ALL-WEATHER PORTFOLIO STABILITY

A Signals Matter Investment Primer

What Lies Ahead

How to Navigate Extreme Markets
& Extreme Monetary Policy

2020 Edition

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PORTFOLIOS FOR TOMORROW
Table of Contents

INTRODUCTION
Unprecedented Central Bank Intervention
Interest Rates Will Rise
Risks Everywhere
Old-Fashioned Portfolios
Goodbye to the 60/40 Pie Chart Portfolio

PART I – THE IMPACT OF RISING INTEREST RATES
Traditional Portfolios vs. Interest Rates
A Two-Sided Coin
Double-Trouble

PART II – THE SCIENCE OF PORTFOLIO DIVERSIFICATION
Defining Diversification
Measuring Correlation
Picture Perfect Example
Traditional vs. Alternative Investing
Here's Where It Gets Interesting
Charting Traditional Portfolios
There's Another Approach
Comparing Correlations: Traditional vs. Alternative Investing
Double-Trouble, Again

PART III – THE ART OF INVESTING ALTERNATIVELY
Active vs. Passive Portfolio Management
Building Alternative Investment Portfolios
Alternative Portfolio Pie Chart
An Artful Science
Key Pillars for Building Alternative Portfolios
Informed Investing
The Predictable Nature of Market Cycles
Meaningful Diversification
Risk Abatement
Technical Analysis
Proper Benchmarking
Trust Us – Holy Grail Investing Works

CONCLUSION – OUR CALL TO ACTION
It's Your Turn Now
You Decide

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INTRODUCTION

The key to any great portfolio is not only the investments it holds, but also the macro environment surrounding it. In this updated Investment Primer, we will describe in great detail how we construct a truly-diversified all weather portfolio in the pages that follow, but first we explain a few key macro factors that will influence portfolio performances for years to come.

Tectonic plates that lie beneath the global economy are shifting as we pen this Investment Primer for 2020. Given the unprecedented levels of post-2008 central bank intervention in the public markets through trillions of printed dollars (i.e., QE), used to facilitate the purchase of US Treasuries and other critical US debt instruments, the Federal Reserve has been able to essentially "buy" large swaths of the credit/bond market.

The extreme power, as well as extreme dangers, which underpin such central bank "accommodation," cannot be ignored and are foundational to portfolio construction. Thus, we address these first.

Unprecedented Central Bank Intervention

Such extreme monetary policies (i.e., artificial bond purchasing support from the Fed with dollars created from nothing) have allowed bond prices to remain artificially bought/supported and thus artificially elevated.

By keeping bond prices higher than natural supply and demand forces would otherwise dictate, bond yields, which move inversely to price, have thus been artificially lowered/suppressed.

This is a critical aspect of the markets to understand.

Why?

Because artificially low yields in the bond market means that interest rates are also artificially low.

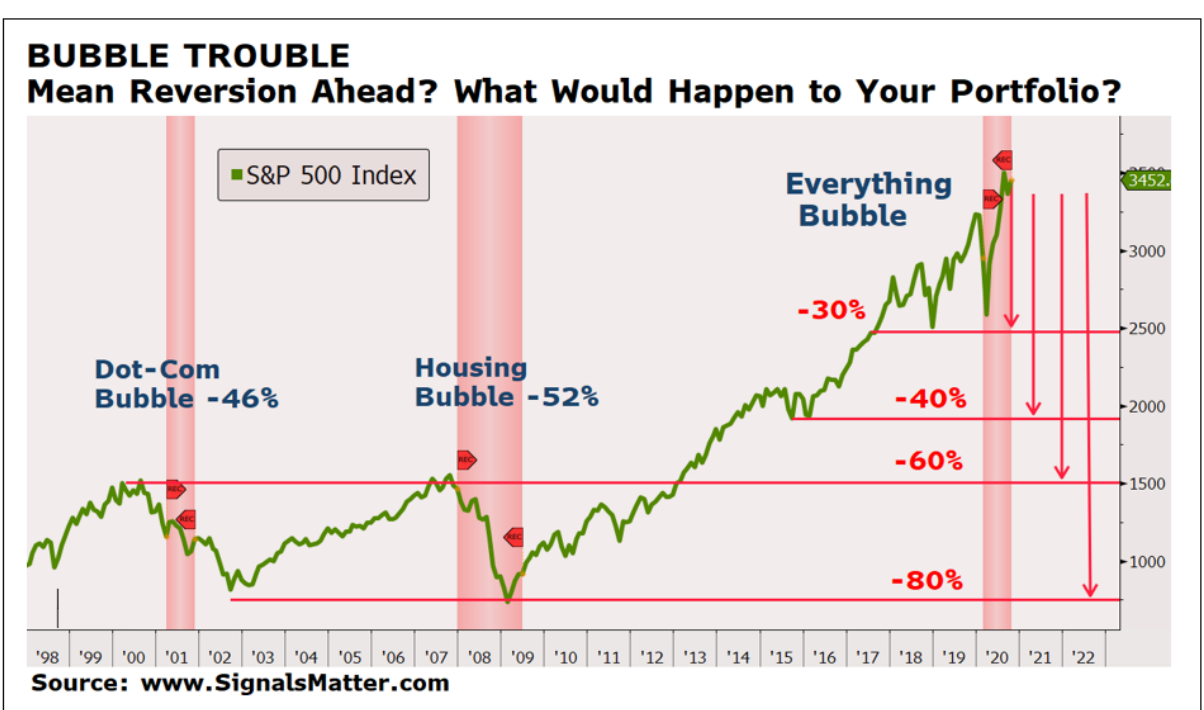
Interest rates, of course, represent the cost of borrowing. With rates repressed to the zero-bound for years, this means that corporations listed on the stock market, households on Main Street, and government agencies in DC have been on a record-breaking, low-rate borrowing binge. Post-'08 government, household, and corporate debt levels are now at record (and hence dangerous) highs—well over $80 trillion in combined toxic height.

Such low rates have allowed companies to borrow at disgracefully high levels ($11 trillion and counting) to purchase their own shares, make dividend payments, and otherwise go deeper into debt to survive, even thrive in the stock and bond exchanges, despite horrific balance sheets.

Unfortunately, such debt-based "survival" (even "bullish euphoria") is not only egregious and unprecedented, it's also unsustainable. The stock and bond markets, also at record-highs, are equally unsustainable.

Take a look at the chart below and ask yourself these questions:

- How long can this last?
- How long can stocks and bonds defy the force of gravity?
- How much mean reversion can you afford when interest rates turn?
- What would happen to your portfolio?



Interest Rates Will Rise

At some point, rates will rise. Bond and stock markets will be compromised. Such a rise in rates can be triggered by inflation, sudden bond sell-offs, or any number of other seen and unforeseen forces.

The very debt which brought markets to record highs will also bring markets to record lows when the cost of that debt (i.e., interest rates) rises and faith in the power of central bank support fades.

This happens as US Dollar strength slowly erodes, which occurs every time a government or nation resorts to desperate currency-dilution/creation to allegedly solve a debt crisis.

As holders of the world's reserve currency, the US has been able to play this dangerous game for longer than most other nations.

In short: Debt-driven markets rise and fall as interest rates fall and rise. Today, these rates are currently managed by central bank "accommodation" rather than natural market forces. Stated simply, the markets are no longer "stock" or "bond" markets—they are essentially "Fed Markets."

Such extreme central bank “accommodation” of the markets is un-natural as well as unsustainable. In the end, *natural* market forces always prevail over the hubris of *un-natural* “stimulus,” from 4th century Rome, 18th century France, or 21st century America.

Risks Everywhere

Numerous waves of risk are now rolling toward these markets, and hence your portfolio. This is fact, not fear-mongering.

At Signals Matter, we look at these larger macro risks when assembling the best possible portfolio at the micro-level to prepare for, and even thrive, during periods of higher risk. But we also recognize that Fed support can create favorable and temporary tailwinds, as well as periods of significant volatility, in these new “Fed Markets.” Thus, we build portfolios to operate in rising, falling, and sideways markets by exploiting all of the signals, tools, and indicators described in greater detail in this Investment Primer.

