Episode 182: When Disaster Strikes… Should You Invest?

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Retirement income, financial personality, alternative investments, natural resources, commodities, catastrophe bonds, infrastructure, private equity, inflation hedge, risk management, portfolio diversification, investment strategies, asset classes, financial planning, retirement income planning.

SPEAKERS
Briana Corbin, Wade Pfau, Alex Murguia

Briana Corbin 00:00
The purpose of retire with style is to help you discover the retirement income plan that is right for you. The first step is to discover your retirement income personality. Start by going to risaprofile.com/style, and sign up to take the industry's first financial personality tool for retirement planning. You if you've ever wondered how timber toll roads and tornadoes could fit into your retirement plan. You're not alone. Wade and Alex are here to explain, and no, you don't need to own half of Montana to make it work.

Wade Pfau 00:55
Hey, everyone, welcome to retire with style. I'm Wade. I'm here with my trusty co host, Alex, and we're continuing, actually, with the final episode in the arc on alternative investments. In particular Alex will talk about last week. The coverage was real estate, both commercial and residential, and REITs, as well as infrastructure. This week we have on the agenda is going to be natural resources commodities and a special bonus on catastrophe bonds. And then also, we realized that actually last week, Alex blended some of the material on natural resources into the infrastructure discussion. So we'll do a quick review of that and make sure everyone's clear on which is which. But Well, yeah, we'll get things going here. Alex, welcome, welcome back. You're going to be our main speaker today and finishing up this arc on alternative investments. Yeah, thanks for excitement.

Alex Murguia 01:49
In my excitement, I couldn't help it, and I blended into, I bled into, excuse me, I blended into the natural resources and infrastructure, if you will. So just to clear it up again, the infrastructure is specifically related to like, think about it, toll operators, utilities, investments in private infrastructure companies. Now, again, there's daily liquid ETFs that you can buy into that. And there's listed infrastructure companies, such as toll operators that you can invest directly into. And there's even interval funds by like Brookfield and stone peak that offer private exposure to those. But again, this is not an endorsement. This is like a starting point for you folks to do due diligence of infrastructure is something that appeals to you

Wade Pfau 02:43
private, I think you need a t shirt or a hat that says, right, there's not an endorsement, yeah, exactly, or a non endorsement, yeah,

Alex Murguia 02:53
like, you know, individually, each of these can make sense. There's also these have longer lockups, such as, you know, there's private infrastructure funds that those lockups tend to be 10 to 12 years, if you will. And but there's more of an institutional focus with those right. And so that was the infrastructure piece that I started blending with natural resources. Now, with natural resources, you know, those are specific. Those are long term real assets, income and inflation protection, and those include Timberland, farmland, water rights, mineral royalties, things along those lines, and they offer both biological and land based growth opportunities, uncorrelated to the markets. Because if you can imagine, farmland has nothing to do with the market itself. You know, the s, p goes up, doesn't mean that crops aren't going to grow this year, right? And water rights, everyone's going to drink, etc, etc, etc. And again, capital appreciation from those is through land value and resource demand. Now, there's many you can own it directly. There's interval funds that allow you to do that. There's timber ETFs, such as wood and cut that track forestry companies. And there's Private Limited Partnerships for agriculture, water, water rights. And so there's, there's the availability to be able to invest in these. Again, the caveat is, if it's private, you're so you're most likely subject to the accredited investor limits. That being the case, we can move on now to commodities. Now. This is a question that comes up all the time. In fact, you know Wade I was playing. Guess what? I was playing this morning?

04:40
Wade, pickleball. Yeah.

Alex Murguia 04:43
Invariably, someone asked, What do you do for a living? We tell them what we do. I do for a living. Professional pickleball. Right now, you're getting a lot of, hey, what about gold? Things along those lines, and the idea is that serves as an inflation hedge against geopolitical shocks. That's why I want gold. Whenever people start. About the dollar gold starts coming up, right? And so ultimately, commodities offer exposure to real assets, you know, tangible assets, you know, and you're going to be subject to the just the general global supply and demand dynamics around that. A lot of folks will say they're uncorrelated or negatively correlated to stocks or balance and may enhance diversification and improve risk adjusted returns. Now that's what they say. Do they do that? I'm of the opinion. I'm not a gold bug by any means. I'm of the opinion that over the long term, commodities, especially hard metals and the like, they effectively track inflation, and they track inflation with a standard deviation that's more so than stocks and so theoretically, speaking, something that moves. If you're watching this on YouTube, it'll make sense. If you're listening, it won't make as much sense. So I encourage you to go to YouTube, retire with style. But if you're if gold has this kind of volatility, and I'm effectively doing doing like an up and down movement with my arm, this the entire size of my screen. If gold moves like this, and stock stocks move like this, and I'm not moving, I'm just covering half the screen with my finger like this. It is, it is statistically very difficult to say that the first item that I mentioned gold is hedging stocks, simply because gold, you know, the long term return of gold is, you know, roughly a little bit like inflation. Stocks have a significantly higher return than inflation. It they have a standard deviation, let's say about 17. And gold, you know,

hard metals, have standard deviations that are, you know, that plus more so to get a lower return for significantly more standard deviation to say that that is hedging against the other, it's very hard to say you're going to need, like, 400 years of data to able to disentangle the signal from the noise of that relationship. So I don't think it's as easy to just say, Yes, look and yes, okay, over the last three months, it's done such and such, but again, it's going to trend up, it's going to trend down, it's going to trend up, it's going to trend down. And that's why

