might be some value to using fundamental analysis to determine which companies you should invest in. Probably not, but maybe. But when a company's value can make an $8 billion swing based on insults and apologies, stock picking is far too risky a game to play.

Sources: "Elon Musk makes the 'most valuable apology of all time' on Tesla's earnings call" by Tae Kim, cnn.com, 8/2/2018.

"Questions I'd Be Asking If I Owned Tesla Stock" by Vitaliy Katsenelson, Advisor Perspectives, 8/2/2018.

"10 Reasons Why The Yankees Are America's Most Hated Team" by Curt Hogg, bleacherreport.com, 5/17/2010.

—*Steve*

ALTERNATIVE REALITY

Diversification has been called the only free lunch in investing.

This idea is based on research showing that diversification, through a combination of assets like stocks and bonds, could reduce risk without reducing expected return, or could increase expected return without increasing risk compared to those individual assets alone.

Many investors have taken notice, and today, highly diversified portfolios of global stocks and bonds are readily available to investors at a comparatively low cost. A global stock portfolio can hold thousands of stocks from dozens of countries around the world, and a global bond portfolio can be diversified across bonds issued by many different governments and companies and in many different currencies.

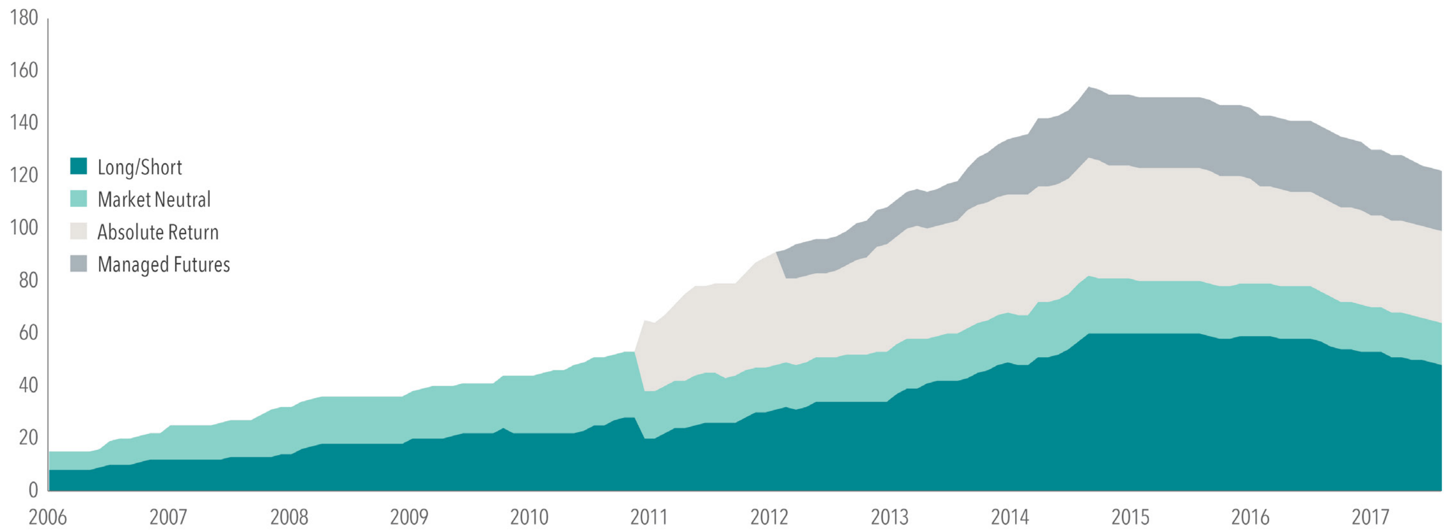
Some investors, in search of additional risk reduction or higher returns, may look beyond stocks and bonds to other assets, many of which are commonly referred to as "alternatives." Depending on who you're talking to, alternatives could include:

- hedge funds
- private equity
- commodities
- derivatives
- futures contracts
- pretty much any investment other than stocks, bonds or cash

These investments are often marketed as having greater return potential than traditional stocks or bonds, or low correlation with other asset classes (the definition of diversification).

In recent years, "liquid alternatives" have increased in popularity considerably. This sub-category of alternatives consists of mutual funds that may start from the same building blocks as the global stock and bond market but then select, weight, and even sell securities short (bet on their prices falling) to try to deliver positive returns that differ from the stock and bond markets. **Exhibit 1** shows how the growth in several popular classifications of liquid alternative mutual funds in the U.S. has ballooned over the past several years. (Please refer to "Alternative Strategy Definitions" section later in this article for a description of each category.).