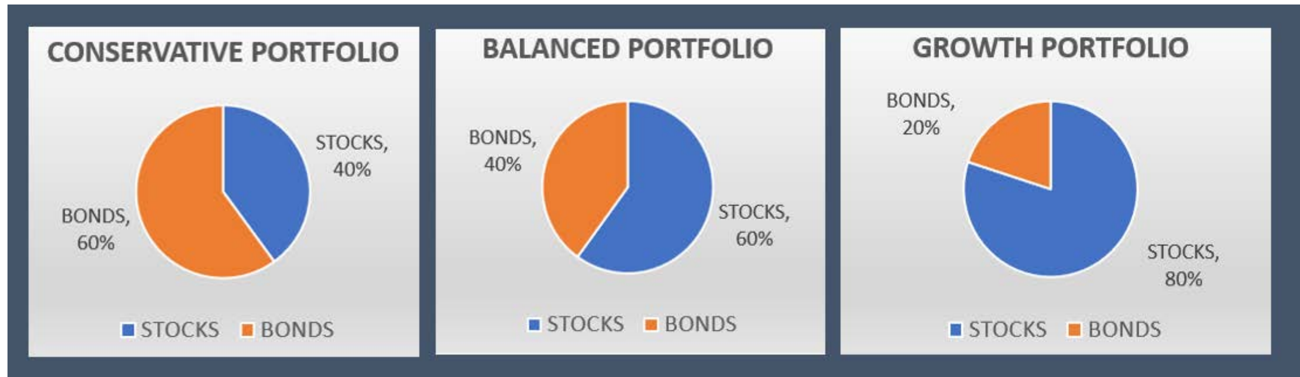
As the economic landscape changes from natural capitalism—i.e., natural supply and demand forces replaced by central bank intervention—informed investors need to honestly confront this new “abnormal” with open eyes. The traditional understanding, for example, of bonds as “safe-haven” assets needs to be re-thought. Bonds are now so artificially over-bought, and hence yield so artificially low in a zero-rate policy environment, that they have very little runway left.

Even if rates are forced below zero, as is likely, bonds are not what they once were in our father’s markets. The same is true for stocks, as they have become grossly overvalued due to the low-rate debt levels accorded by this bond bubble.

Therefore, investors need to re-think just about everything they once knew and believed about traditional risk assets like stocks and bonds along with traditional stock and bond portfolio construction.

Old-Fashioned Portfolios

Despite a critical need to re-think traditional investing approaches, old-fashioned 60/40 (stock/bond) portfolio allocating is in vogue, and has been for decades. Pick your flavor:



The 60/40 Balanced Portfolio is in the middle, a top pick by most advisors, weighted towards stocks, but protected with "safe" bonds. If you're conservative or looking for growth, just tweak

the percentage allocations, and bingo, you can account for a "safer" or more "aggressive" portfolio based upon circumstances of age, risk tolerance, personal wealth, etc.

Until now, the 60/40 portfolio has survived and worked. Stocks and bonds have been rising together as interest rates have fallen. Bonds were always there to save you, traditionally touted as a portfolio-volatility buffer and as a safe-haven investment.

Well folks…not anymore. That worked back when interest rates were falling, and recessions were fixed by lowering rates. But now that interest rates are at zero, there are few tricks left up the sleeves of a central bank running out of options and room to adjust rates as economic conditions worsen.

Goodbye to the 60/40 Pie Chart Portfolio

And when those interest rates rise, it's over for the 60/40, stock/bond portfolio, as we describe in these pages. It's been quite a run, for decades. As interest rates have tumbled, that tectonic plate that has nurtured a win/win scenario for stocks and bonds.

Just as falling interest rates have favored both stock and bonds together, as we will describe, when that plate shifts and interest rates rise, stocks and bonds will together be adversely impacted.

Interest rate manipulations by a desperate Fed are slowly losing power and that is going to have a direct impact on your wealth. Goodbye, traditional investing. Goodbye, 60/40. Goodbye, passive management. Hello, "alternative" investing. Hello, massive diversification. Hello, active management.

In Part I of this Investment Primer, we discuss the common-denominator of it all, the impact of the rising interest rates to come. In Part II, we'll turn to the science of portfolio diversification the old-fashioned way, revealing the key aspects (and flaws) of traditional investing. In Part III, we shift gears from traditional investing to the art of investing alternatively. Finally, we provide a concluding Call-to-Action.

PART I - THE IMPACT OF RISING INTEREST RATES

Interest rates have been falling since the dot.com era and have continued to fall in the past 5-years. Low rates, as discussed in our introduction, have provided historical tailwinds for stocks and bonds. Stocks and bonds rise together in falling interest-rate environments, which is good until that environment changes.

Traditional Portfolios vs. Interest Rates

Just to set the stage, we plot below a traditional portfolio of 20-picks of traditional stocks and bonds (which we individually disclose in Part II), and overlay their performance in the backdrop of falling rates as measured by US-Treasury 10-year interest rates.

Notice just how fast and far interest rates have fallen over just the past 5-years, from a high of 3.2% back in November 2018 to a low of 0.5% in August 2020.

Do you sense a problem here if interest rates were to rise?

A Two-Sided Coin

When interest rates fall, bonds rise. That's supportive of both stocks and bonds. Corporations pay less in interest expense; that boosts profits, earnings, and stock prices. As interest rates fall, bonds too are advantaged as previously-issued bonds with higher coupon rates are bid-up. That makes bond prices rise.

There you go. In a nutshell, that's why stocks and bonds rise together when interest rates fall. But here's the rub, and the risk. When interest rates (near zero today) start rising again, the reverse kicks in. Both stocks and bonds are adversely impacted. Corporate interest expense will rise, not good for stocks. Bond buyers will sell their low coupon bonds in favor of bonds with a higher yield, causing bond prices to fall and hence rates/yields to rise, a pressure-cooker for that so-called "bond hedge" or "safe-haven" allocation.

Double-Trouble

That's double-trouble for traditional 60/40 equity/bond portfolios. Not only are 60/40 portfolios poorly constructed with insufficient diversity, but they are now about to get destroyed when (not if) interest rates rise.

With interest rates this low, that 40% bond allocation is a risk, no longer a hedge.
Which means that a 60% stock allocation is no longer protected.

Do not despair. There's hope.

And that hope lies with actively-managed portfolios that embrace alternative investments, where correlations are demonstrably lower, reducing risk in favor of higher return.

To understand the hope, you'll need first to understand the problem.

Buckle up. In Part II, we're going to walk you through the science of portfolio diversification. We'll get to the artful part of portfolio construction in Part III.

PART II - THE SCIENCE OF PORTFOLIO DIVERSIFICATION

Defining Diversification

Diversification speaks to the practice of spreading investments around so that exposure to any single type of asset is limited. The method is designed to help reduce the volatility of your portfolio over time by diversifying.

From a technical perspective, diversification is measured by correlation, a statistic that measures the relationship between two random variables, or in this case, investments. The more two investments behave like each other, the more "correlated" they are.

In the financial industry, correlations among investments is a key factor in determining diversity. Diversity is good. It avoids concentration risk. If stock-A and stock-B are highly correlated, there is little reason to include both in the same portfolio if diversity is the goal.

Measuring Correlation

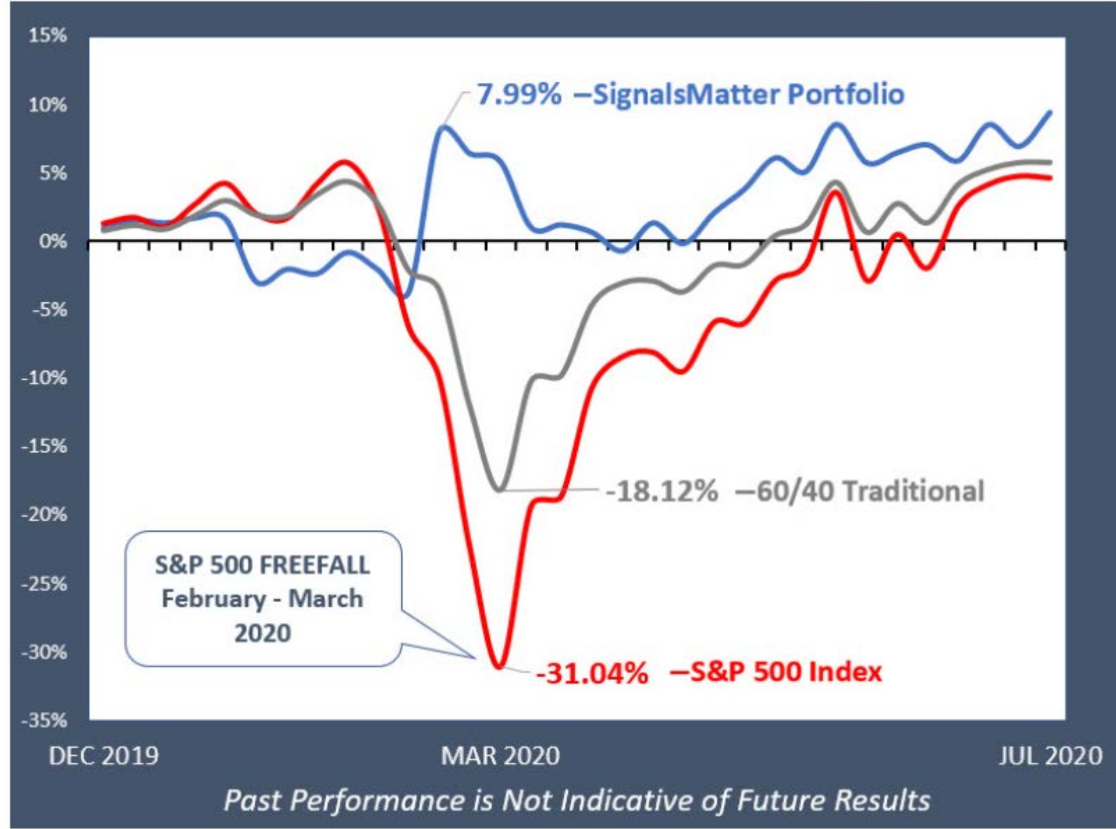
Correlations run from +1 (or +100%) to -1 (or -100%). Two highly correlated stocks, say 80-100%, can be expected to move in sync. Two stocks that bear low (or even negative correlation) tend to move in opposite directions when defining market events erupt (like Covid-19) and can save the day when markets turn.