Wade Pfau 07:26
correlations look like because if it had a very negative correlation, there could still potentially be value, but they're

Alex Murguia 07:34
not, you know. And frankly, if you hold that asset class, it's just going to drive you bonkers, simply because, yes, you're gonna have three months of great returns, but you're gonna have three months of crap returns, and then in the end, what did you get? You know, you got something that basically tracks inflation for the headache to me, I that's not something that is interesting from my vantage point. And you know, I the standard division is so high on these. That's why commodity trading advisors use them a lot, because they have so much momentum built in. I don't want to play the momentum game when it comes to anything from an investment standpoint, especially with regards to my retirement income ability, you know, my ability to to draw retirement income from a portfolio. So from that vantage point, I don't, I don't see it. I'd rather invest in companies that use the commodities to make earnings, as opposed to the commodities themselves. To me, the commodities are an input. They're not an output, and so they're not that interesting to me. But that being the case, you know, people have different ideas than than I do around this, and that's fine. That's what makes the world go around. But you know, here commodities, you know, they include both hard, hard commodities, which are like metals and energy, the oil and Soft Commodities, which is considered like agriculture and livestock. All right. Now, can you access them? Yeah, absolutely. And you have precious metal ETFs that have them. You have agricultural ETFs, you know, specific to wheat, to corn and the like. And these are long only. You have energy ETFs such as uso or XLE that offer direct exposure to specific energies. Now, if you're going to expose yourself in commodities, to me, the momentum is so strong in these that to just go long only over an extended period of time, I think the return is effectively inflation. And so from that vantage point, you're better off. If this is something that's interesting to you, to consider more CTAs commodity trading advisories, where you're going to play the momentum game, and they're going to go long short, depending on where the momentum is going. Momentum is going, right? There's also future based strategies, futures based strategies with regards to commodities. You see that with Goldman Sachs, they have, you know, they have opportunities to invest like that. And you see commodity like notes. You see structured products and the like you don't need to. Own, like gold bullion, or things along those lines, you can get, you can get funds that just do all that stuff for you.

Wade Pfau 10:08
Now there's a lot of companies that are spending a lot on marketing, selling gold to the public. You

Alex Murguia 10:15
tell me, Wade, what do you think of those you wake up Saturday morning. I know you know you just as an aside, I'm sure people are wondering, what do you think about that? Obviously, I think

people can gather what my thoughts on that are after I just spent five minutes talking about gold. What do you think when you wake up Saturday morning, you're going through the stations and you know, you see people talking about gold coins, or just gold in general.

Wade Pfau 10:39
Yeah, I'm just wondering if it was such a great investment, why they're spending all this money trying to sell it to you rather than just keeping it for themselves. I guess they get some sort of service fee. But makes me suspicious Whenever someone's spending a lot to market something that they're claiming is a great investment,

Alex Murguia 10:58
I ultimately think they're I think those people know what they're doing in a bad way. I think ultimately they're just taking advantage of fear. They're taking advantage. They'll make the argument that, oh my goodness, the dollar is going to hell in a hand basket, and you need to get out now, and Gold is the only thing that offers, you know, a good diversification play from this blah blah, blah, blah blah. I don't, I don't subscribe to that at all. I think those arguments are weak when you start looking at the numbers over the long term, as opposed to finding some sort of 10 year period where something did well versus something else, and picking and choosing like that, or cherry picking, a better word, like that. I think ultimately, at the end of the day, commodities are best used by companies to make something, to earn, to use that, and by make something, I mean to make profits from it. I think commodities, in and of themselves, are inputs that track inflation. I don't know how else to say that. I can say that in 20 different ways, but that's ultimately my conclusion. If you feel you can trade on it, like, Oh, I think for the next six months, gold is going to go up because people are just doubting the dollar. And you know, the US isn't going to be the currency of choice anymore. And etc, etc. If you feel you can do that, then, you know, no one's stopping you do. I think that's what you should be thinking about when creating a retirement income portfolio, to try to take consistent distributions from your portfolio. You know, I think there's better ways to allocate your resources then, then commodities. If you will, right?

Wade Pfau 12:44
Fair enough.