EXHIBIT 1. NUMBER OF LIQUID ALTERNATIVE MUTUAL FUNDS IN THE U.S., JUNE 2006–DECEMBER 2017



Sample includes absolute return, long/short equity, managed futures, and market neutral equity mutual funds from the CRSP Mutual Fund Database after they have reached $50 million in AUM and have at least 36 months of return history. Multiple share classes are aggregated to the fund level.

The growth in this category of funds is remarkable given their poor historical performance during that same period. Exhibit 2 illustrates that the annualized return for such strategies from 2006 to 2017 has been underwhelming when compared to less complicated approaches such as a simple stock (Russell 3000) or bond (Bloomberg Barclays U.S. Aggregate) index. The return of this category has even failed to keep pace with conservative, low expected return investments such as U.S. Treasury bills. Here's a pretty good rule of thumb for investing: If your investments cost way more than T-bills, and have much more risk than T-bills, you want a better return than T-bills.

EXHIBIT 2. PERFORMANCE AND CHARACTERISTICS OF LIQUID ALTERNATIVE FUNDS IN THE US VS. TRADITIONAL STOCK AND BOND INDICES, JUNE 2006–DECEMBER 2017

	Liquid Alternative Funds Sample	One-Month US Treasury Bills	Russell 3000 Index	Bloomberg Barclays US Aggregate Bond Index
Annualized Return (%)	0.83	0.90	8.93	4.52
Annualized Standard Deviation (%)	5.56	0.46	14.80	3.17
Average Expense Ratio (%)	1.42	—	—	—
Average Annual Turnover (%)	199.80	—	—	—

Past performance is no guarantee of future results. Results could vary for different time periods and if the liquid alternative fund universe, calculated by Dimensional using CRSP data, differed. This is for illustrative purposes only and doesn't represent any specific investment product or account. Indices cannot be invested into directly and do not reflect fees and expenses associated with an actual investment. The fund returns included in the liquid alternative funds average are net of expenses. Please see a fund's annual report and prospectus for additional information on a specific portfolio's turnover and the expenses it incurs.

Liquid Alternative Funds Sample includes absolute return, long/short equity, managed futures, and market neutral equity mutual funds from the CRSP Mutual Fund Database after they have reached $50 million in AUM and have at least 36 months of return history. Dimensional calculated annualized return, annualized standard deviation, expense ratio, and annual turnover as an asset-weighted average of the Liquid Alternative Funds Sample. It is not possible to invest directly in an index. Past performance is not a guarantee of future results. Source of one-month U.S. Treasury bills: © 2018 Morningstar. Former source of one-month U.S. Treasury bills: Stocks, Bonds, Bills, and Inflation, Chicago: Ibbotson And Sinquefield, 1986. Bloomberg Barclays data provided by Bloomberg Finance L.P. Frank Russell Company is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes.

Standard deviation is a measure of the variation or dispersion of a set of data points. Standard deviations are often used to quantify the historical return volatility (risk) of a security or a portfolio. Turnover measures the portion of securities in a portfolio that are bought and sold over a period of time.

Returns from such strategies (and most other investment strategies) are unknown and unpredictable. However, the costs and turnover associated with them are easily observable. The average expense ratio (cost) of such products tends to be significantly higher than a long-only stock or bond approach. High cost means an investment needs to perform better just to provide the same return as a lower cost investment. High turnover (the percentage of assets within the fund that are bought and sold each year) is also a cost driver for several reasons: more buying and selling means more trading cost, but it also means higher cost structure at the fund company. Someone (or many someones) has to determine what to buy and sell, how much to buy and sell, and actually place the trades. Higher cost and turnover in this category are likely suspects to explain poor performance compared to more traditional stock and bond indices.

CONCLUSION

This data by itself, though, does not warrant a wholesale condemnation of any assets beyond stocks or bonds. The conclusion here is simply that, given the ready availability of low cost and transparent stock and bond portfolios, the intended benefits of some alternative strategies may not be worth the added complexity and costs.

When confronted with choices about whether to add additional types of assets or strategies to a portfolio for diversification beyond stocks, bonds, and cash it may help to ask three simple questions:

1. What is this alternative getting me that is not already in my portfolio?
2. If it is not in my portfolio, can I reasonably expect that including it will increase returns or reduce risk?
3. Is there an efficient and cost-effective way to get exposure to this alternative asset class or strategy?