As one security tanks, the other (uncorrelated) security rises, thus providing a protective "hedge" in times of market storms.

Picture Perfect Example

Here's how this worked for Signals Matter subscribers in February/March of 2020, as Covid-19 unleashed its fury on global markets. Highlighted in the chart below is Signals Matter performance vs. that of the S&P 500 Index and the traditional 60/40 portfolio.

You be the judge.



Source: www.SignalsMatter.com

This is what we mean by the "benefits of non-correlation. Signals Matter up 8% vs. stocks down -31% is the personification of non-correlation. The proof is in the pudding.

Why did we thrive while others suffered? In short: Low and negative correlation among portfolio allocations saved the day. The takeaway message is this:

We cut our losses short and let our profits run by smartly allocating to uncorrelated assets.

Under all manner of market conditions, it takes decades of experience to build negatively correlated portfolios like this, and a fair amount of hedge fund experience to boot, to ensure portfolio survival when you need it most.

The performance charted above is more than a science; it's an artful science that calls heavily upon combining *traditional* investments with *"alternative"* investments in a portfolio that zigs when stock markets zag. We'll get to that in Part III.

Traditional vs. Alternative Investing

We prefaced traditional investing in our Introduction, but let's be a bit more precise and crystal clear. You are investing *traditionally* when you limit your investments primarily to cash, stocks, and bonds, as most investors do—typically 60% in stocks and 40% in bonds—hence the term

"60/40 portfolio." Allocations to *anything other than cash, stocks, and bonds,* we define as an *alternative investing.*

Here's Where It Gets Interesting

Now armed with a firm understanding of diversification, correlation, the consequential benefit of non-correlation, and traditional vs. alternative investing, let's dig deeper.

In the table below titled *Traditional Asset Allocation*, we've assembled a correlation matrix of 20 typical traditional investments, primarily in the stock and bond categories. Each investment is disclosed in a text box beneath the table.

TRADITIONAL ASSET ALLOCATION – CORRELATIONS (SEP 2015-AUG 2020)

TRADITIONALL SECTORS		DENOTES 50-100% CORRELATION							DENOTES 0-50% CORRELATION							DENOTES <0% CORRELATION					
	SYMBOLS	IVV	IJH	IJR	VXUS	VTI	SCHD	VIG	DNL	ARKK	FIDU	PGF	RYH	PBW	SUSA	BOND	TOTL	BIV	BKLN	ICSH	BNDX
S&P 500	IVV		94%	89%	88%	100%	96%	98%	86%	79%	92%	67%	88%	80%	99%	38%	23%	24%	75%	45%	21%
S&P Mid-Cap	IJH	100%		98%	87%	96%	92%	93%	83%	75%	95%	70%	81%	83%	94%	39%	29%	24%	79%	43%	22%
S&P Small-Cap	IJR	94%	98%		83%	91%	87%	87%	77%	74%	93%	63%	76%	83%	89%	31%	26%	16%	73%	34%	15%
Int'l Stocks	VXUS	89%	87%	83%		89%	86%	86%	94%	73%	86%	65%	75%	82%	88%	42%	30%	27%	70%	40%	23%
Total Stocks	VTI	88%	96%	91%	89%		96%	97%	87%	80%	93%	68%	88%	82%	99%	38%	24%	23%	76%	44%	21%
Dividend Stocks	SCHD	100%	92%	87%	86%	96%		97%	84%	69%	93%	64%	83%	75%	96%	37%	21%	24%	74%	45%	20%
Dividend Appr	VIG	96%	93%	87%	86%	97%	97%		85%	72%	93%	65%	86%	77%	97%	39%	24%	26%	73%	44%	23%
Global Stocks	DNL	98%	83%	77%	94%	87%	84%	85%		71%	81%	68%	74%	76%	87%	46%	26%	33%	72%	45%	27%
Innovation	ARKK	86%	75%	74%	73%	80%	69%	72%	71%		69%	52%	76%	75%	78%	31%	22%	18%	55%	25%	19%
Industrials	FIDU	79%	95%	93%	86%	93%	93%	93%	81%	69%		65%	77%	79%	92%	35%	22%	20%	75%	43%	17%
Financial Pfrd	PGF	92%	70%	63%	65%	68%	64%	65%	68%	52%	65%		57%	56%	67%	72%	46%	62%	88%	67%	55%
S&P 500 Eq Wt	RYH	67%	81%	76%	75%	88%	83%	86%	74%	76%	77%	57%		70%	87%	33%	22%	24%	62%	38%	20%
Clean Energy	PBW	88%	83%	83%	82%	82%	75%	77%	76%	75%	79%	56%	70%		79%	33%	29%	19%	62%	28%	19%
ESG Select	SUSA	80%	94%	89%	88%	99%	96%	97%	87%	78%	92%	67%	87%	79%		38%	24%	25%	74%	44%	22%
Active Bond	BOND	99%	39%	31%	42%	38%	37%	39%	46%	31%	35%	72%	33%	33%	38%		78%	93%	64%	65%	82%
Tactical Bond	TOTL	38%	29%	26%	30%	24%	21%	24%	26%	22%	22%	46%	22%	29%	24%	78%		79%	39%	36%	70%
Intermed Bond	BIV	23%	24%	16%	27%	23%	24%	26%	33%	18%	20%	62%	24%	19%	25%	93%	79%		53%	62%	84%
Senior Loans	BKLN	24%	79%	73%	70%	76%	74%	73%	72%	55%	75%	88%	62%	62%	74%	64%	39%	53%		73%	41%
Short-Term Bond	ICSH	75%	43%	34%	40%	44%	45%	44%	45%	25%	43%	67%	38%	28%	44%	65%	36%	62%	73%		47%
Int'l Bonds	BNDX	45%	22%	15%	23%	21%	20%	23%	27%	19%	17%	55%	20%	19%	22%	82%	70%	84%	41%	47%	
AVG CORREL		77%	71%	66%	68%	72%	69%	70%	68%	58%	68%	64%	63%	62%	71%	50%	36%	40%	67%	46%	35%
MATRIX CORRELATION		61%																			

S&P 500 (IVV) • S&P Mid-Cap (IJH) • S&P Small-Cap (IJR) • Int'l Stocks (VXUS) • Total Stocks (VTI) • Dividend Stocks (SCHD) • Dividend Appr (VIG) • Global Stocks (DNL) • Innovation (ARKK) • Industrials (FIDU) • Financial Preferred (PGF) • S&P 500 Eq Weight (RYH) • Clean Energy (PBW) • ESG Select (SUSA) • Active Bond (BOND) • Tactical Bond (TOTL) • Intermediate Bond (BIV) • Senior Loans (BKLN) • Short-Term Bond (ICSH) • Int'l Bonds (BNDX).

Next, we ran the correlations amongst the 20-investments, weekly, back 5-years from August 2020.

In the left-most column, we list the traditional investments used, along with traditional category descriptions. Across the top of the matrix, we again list the investment vehicles. To see the correlation of one investment to another, we simply compare them. By example, comparing Dividend Appreciation (VIG) in the left-hand column vs. Global Stocks (DNL) in the top row reveals a cross-correlation of 85%.

That's high, really high. What's the point of allocating to two investments with an 85% correlation? They'll rise together and they'll fall together. Just one of them would do just fine, especially if paired with an investment less-correlated, yet with attractive performance attributes. That's what we mean by "diversification through non-correlation."

