Cape Ann Capital, Inc.

April Letter

Dear Friend:

Commodities surged in April; up 8.5% on the month. European stocks, up 2.8%, were a strong second. All other assets classes returned between 0% and 1%. Commodities lead the pack for year-to-date performance as well. Commodities are up 9% with emerging markets not far behind at 6.1%. Only Pacific stocks are in negative territory for the first four months of 2016.

	2012	2013	2014	2015	YTD	April
U.S. Cash	0.0%	0.0%	0.0%	0.1%	0.1%	0.0%
U.S. Bonds	4.0%	-2.3%	5.8%	0.3%	3.5%	0.4%
U.S. Stocks	16.3%	33.3%	12.4%	0.3%	1.5%	0.6%
European Stocks	20.8%	24.7%	-6.7%	-2.0%	0.3%	2.8%
Pacific Stocks	15.5%	17.4%	-4.7%	2.2%	-1.1%	0.9%
Emerging Markets Stocks	18.6%	-5.2%	0.4%	-15.5%	6.1%	0.8%
Commodities	-1.1%	-9.5%	-17.0%	-24.7%	9.0%	8.5%
Risk Level 8 (0/42/22/7/7/7/15)	9.0%	7.4%	1.8%	-4.6%	3.5%	1.9%

Suppose you have a classic 60/40 portfolio; 60% stocks and 40% bonds. The bonds are there to reduce volatility, but at what cost? Are the bonds a better diversifier than cash or commodities? To shed some light on these questions we analyze the performance of a 100% stock portfolio versus three 60/40 splits: stocks/bonds, stocks/cash and stock/commodities. Our data cover 46 years and three months from January 1970 through March 2016.

The stock and the stock/commodity portfolios grow from $10,000 to about $960,000 (10.3% per annum). The stock/bond portfolio grows to $720,000 (9.7% per annum) and the stock/cash portfolio grows to $470,000 (8.7% per annum). The choice of commodities over cash adds an average of 1.60% per year to returns. Over the 46-year period this swap is worth nearly half million dollars; more than doubling ending period wealth.

The growth path of the stock portfolio is far from a straight line. With straight-line growth the portfolio would always be at an all-time high. Of the 556 months studied, the stock portfolio was at an all-time high only about one third of the time. The stock portfolio suffers long stretches of moving down from an all-time high or recovering to a new all-time high. Blending bonds and cash into the mix does a decent job of reducing the size and duration of these unpleasant periods. Commodities are not as reliable. At times commodities serve to extend the pain rather than reduce it.

Returns expressed as ten-year moving averages reveal very few periods where the presence of cash or bonds increases returns. Commodities augment returns 44% of the time.

So what can we conclude from this analysis? As with many questions concerning asset allocation there is no one right answer. If the pain you feel from short-term losses is severe, you should probably limit the use of commodities as a diversifier and give preference to bonds and cash. If short-term pain is not a big deal and you are more interested in maximizing long-run return, you might consider a portfolio that is all stock or a mix of stock and commodities.