The ACM Journal

Hard Assets

With everyone talking about inflation these days, investors' attention has turned to hard assets. Anxious buyers have been snapping up rental properties, commodities, and precious metals. I have personally spent a lot of time lately amassing hard assets, though of a different sort.

We recently had a nasty wind and rainstorm tear through our area. Trees and power lines were down, cutting out power in some neighborhoods for a couple days. Downed limbs littered the streets. A considerable poplar in our office parking lot dropped three hours' worth of cleanup work on our building's maintenance crew.

While that is all generally bad news, I prefer to view the glass as half full. There are piles of limbs on the side of the road at just about every house. Free firewood abounds, making a bad storm a boon to those of us who use a wood stove for heat.

Just driving around, I have been able to scout out the best wood. One afternoon I stopped at a house that had been hit particularly hard. They had a huge old maple tree fall and were putting some prime logs out by the road. My son Amer was with me, and when we asked if we could take some of the wood,

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Portfolio Review

Investments returns were solid across all asset classes in the second quarter, as economic growth continued to rebound from last year's pandemic. U.S. stocks, international stocks, alternative investments, and bonds all generated positive returns.

U.S. large-cap stocks led quarterly equity returns, generating 8.6% as the S&P 500 reached new record highs. Mid-cap and small-cap stock returns added 3.6% and 4.5%, respectively, to their impressive year-to-date returns of 17.6% and 23.6%.

As vaccinations increased and active cases of COVID-19 declined, governments and businesses eased many of the restrictions put in place during the beginning of the pandemic.

A full economic reopening, coupled with pent-up demand and trillions of dollars in stimulus checks should drive favorable increases in GDP in the near term. However, there is the fear that this will also contribute to higher inflation. The market reacted negatively to inflation fears several times this quarter as inflation indicators grew. Fed policy makers revised their expectations for interest rate hikes, forecasting increases sooner than previously anticipated. The market quickly recovered from these bouts of volatility, but inflation continues to be a hotly debated concern for investors.

While returns of "value" stocks cooled this quarter, value has still managed to outperform the market year-to-date. This is driven by strong returns in energy and financials, two sectors with a high concentration of value stocks. Additionally, value stocks are still trading at attractive levels relative to growth stocks, which bodes well for the prospective returns of value stocks compared to growth.

International and emerging market stocks generated returns of about 5% for the quarter, not far off from U.S. stock returns. The spread of new coronavirus mutations in some countries shows that economic risks are still present from the pandemic and could impact stock markets, especially in nations where vaccine availability is limited.

Aggregate bond market returns were a respectable 1.8% for the quarter, recouping some losses experienced during the first quarter. Despite signs of increasing inflation, the U.S. 10-Year Treasury yielded about 1.45% at the end of the quarter, down from 1.7% at the end of the first quarter, yet still higher than the 0.9% yield at the beginning of the year. With interest rates at historically low levels, expected returns for bonds are muted.

Alternative investments have had a much-needed resurgence so far this year. While it is too early to declare the start of a bullish cycle for alternative investments, we believe they remain an attractive source of unique returns. Their ability to diversify traditional stock and bond

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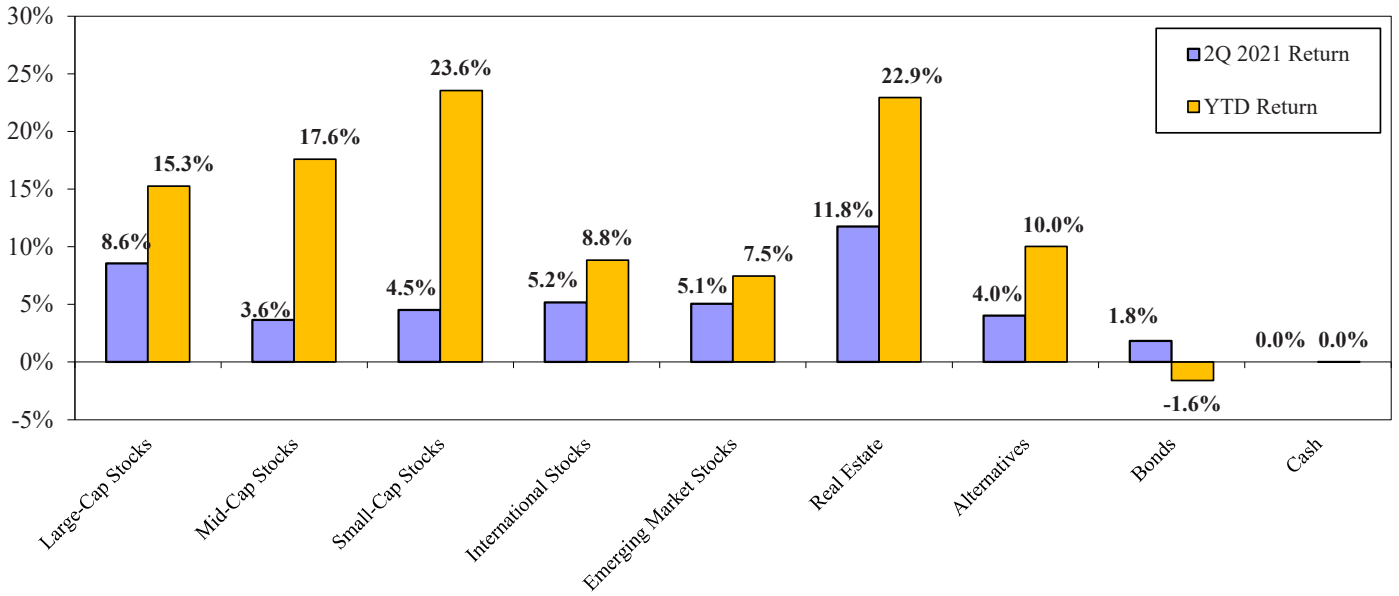
Second Quarter 2021 Asset Class Returns