Next, we run the math. Namely, we let excel calculate the correlations between each investment to each other investment, back over 5-years. That's 400 data points (20 picks times each other), weekly (52 times per year), over 5-years. That's 104,000 data points in all.

To make the chart easy-to-read, we colored coded the key takeaway for you: correlation.

- Green blocks highlight securities that have a 50-100% correlation with each other.
- Tan colored blocks have a 0-50% correlation with each other.

In total, 64% of the blocks are green (highly correlated); and 36% of the blocks are tan (correlated). Had we discovered any blocks that were inversely correlated (where one investment zigs when the other zags), we would have colored them in red. There were none.

Here's the critical takeaway based on this color-coding. ALL OF THE BLOCKS in the matrix have a positive correlation. There are no 'non-correlated' securities in this matrix over the past 5-years. The overall matrix correlation (of all investments correlated to each other) is 61%.

That's, well…not good. It's high. Financial advisors that tell you this is a "diversified "portfolio don't understand the available alternatives, not to mention the adverse impact on bonds of rising interest rates, now at the zero-bound level. Traditional portfolio "diversification" is essentially a myth today.

Such portfolios will do well when markets are rising, which explains the popularity. But it also explains why these portfolios will sink, including most investments together, when markets are falling, especially with interest rates rising.

Unfortunately, most investors (and their advisors) don't like to talk about potentially harmful periods in the markets. Thus, they won't recognize or examine the dangers within their portfolios until it is too late, as when those interest rates make the turn.

Charting Traditional Portfolios

Next, we created an equally-weighted, traditional portfolio of the 20-investments tabled above, gave it a ticker, and plotted it against the S&P 500 Index. Here's what we got by way of relative performance, back 5-years, namely a highly correlated portfolio! The portfolio is yellow-colored; the S&P500 Index is tan-colored. Look-alike?

Naturally, by adding bonds to stocks, the yellow-portfolio performance underperformed the S&P stock index in orange. By adding bonds to stocks over the period, investors achieved little diversification. Over 5-years, portfolio performance was 86% correlated to the performance of the S&P 500 Index! Why would we expect a different result? After all, we started with portfolio selections already 61% correlated in the aggregate.

In short, investors in our example portfolio received almost no “diversification” at all. Sure, they did well when markets rose, but got crushed when markets fell. That, again, is not a good way to manage risk or a portfolio, as every true investor knows that the key to making money in the markets is not losing money in the markets.

Pause and think about that for a second.

The good news is this. There’s an alternative path. Investors can do much better than this by simply adding protective investments to the portfolio that zig when traditional investing zags.

When this happens, you lose less, and by losing less, you make more over time. You can now well-understand that those bonds (seen as “safe havens” in traditional portfolio *theory*) really haven’t helped out that much in *practice*.

Going forward, with interest rates now at zero, those bonds are *toxic* diversifiers.
They’re not going to save you.

Next, let’s switch gears and examine *alternative* investing that can keep you safe in the rising tide of interest rates ahead.

There's Another Approach

Below, we flip the switch from traditional investing to *alternative* investing. Remember, alternative investing is anything that does not walk and talk like traditional cash, stocks, or bonds.

Taking the same approach as we did with traditional investing, we've developed an Alternative Asset Correlation Table using the same methodology as above, but applied to a range of very different securities, namely Exchange Traded Funds (ETFs), again provided beneath the table.

We did cheat a bit, by adding 1-line of ETF stocks and 1-line of ETF bonds as picks, for a good reason: they're not correlated with the alternatives we have chosen. That's smart investing.

The color-coding remains the same:

- Green blocks highlight securities that have a 50% or greater correlation with each other.
- Tan-colored blocks have a 0-50% correlation with each other.

Red-colored blocks have a <0% (negative correlation) with each other.

ALTERNATIVE ASSET ALLOCATION – CORRELATIONS (SEP 2015-AUG 2020)

ALTERNATIVE SECTORS		DENOTES 50-100% CORRELATION							DENOTES 0-50% CORRELATION							DENOTES <0% CORRELATION					
		VTI	BIV	GLD	SLV	PPLT	DBC	DBA	DBO	PALL	UNG	UUP	FXE	FXY	FXF	VXX	AQMIX	MNA	QAI	FTLS	UCON
Stocks	VTI		23%	13%	37%	49%	53%	35%	52%	46%	20%	-23%	18%	-16%	7%	-81%	-8%	61%	89%	92%	69%
Bonds	BIV	23%		61%	56%	45%	15%	-3%	9%	34%	-2%	-48%	40%	57%	46%	-17%	17%	31%	52%	16%	78%
Gold	GLD	13%	61%		79%	66%	24%	10%	11%	42%	-2%	-59%	47%	60%	54%	-13%	26%	21%	33%	12%	46%
Silver	SLV	37%	56%	79%		76%	41%	16%	28%	51%	10%	-49%	39%	37%	40%	-35%	14%	31%	50%	34%	62%
Platinum	PPLT	49%	45%	66%	76%		46%	23%	36%	61%	10%	-50%	43%	31%	40%	-49%	4%	41%	61%	43%	70%
Commodities	DBC	53%	15%	24%	41%	46%		47%	94%	42%	27%	-31%	24%	-2%	13%	-62%	-11%	43%	52%	44%	51%
Agriculture	DBA	35%	-3%	10%	16%	23%	47%		30%	25%	10%	-27%	23%	-3%	18%	-36%	-17%	27%	30%	28%	20%
Crude Oil	DBO	52%	9%	11%	28%	36%	94%	30%		35%	20%	-22%	15%	-9%	3%	-56%	-13%	40%	48%	43%	43%
Palladium	PALL	46%	34%	42%	51%	61%	42%	25%	35%		3%	-36%	25%	7%	18%	-43%	0%	43%	55%	43%	54%
Natural Gas	UNG	20%	-2%	-2%	10%	10%	27%	10%	20%	3%		-2%	6%	-9%	2%	-23%	-13%	7%	16%	16%	16%
US Dollar	UUP	-23%	-48%	-59%	-49%	-50%	-31%	-27%	-22%	-36%	-2%		-94%	-57%	-83%	22%	5%	-39%	-44%	-16%	-57%
Euro	FXE	18%	40%	47%	39%	43%	24%	23%	15%	25%	6%	-94%		49%	84%	-14%	-8%	28%	35%	9%	57%
Japanese Yen	FXY	-16%	57%	60%	37%	31%	-2%	-3%	-9%	7%	-9%	-57%	49%		60%	28%	23%	-3%	8%	-21%	41%
Swiss Franc	FXF	7%	46%	54%	40%	40%	13%	18%	3%	18%	2%	-83%	84%	60%		4%	1%	18%	25%	2%	51%
Volatility	VXX	-81%	-17%	-13%	-35%	-49%	-62%	-36%	-56%	-43%	-23%	22%	-14%	28%	4%		-13%	-58%	-73%	-82%	-46%
CTA Strategy	AQMIX	-8%	17%	26%	14%	4%	-11%	-17%	-13%	0%	-13%	5%	-8%	23%	1%	-13%		-18%	-1%	4%	-20%
Real Estate	MNA	61%	31%	21%	31%	41%	43%	27%	40%	43%	7%	-39%	28%	-3%	18%	-58%	-18%		68%	53%	61%
Multi-Strat	QAI	89%	52%	33%	50%	61%	52%	30%	48%	55%	16%	-44%	35%	8%	25%	-73%	-1%	68%		79%	83%
L/S Equity	FTLS	92%	16%	12%	34%	43%	44%	28%	43%	43%	16%	-16%	9%	-21%	2%	-82%	4%	53%	79%		57%
Unconstrained	UCON	69%	78%	46%	62%	70%	51%	20%	43%	54%	16%	-57%	57%	41%	51%	-46%	-20%	61%	83%	57%	
AVG CORREL		28%	27%	29%	32%	33%	25%	12%	20%	25%	5%	-38%	23%	17%	22%	-31%	-1%	22%	32%	20%	37%
MATRIX CORRELATION		17%																			

Stocks (VTI) • Bonds (BIV) • Gold (GLD) • Silver (SLV) • Platinum (PPLT) • Commodities (DBC) • Agriculture (DBA) • Crude Oil (DBO) • Palladium (PALL) • Natural Gas (UNG) • US Dollar (UUP) • Euro (FXE) • Japanese Yen (FXY) • Swiss Franc (FXF) • Volatility (VXX) • CTA Strategy (AQMIX) • Real Estate (MNA) • Multi-Strat (QAI) • Long/Short Equity (FTLS) • Unconstrained (UCON).

Red (negative correlation) is excellent; tan (low correlation) is good; green is less useful but just fine in moderation.

In total, for the alternative matrix, just 18% of the blocks are green (positively correlated); 53% of the blocks are tan (correlated), and 29% of the blocks are red (uncorrelated).