If investors are left with doubts about any of these three questions it may be wise to use caution before proceeding. A good advisor can help investors answer these questions and ultimately decide if a given strategy is right for them.

ALTERNATIVE STRATEGY DEFINITIONS

Absolute Return: Funds that aim for positive return in all market conditions. The funds are not benchmarked against a traditional long-only market index but rather have the aim of outperforming a cash or risk-free benchmark.

Equity Market Neutral: Funds that employ portfolio strategies that generate consistent returns in both up and down markets by selecting positions with a total net market exposure of zero.

Long/Short Equity: Funds that employ portfolio strategies that combine long holdings of equities with short sales of equity, equity options, or equity index options. The fund may be either net long or net short depending on the portfolio manager's view of the market.

Managed Futures: Funds that invest primarily in a basket of futures contracts with the aim of reduced volatility and positive returns in any market environment. Investment strategies are based on proprietary trading strategies that include the ability to go long and/or short.

Category descriptions are based on Lipper Class Codes provided in the CRSP Survivorship bias-free Mutual Fund Database.

—Adapted from a paper published by Dimensional Fund Advisors LP

WINNING STAGE RACES

I enjoyed watching parts of the Tour de France last month. I would catch glimpses of it on TV as we dined in local restaurants and would stumble across it channel surfing at home. I love watching the racing but I also love seeing the beautiful French countryside as the backdrop to the 21 stages the 176 racers covered throughout France.

I grew up around cyclists and remember the great Belgian racer from the 1970's, Eddy Merckx. Merckx is one of three racers to have won 8 of the 21 stages—the most in any single tour. Merckx did this in 1970 and 1974 and ended up winning both of those tours.

Contrast that with another great racer, Greg "LeMonster" LeMond, the American cyclist who won the Tour de France in 1986 and 1989. Then in 1990 he did it again but this time without winning a single stage. This isn't an anomaly either – five other cyclists have won the Tour without winning a single stage.

Apparently you don't have to win any stage races to still come out on top.

As an investor, it's important to keep this in mind. You don't have to win every month, quarter or even every year to end up on the podium wearing the Yellow Jersey. Actually, trying to keep up with the short-term winners can be counter-productive to long-term success. It'll also burn you out.

I see this with other types of athletes besides cyclists as well. The greatest, those who have a history of winning, have an ability to pace their race. They aren't distracted by what others are doing around them. They have tremendous discipline, patience and focus and don't fall to distractions or external influences that could potentially derail their strategy.

As investors we all feel self-doubt creep in from time to time, tempting us into alternative strategies and abandoning current plans. But we know what can't be denied, that having a detailed investment plan in place based on evidence and not speculation, designed for up and down markets, will get us where we want to go, if we stick to it.

You don't have to win every race to make it to the podium. Have a plan, make sure it's based on real historical evidence, and don't get distracted. If you have questions or would like a better understanding of your investment strategy give your advisor a call.

—Allen

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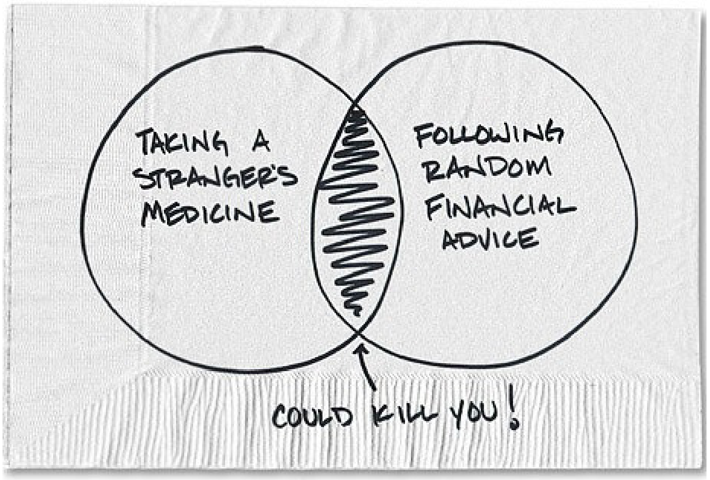
FROM CARL RICHARDS' NAPKIN BLOG



FINAL THOUGHT

"I don't want to worry you, but the guy who delivered the pizza was your financial planner."