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indicies. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Bonds are the Barclays Aggregate Bond Index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Cash is the yield on the 3-month T-Bill.

Portfolio Review

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portfolios can help reduce the risk of the stock market and bring returns greater than the bond market.

While stock market returns have led the way over alternatives and bonds in the first half of the year, this has pushed already-elevated stock valuations to even higher levels. International stocks and factors such as value and low volatility appear relatively undervalued compared to U.S. large-cap stocks. Maintaining a diversified strategy will be more important than ever in the years to come.

LENDX

There has been quite a bit of activity lately for one of our alternative funds, and we thought it would make sense to provide an update.

The Stone Ridge Alternative Lending Risk Premium Fund (LENDX) buys small consumer, business, and student loans. It does this through on-line lending platforms like Lending Club, Square, Sofi, and others. These loans are made to high quality borrowers with average FICO scores above 700. The interest rates on these loans are relatively high, as they are generally too small to be of interest to traditional lenders, such as banks.

This creates an opportunity for investors to potentially earn higher returns than with traditional bonds, but with different risk characteristics. For example, while a spike in unemployment could result in delinquencies for LENDX loans, the fund has very little sensitivity to interest rates, unlike traditional bonds. This makes LENDX an interesting portfolio diversifier when used as a component of a more traditional stock/bond portfolio.

While the fund generally invests only in loans, it recently found itself with a couple of stock holdings. Because LENDX buys loans from its partner platforms in such large size, it is often able to negotiate better terms than other investors. These benefits typically amount to higher interest rates or lower platform fees. Notably, in a couple of cases it has meant taking an equity position in the platforms themselves when they were still private companies. This was true for the SoFi platform and the Upstart Holdings platform.

Recently, both SoFi and Upstart Holdings filed IPOs. Their stocks have performed quite well, creating

a windfall for LENDX. Historically, the fund has earned returns of around 6% per year, but because of its stock holdings, it has returned almost 40% over the past year. While this is unlikely to repeat in the future, we still believe the fund is attractive because of its core loan buying strategy.

The excess returns this year have certainly been welcome, but they have also created some confusion. When LENDX sold the stock positions, it realized a substantial capital gain. Mutual funds are required to pay out their realized capital gains to shareholders each year. So, LENDX did a special distribution that amounted to a 21% "dividend" just before the end of the second quarter. When a fund or stock pays a dividend or capital gains distribution, its share price drops by the amount of the distribution. This makes sense since cash held by the fund gets returned to shareholders, making the shares worth less. However, while the share price drops, the return earned by the fund is still quite high since dividends and capital gains are components of total return.

When LENDX made its special distribution, it marked its shares down 21%. Your account statement may seem to show that the fund took a big loss that day. The truth of the matter is hard to discern from just your account statement. Things aren't always what they seem. What was actually a very positive event (excess returns) could easily have been misconstrued as something negative (a huge one-day loss).

Chris's Corner: The Mega Backdoor Roth

Traditional retirement savings largely takes place within company-sponsored retirement plans, such as a 401(k) plan. The premise is simple: put money away directly from your paycheck and save money on taxes. However, for those with unique tax circumstances, Roth 401(k) plans are also available. The idea is the same as with a traditional 401(k), except that you don't get a tax deduction when you make the contribution, and the money grows tax free thereafter and may be withdrawn tax free during retirement.