A quick look at the colored matrix shows that alternative investments have a greater propensity to zig when stocks and bonds (top 2-rows) zag, precisely because they are *not* stocks and bonds. Pretty straightforward. They are commodities, precious metals, currencies, actively-managed strategies, real estate, long/short strategies, and other unconstrained approaches.

Comparing Correlations: Traditional vs. Alternative Investing

To sum up, here are the 2-matrices compared. The results are startling for investors unacquainted with alternative investing.

The bottom line of all of this analysis is colored in blue. The traditional investments chosen generated an overall correlation, each to the other, of 61%. The alternatives selected generated an overall correlation of 17%.

That's 72% lower, and that's your takeaway.

CORRELATION Traditional vs. Alternative Investing	Traditional Asset Allocation	Alternative Asset Allocation
Positive Correlation (50% - 100%)	64%	18%
Positive Correlation (0% - 50%)	36%	53%
Negative Correlation (<0%)	0%	29%
Matrix Correlation	61%	17%

Double Trouble, Again

To further summarize, this we now know:

Stocks and bonds are more correlated with each other than the alternatives.

That's a problem. But here's another:

Stocks and bonds are correlated with interest rates much more than you think.
That's double-trouble for traditional investing.

Hoping we've raised an eyebrow, let's move on to the art of building portfolios that invest alternatively.

PART III - THE ART OF INVESTING ALTERNATIVELY

The art of investing alternatively is founded on the premise that active portfolio management beats passive portfolio management hands down, especially during periods of market stress.

Active vs. Passive Portfolio Management

Investors have debated the merits and demerits of active vs. passive portfolio management for ions and for good reason. Active and passive each have a role to play, *depending on the macro environment*. We've noted for decades that passive 60/40, stock/bond management has worked just fine in a falling interest rate environment. But when that tide turns, it's active management that going to save you.

And that tide is about to turn.

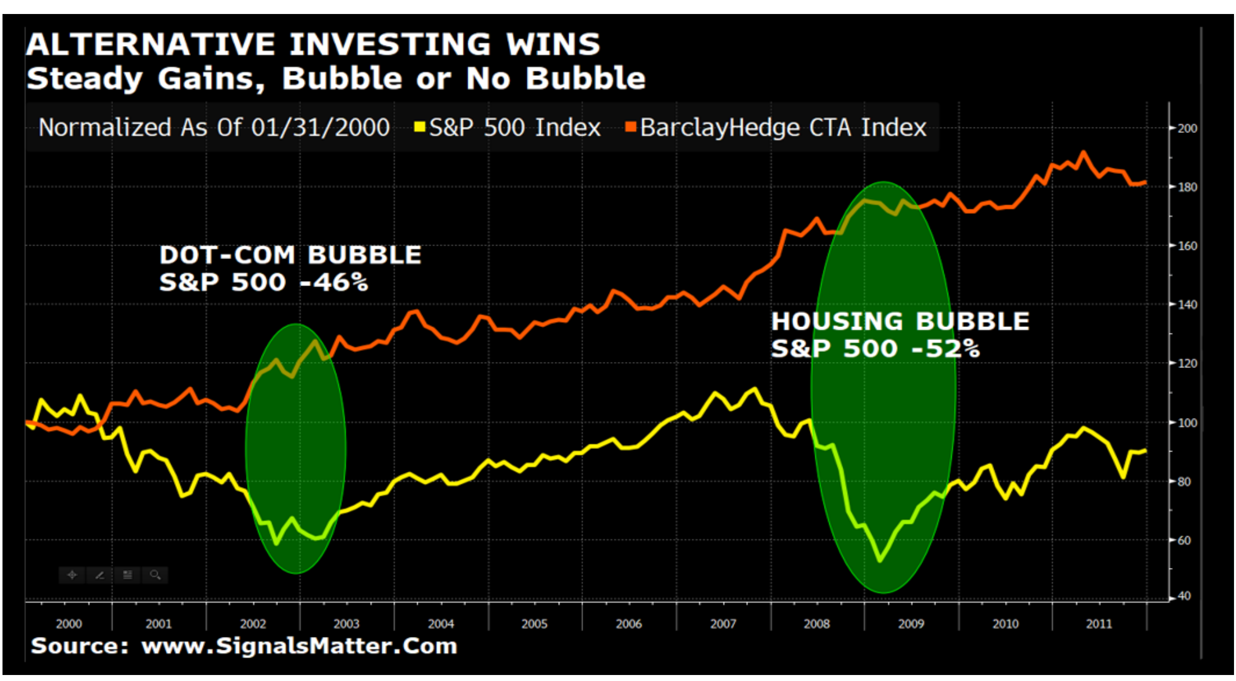
Active investors like Signals Matter chose their investments based upon individual merit, and they invest well-outside of stocks and bonds, irrespective of traditional benchmarks like the S&P

500 Index. For us, it's the rate-of-return that matters (we call that "absolute return"), not passively managed "relative" return, as with the S&P 500. There are no risk managers across town in NYC manning the Standard & Poor's offices.

Morgan Stanley penned this note in a recent market update to clients when discussing whether active or passive portfolio management is better:

"This isn't just an academic conversation: It has the potential to affect your investment results in a real and meaningful way. Morgan Stanley Wealth Management has found that in many cases active management may help investors improve their risk-adjusted returns. We've found that active managers can be especially helpful during periods of market stress, when outperformance can be most critical for investors."

The facts show that high-quality active managers (often likened for benchmark purposes to the Commodity Trading Advisor (CTA) Index charted below) consistently outperform the S&P 500 during periods of stress and consistently falling interest rates. Like Signals Matter, CTAs go anywhere for gain, well-outside of stocks and bonds, investing on both the long and short side depending on the trend.



To be included in the CTA Index charted, CTAs must have at least four years of prior performance history, years that are not included in the Index.

We beat that hands down.

Your authors of this Investment Primer and Co-Founders of Signals Matter have spent decades, not only as a CFTC-registered Commodity Trading Advisor and Commodity Pool Operator, but as an allocator to CTAs and alternative investment managers from the shores of Morgan Stanley, the J.H Johnson family office, and the Massey Quick family offices.

In short, we've been there, done that, and are now dedicated 100% to building alternative investment portfolios for Subscribers and their families at the most important time in our investing history, as interest rates rise are about to turn.

Building Alternative Investment Portfolios

Building alternative investment portfolios is conceptually simple. To get away from traditional investing, you just need to go fish in a different pond. The stock and bond ponds are getting polluted. Hop in the car—head back to the tackle shop. Equip yourself with some new lures. And off you go!

Those new lures are alternative investments. The new pond is those same alternatives we saw earlier in our correlation bucket, namely: :

Stocks • Bonds • Gold • Silver • Platinum • Commodities • Agriculture • Crude Oil • Palladium • Natural Gas • US Dollar • Euro • Japanese Yen • Swiss Franc • Volatility • CTA Strategy • Real Estate • Multi-Strat • Long/Short Equity • Unconstrained strategies • And a whole lot more.

Having mastered the science of portfolio diversification and correlation, and with a better understanding of the macro risks, it's time to turn to the art of alternative portfolio construction, the more challenging part—first, a pie chart, then some explanation.

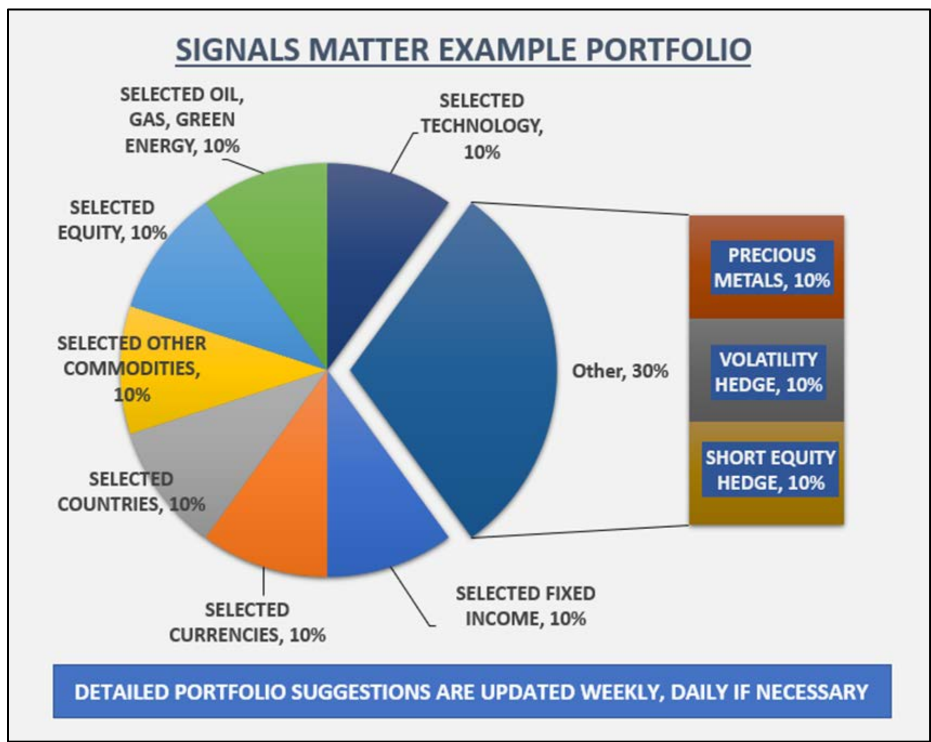
Alternative Portfolio Pie Chart

Below is a pie-chart example of a typical Signals Matter Portfolio.

The 10-Suggestions plotted by Signals Matter are *meaningfully* diversified because:

- The portfolio is not just about stocks and bonds.
- Within stocks and bonds, some positions are long; others are short (i.e., they go up in price when the assets within them go down in price).
- Commodity suggestions are in full display.
- Other suggestions directly shelter the portfolio against risk and volatility.

Traditional Portfolios are limited by comparison, allocated very simply and only to long-only stocks and bonds. This difference is huge.



An Artful Science

Constructing portfolios that hold up in all-weather conditions is more than a science. It's an artful science, built upon informed investing, market cycle discovery, meaningful diversification, risk abatement, technical analysis, and proper benchmarking. Let's briefly review these six foundational tools that will reliably generate and protect your wealth.

Key Pillars for Building Alternative Portfolios

Here are six key pillars for building alternative portfolios, each described in further detail beneath.

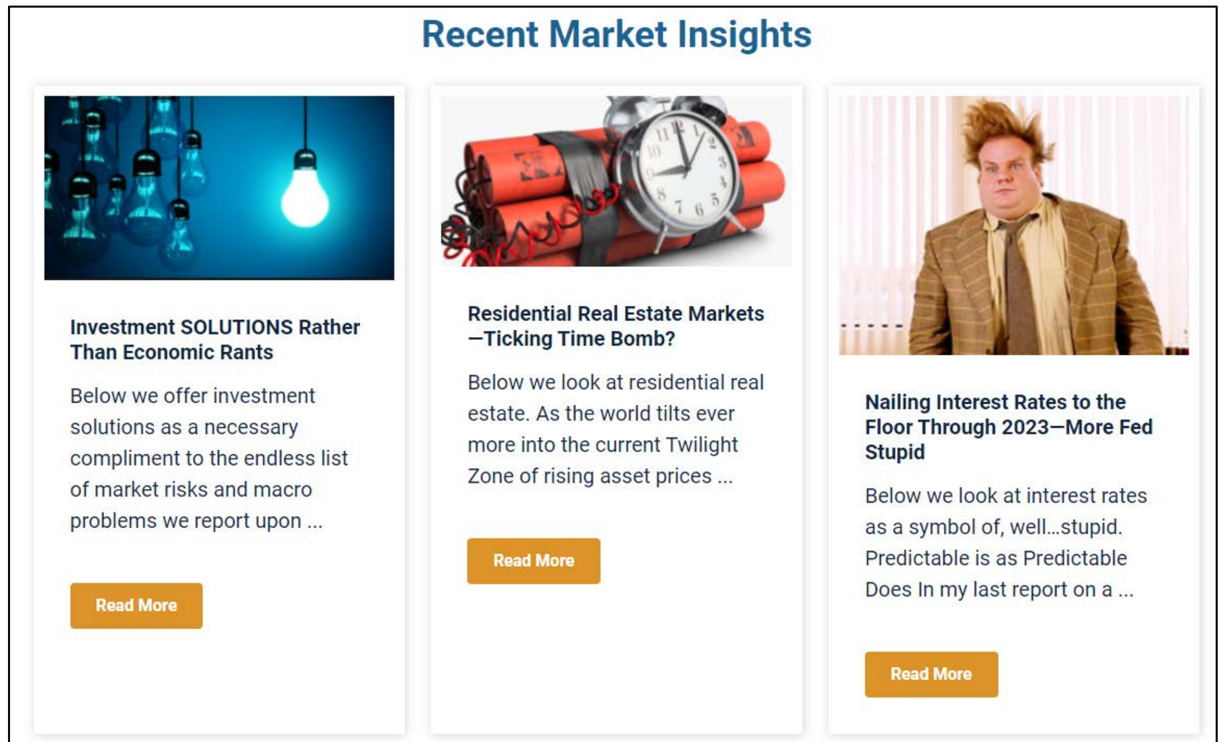
1. Informed Investing
2. The Predictable Nature of Market Cycles
3. Meaningful Diversification
4. Risk Abatement
5. Technical Analysis
6. Proper Benchmarking

(1) Informed Investing

Well-informed investors are better investors. That's why we go the extra mile at Signals Matter to educate our Subscribers, to share what we're constantly thinking. That's why we post new daily insights, charts, and commentary each day that inform and protect, and why we update and display our macro thinking every week.

Our library of blogs, Market Reports, and podcasts include literally thousands of pages of industry-leading commentary on bonds, central banks, foreign markets, macro, real estate, stocks, and so much more.

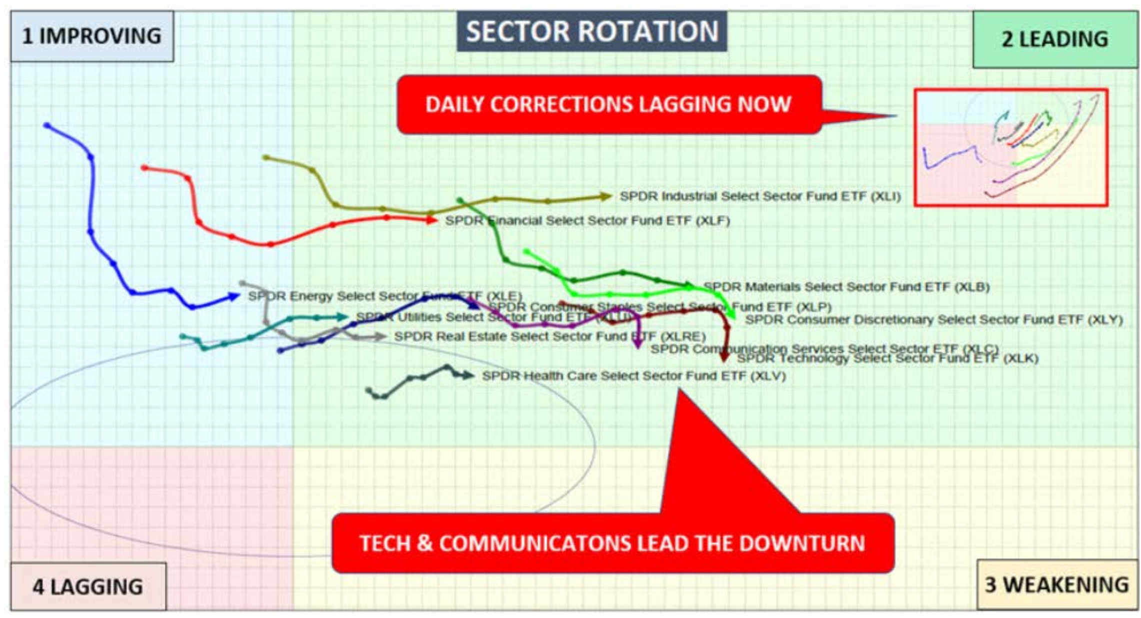
Sometimes entertaining, sometimes just plain frank, yet always informing, our reports cut through the Wall Street glaze and give you straight-talk when it comes to what you need to know to invest wisely.



(2) The Predictable Nature of Market Cycles

Market cycles are predictable, across every timeframe and every sector, so long as you have the right experience and the right tools to measure and do the tracking. Market cycles are also actionable when it comes to making money, whether cycles are improving, leading, weakening, or lagging. They provide the opportunity to profit, no matter what the direction.