There are of course restrictions and nuances to how these accounts work, but generally you may contribute up to $19,500 (or $26,000 if you are over 50) to your 401(k) plan. This can be done in a traditional 401(k) or a Roth 401(k). However, there is a lesser-known retirement strategy that may allow you to save an extra $38,500 in a Roth IRA or Roth 401(k). It is called the "mega backdoor Roth". Though, we have often been found calling it the "mega, ultra, colossal, ginormous backdoor Roth," or any such combination of superlatives.

The reason this strategy is lesser known is that there are a lot of nuances and restriction as to who can participate. Here's what you'll need in order to take advantage of the mega backdoor Roth:

1. A 401(k) plan that allows you to contribute after-tax dollars beyond the pre-tax limits. If your company's plan does not allow after-tax contributions or the ability to contribute larger amounts, start lobbying your HR department now. This feature is separate from your pre-tax traditional 401(k) contributions or Roth 401(k) contributions.

2. A 401(k) plan that allows for in-service distributions to a Roth IRA or lets you move after-tax contributions into the Roth 401(k) part of the plan.

3. Maxed out traditional 401(k) and Roth IRA contributions. Most people considering this strategy have already outgrown a traditional Roth IRA account.

4. Additional savings you would like to stash away in a qualified account.

Note that the normal rules around Roth accounts still apply. You must be over 59½ and wait five years after depositing to avoid a 10% early withdrawal penalty. If you are under 59½, your earnings may be subject to taxes and penalties on withdrawal.

The Advantage

While traditional 401(k) contributions are capped at $19,500, you and your employer combined can contribute up to $58,000. If you are over 50, that number increases to $64,500 due to allowances for catch-up contributions. If your employer does not have a match, or does not make profit-sharing contributions, you can add up to $38,500 of after-tax dollars into the plan. If your company does have a match and/or a profit-sharing contribution, you will have to subtract those contributions from the $58,000 total. Estimating your match should be straightforward, though profit-sharing contributions can change from year to year.

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they were all too happy to get rid of it. Amer and I were all too happy (Amer maybe less so) to collect it for our winter stores.

Because folks need to cut up the wood into manageable pieces before they put it out by the road, much of the work we would ordinarily have to do is already completed. We'll need to do a little more chainsaw work, and a bunch of splitting, but at least we don't have to cut down the trees and deal with all the limbs that aren't suitable for burning. That saves a lot of time and effort.

Still, I may have gone a little overboard with my treasure hunting. Chris and I were coming back from a business meeting one day, and I spotted a particularly nice pile of what appeared to be fruitwood. Apple, pear, cherry, and the like provide some of the best heat as firewood goes. Enlisting Chris' help, I pulled over to load up the truck. He is still having a lot of fun at my expense over the sight of the two of us in our shirts and slacks loading the truck up with logs. We also got some funny looks from those passing by.

A man and his spoils.

And, while I'll probably collect a couple hundred dollars' worth of wood, by the time I get it all home, cut it into manageable pieces, and split it up with either a maul or log splitter, I'll have many hours of work into this endeavor. I have tried not to do the math, but it seems the economics may not work. Nevertheless, I'll be glad I did it this winter when we have a fire roaring in the wood stove. It will also give Amer something to talk to his therapist about later in life.

Chris's Corner

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The Process

After you have already maxed out your usual 401(k) savings for the year, these are the steps to take for the mega backdoor Roth:

1. Make your calculated after-tax contribution to your 401(k) plan, which will be up to $38,500

2. If your plan allows in-service distributions, rollover the after-tax contributions to a Roth IRA. This needs to be done immediately to prevent any earnings on those funds, which would be subject to tax.

3. If your plan has a Roth 401(k) provision, you may rollover the after-tax contribution in-plan to the Roth 401(k).

Unfortunately, the ability to do a mega backdoor Roth on most plans is limited because of Actual Contribution Percentage (ACP) testing. ACP testing is used to determine if matching contributions are discriminatory in favor of Highly Compensated Employees (HCEs). To pass the ACP test, there would have to be non-HCEs making after-tax contributions to their plans. However, if the plan only has HCEs, then a mega backdoor Roth is still possible.

This is a complicated and tricky process that will require the cooperation of your employer and likely the third-party administrator (TPA) on your retirement plan. Feel free to call us if you have questions or would like guidance on this topic.

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