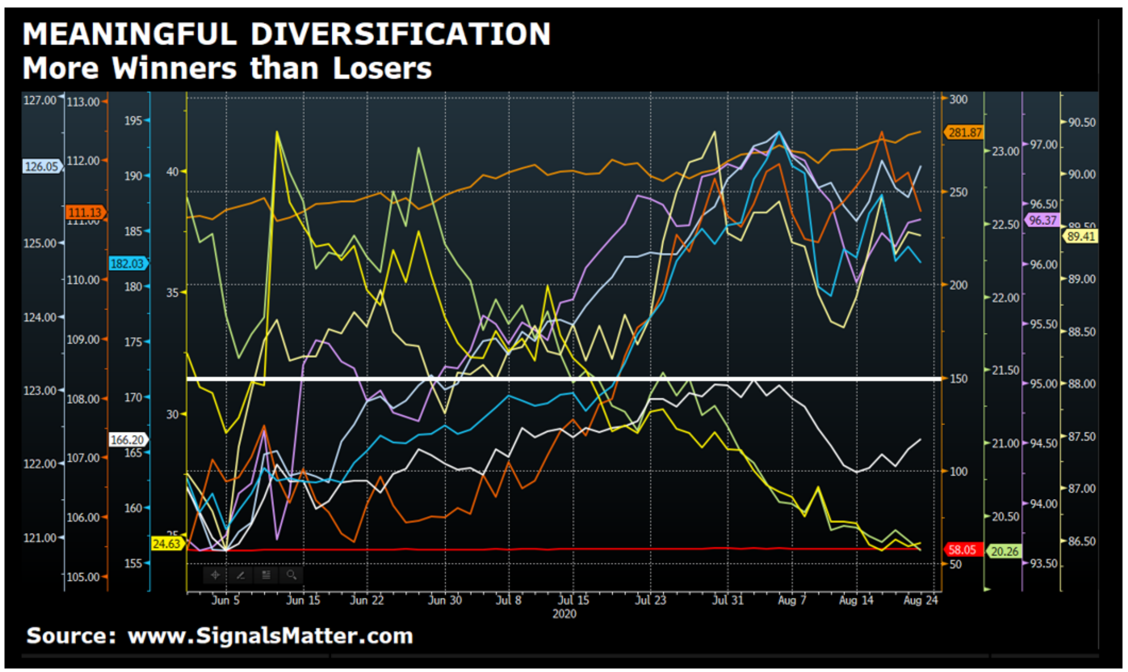
Take, for example, the Sector Rotation chart below of SPDR equity sectors rotating from strength to weakness. By tracking those sectors (*soooo* important), we can also track and select which sectors to buy and which sectors to sell (or sell short), as their rotations inform.



(3) Meaningful Diversification

Meaningful diversification is not about growth vs. value, or high-cap vs. low. It's about allocating smartly across less-correlated stocks, interest rates, bonds, real estate, currencies, commodities, precious metals, countries, sector-focused funds, and alternative asset classes, long and short. Meaningful diversification contains portfolio volatility.

This spaghetti-chart is what it looks like: Lots of diversification, with more winners than losers. Thus, simple solutions and profits emerge as risk is contained.

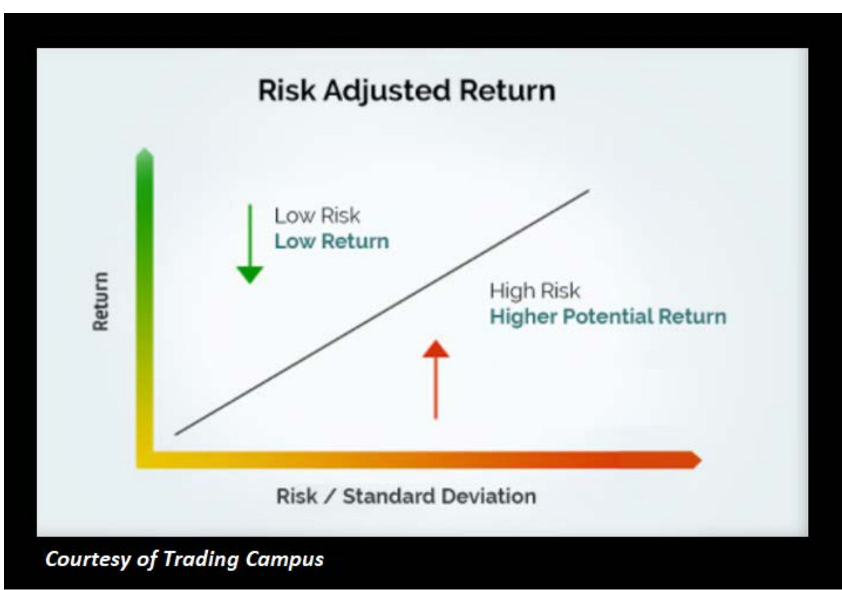


(4) Risk Abatement

Proper wealth preservation is not just about the return. It's about return adjusted for risk or *risk-adjusted return*. Risk-adjusted portfolios let the profits (upside volatility) run while containing the downside (downside volatility). The risk is proportionately adjusted, providing for a smoother ride.

Risk management is a core competency here at SignalsMatter.com, built upon years of developing and applying risk-overlay technology for the hedge funds we have managed and institutional and family-office clients we have assisted.

The concept is to increase the return with less risk by navigating portfolios to the upper left-hand corner of the chart below, where returns are higher and risk is lower. That's what we do, in a nutshell.



Courtesy of Trading Campus

(5) Technical Analysis

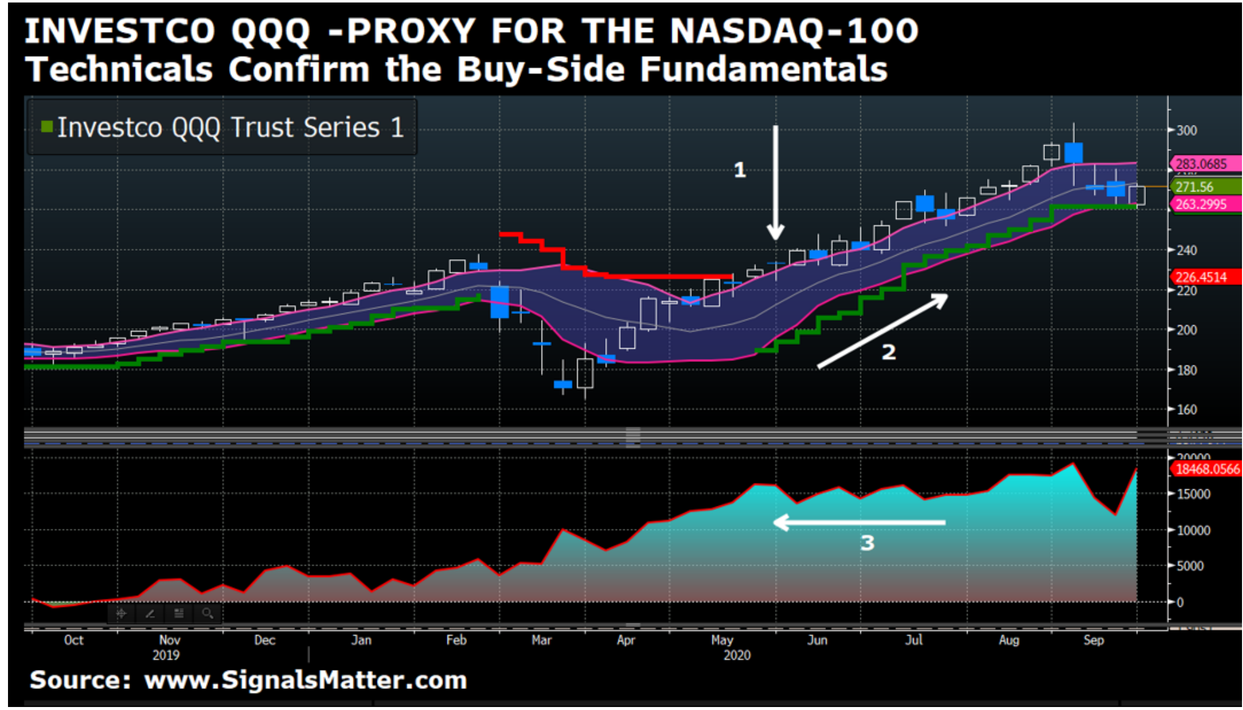
SignalsMatter.com practices its own methodology for forecasting price direction and pace, honed from our hedge fund days. We always parse potential investments for coincident rotational opportunity, relative strength, trend, volatility expansion, low correlation, and positive investor money-flows, among other criteria.

Tides rise until they fall. The sun rises until it sets. Fads come until they go. Central banks create bubbles until they pop. And folks, ALL bubbles pop. Always.

Stocks are no different, especially in the short term. They get bid up until they don't. Technical analysis need not be based solely on past results when future intentions are the key.

Take the Nasdaq-100, for example. In September 2020, the Nasdaq was raging upwards, until it stopped. Here's how we knew before almost everyone else. Charted below is the Invesco Trust Series 1 ETF (QQQ), that tracks the Nasdaq 100 Index of 100 of the largest non-financial

companies by market cap listed on Nasdaq, with concentrations in computer hardware, software, telecommunications, retail/wholesale trade, and biotechnology—i.e., "Tech."



There's a lot going on in this chart. Coming into June (1-3 in the chart refer):

1. QQQ broke out reliably above trend and associated volatility channels.
2. *The trend* had reliably moved to the upside.
3. Investment *flows* into the QQQ ETF were reliably building.

We also do this to the short side here at Signals Matter, agnostic as we are to direction, up or down. We publish it as we see it, despite our over-all bearish concerns for Fed-supported markets and Fed-ignored risks. We post Portfolio Suggestions that go long the market, but we stop-and-reverse when needed, and go short the market, according to our Market Insights, taking into account our larger macro views.

More importantly, however, unlike passive, buy-and-hold, set-it-and-forget-it 60/40 traditional portfolios, we do not passively invest.

Active management of the Signals Matter Portfolio is a critical strength that helps us navigate financial markets' changing tides. Technical analysis keeps us and you on the right side of the markets, removing the emotion, the media hype, and the tendency to do precisely the wrong thing at market tops and bottoms.

History and investor behaviors confirm that most investors buy at tops (when its popular to do so, based upon FOMO—or a "fear of missing out") and sell at bottoms (when they are shell-shocked and scared).

Needless to say, we patiently wait for bottoms to buy and like to sell at tops, as our fathers taught us.

(6) Proper Benchmarking

Benchmarking is foundational to sound investing and performance monitoring. If you're using the wrong benchmark, like the S&P 500 Index, you're already behind. The S&P 500 is a *relative return benchmark*, and trust us, it's not relevant to diversified investing.

There's a better approach, called *absolute-return benchmarking*. We teach the difference.

The S&P 500 is a relative-return benchmark. A target return of 15%, however, is an absolute-return benchmark.

Measuring portfolio performance against stocks is a fool's journey. Measuring how you're doing vs. the return you need or expect is what really matters.

Trust Us - Holy Grail Investing Works

The Holy Grail of Investing is making money without losing it in any market cycle. Holy Grail Investing demands levels of diversification well-beyond stocks and bonds at all times, so that when one asset class zigs, the other zags.

It works by containing volatility and hence downside risk, allowing profits to run unabated. We’ve been doing this for some 50+ combined years. Trust us by what we do rather than what we say. Regain confidence, no matter what lies ahead.

CONCLUSION – OUR CALL TO ACTION

It's Your Turn Now

As market veterans, we've seen plenty of market cycles and have built plenty of portfolios for plenty of wealthy clients, both private and institutional.

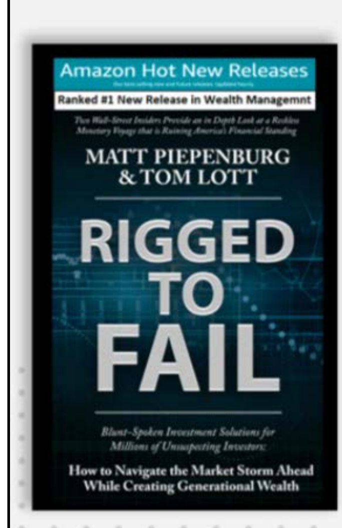
What We Know

The years teach things the days do not often notice, and over these many years and cycles, we've learned, like any veteran in any field, to recognize what works and what does not.

The Investment Primer on portfolio construction, in the backdrop of changing markets and changing risks, is merely a brief summary.

Each of the points touched upon above has been described in far greater detail over the years in our free market reports (thousands of pages in total) under categories like "bonds," "central banks," "macro thoughts," and much other, to be found under "Blogs" on our website.

Also, we've written a well-received/reviewed and best-selling book, ***Rigged to Fail***, which goes to great lengths to speak bluntly and honestly about the changing nature of markets and hence risks which portfolios need to heed and consider today. It's free on Kindle. Click here to download: Rigged to Fail on Amazon.com.



IN ONLINE BOOKSTORES

Rigged to Fail - Now Published

Despite the record-breaking (and frankly dangerous) market highs of the post-2008 "recovery," current securities markets are poised for an equally record-breaking, and wealth destroying fall.

Rigged to Fail explains all of this with math, not opinions, and offers elegant approaches to protect informed investors from losing fortunes in the pending market storm. With over 50 combined years working in and among Wall Street's top global banks, family offices and alternative investment funds, Matt and Tom bring an insider's perspective that is free of fluff but rich with straight-talk, not sales talk.

Ultimately, our macro view is simple: The Fed has created a massive bubble in stocks and bonds, which is poised to one day fail.

Our micro response is equally simple: Traditional portfolios will get slaughtered in such a failed Fed market.

Our Portfolio Solution

As a result, we've built a better portfolio for everyone—not just the fancy lads we've represented for decades. Why? Because everyone, not just the uber-wealthy, deserves the same straight-talk and blunt solutions.

What If We Are Wrong?

But speaking of straight talk, let's play Devil's advocate and consider a genuine question on your minds, namely: What if we are wrong? Fair question.

That is, what if the Fed can keep interest rates artificially repressed for many, many more years to come? What if the Fed can print trillions and trillions of more dollars to keep bond prices stable, and hence debt levels sustained at nosebleed levels for another generation?

In short, what if printing trillions of dollars out of thin air to buy unwanted bonds can essentially turn the entire stock and bond market into one big, nationalized 401K? What if the Fed has created a market that never really goes down—and even if it did, can just be immediately "recovered" by more unprecedented central bank steroids?

Well, we suppose anything is possible—like deficits, debts, and diluted currencies without tears, a kind of post-2008 central bank Nirvana. After all, the new "Fed-markets" have made it 12 years since the Great Financial Crisis of 2008, and every dip (even the COVID dip of 2020) has become a new high within months or days.

Maybe the Fed really has outlawed market crashes and economic recessions? Perhaps money printing and interest rate suppression really is the new miracle cure? Maybe.

You Decide

After all we've described, are you still thinking you should stick with the traditional stock/bond portfolios and ride this new magical wave? Folks, if something just seems too fantastical and good to be true, that's usually because it is.

Also, if unlimited money printing and artificial rate suppression really is the new "miracle solution" to all national and corporate debt disasters, then why didn't prior administrations, from Eisenhower to Reagan, or Carter to Clinton, simply print more money to solve every crisis their era faced?

And if low rates and quantitative easing (QE) was so safe, then why was the Fed itself trying to raise rates and *tighten* (QT) rather than *ease* its extreme money printing policies throughout 2018? Simple: Because deep down, even the experts know that this current fantasy of printing money and repressing rates really is too good to be true.

When the market monster they created blows up, at least they can blame it on a global virus, rather than take a hard look in the mirror and admit the failure of their own desperate experiment. Sadly, however, every time the Fed tried to raise rates or tighten its balance sheet, the markets immediately got sick and puked. Every time.

In our view then, the Fed, and hence these Fed Markets, are in a dangerous corner of their own design.

The central bankers have no choice now but to steer a fatal course and hope to buy time until, well, hope no longer works, and time runs out. The question for you, and the decision only you can make, is how long you want to trust this Fed course, which some argue is a solution and which we argue is a fantasy.

If you fully believe the Fed will save you, then a 60/40 portfolio is fine. If, however, you respect math, history, debt cycles, and common sense, then you may want a portfolio that will protect you when the current fantasy phase of Fed support comes to a dangerous end.

We built our portfolio suggestions with this end in mind. Although we have no psychic ability to predict this end's timing, we have a portfolio that will protect you when it comes. In the interim, we have a portfolio solution that still delivers steady returns during the current fantasy period.

Does this mean our portfolio will always beat the markets and consistently outperform every rally, melt-up, or even 60/40 portfolio? Nope. Not always. During some months, days, and quarters, our risk-adjusted portfolio will not keep up with the bullish tailwinds of increasingly centralized markets. We're fine with that, because, again, real wealth is made by not losing it.

Real wealth is made by thinking of (and managing) risk before thinking of, or just chasing and capturing, return. Real wealth is also made by buying bottoms and not tops.

We are patient, realistic, and data-driven, as well as common-sense prepared. If you share these values, views, and approaches, we invite you to share our portfolio solutions.

Join Now

To stabilize your portfolio before those interest rates rise, simply click here to Get Started.

Our portfolio suggestions take only minutes a week to review and occasionally update, as clearly directed. It's really that simple. We do all the complicated work for you and then point the way with evidence, not hunches.

We'll look for you on the Subscriber side. Questions? Give us a call. 844-545-5050.

In the meantime, stay safe and stay diversified.

Yours truly,

Tom Lott & Matt Piepenburg
Co-Founders, www.SignalsMatter.com