Alex Murguia 12:46
Yeah. And so with regards to that, what kind of rates are you looking at? Well, again, infrastructure and natural resources. You know, with regards to commodities, you're looking at, again, inflation at best, and then in the high single digits, you know, the correlation to equities are low. They're not extremely high. But again, I think you just have to look at long term correlations relative to the standard deviation that they're bringing into play and seeing how that works out. I mean, maybe that, you know, there are many things that could be uncorrelated with a market. I've said, I mean, like, baseball cards are uncorrelated with the market. You know, Otis Wagner, you know, that kind of thing. Does that make it a great investment within a portfolio? I don't know, right? I would say probably not. So you want to kind of look at not just the correlation, but what's the individual return per unit of risk that that's bringing to the table? And how does that play in I have trouble seeing how something that returns below equities, and it's more similar to inflation with a standard deviation that's equity plus makes sense within a portfolio. And again, yes, there will be six month period where it looks like, wow, this thing is like 30% in six months. Why don't I have this in my portfolio? Well, give it time, right? See how it

looks like in 15 years, which is the time horizon you should be having, right? But at the end of the day, pure infrastructure. We alluded to it in the last episode. Again, the return drivers from infrastructure plays come from usage fees, government payments, inflation pass throughs. That's interesting to me. Risk adjusted returns are favorable, you know, simply because you're getting this consistent stream with, you know, a steady sort of tangible holding, farmland, you know, and Timberland, they produce consistent, real returns over decades, largely because different than, like, let's say gold, there's biological growth that comes with that. You know, there are cycles. There are commodity cycles to it. But you know, you cut down a tree, it grows again. You know not. You know there are, there's new growth from. The seed, etc, etc. So it, you can get repeat usage from it, you know, and you can lease it out. There is even a component of rental units in the sense of your parcel. You have a parcel, then you're leasing it out. You're getting that low operational correlation around the board. So it's, it's interesting. And if you look at historically, natural resources like this have less of a drawdown than commodities, if you will. So to me, it's interesting, especially when you throw in water and royalties that can come off of that, like water resources and the like water rights. Better said, commodities, to me, are just too volatile. Sure they could be beneficial because they track inflation and the like, but it's just or during crisis regimes. And that's a way of saying when people are scared. But to me, I think there's nothing there. You know. Again, I'm not saying they're not It's not valuable and of itself. But again, I'd rather invest in gold and silver, in metals, from the standpoint of how I'd rather invest in the companies that use them, because whatever prices of commodities are that would be reflected in the profits of those underlying companies. And so that's how I'd rather do it, by proxy, in that manner, as opposed to direct investments. All right? And so ultimately, though, what you'll find is these are available in liquid and semi liquid structures, and they're also available in liquid structure. Some of them, you know, obviously commodity, you can get the liquid, but the reality is to be long only commodities is a streaky is a tricky play. You usually see CTAs as a better play with commodities, because you can, you know, they can go long and short natural resources. It's hard, you know, unless you know you're Ted Turner, I know in half of Montana, kind of thing. And so effectively, there are REITs that focus on timber, there's REITs that focus on farmlands. There's interval funds that provide a little more direct exposure, as opposed you know those REITs are investing in forestry companies. Interval REITs will give you direct exposure to those and there's some crowdfunding platforms that offer you exposure so such as farmland partners, acre trader and things along those lines. Right? Infrastructure plays again. It just depends on what it is, such as water rights and the like. But ultimately, there's some core opening funds that you can do it, but you're going to see private LPS that offer you the best direct investments in those if this is something that you wanted to have a part of Now, that being the case, the last item that I want to talk about are insurance linked securities in our space, these are catastrophe bonds, and under that, there's many ways to participate, you know, either through bonds or through what's called quota shares. Now insurance linked securities are, is something that within the advisory space, you're seeing a lot more attention being paid to by advisors. And I think it's, I think it's merited, frankly. And from here, what is this? What are catastrophe plays? And so at the end of the day, for anything, you have to ask yourself, What's Why should I expect an Why should I have an expected return for this, right? What is the expected return for this? And to me, an asset class is something that if you systemically expose your portfolio to you should have an expected you should, you should have a long term expected return. And that the genesis of that usually, because there's some sort of risk that you're bearing, yeah, there's some risks that you're bearing. Hence, there's an expected return for bearing that risk. An asset class isn't necessarily like baseball cards. That's an asset class. There's no expected return from that. It's there's just the hope that there's going to be somebody that's going to want to pay more for my, uh, Ken Griffey rookie card than what I purchased it for, right? That's ultimately what you're betting on there. There's no necessarily, some sort of risk that I'm bearing for holding Ken griffey's rookie car. Now, catastrophe bonds, again, if you think about what's happening is there's a transfer of natural disaster risk from the insurer to the investor at the end of the day, catastrophe bonds are hurricane insurance, earthquake insurance, the California fires, fire insurance, things like that. And so think about the risk there right through in a similar way that Wade talks about annuities have this ability to pool mortality risk, right among many investors? Well, if insurance companies, all of a sudden can pool natural disaster risk, natural disasters across many folks, they diversify a little bit, right, and they're passing on those risks to you. But if you think about natural disaster. Ask, how is that correlated with a mark? How is an earthquake in I don't know. I'm thinking of in Japan related to the stock market, right? It just because the market went down, doesn't mean, oh, it's correlated with an earthquake. So we should expect an earthquake any moment now. No, it just happens randomly, if you will. And so from that standpoint, think about the uncorrelated return stream, return stream that's tied to catastrophe events, right? There's a bearing of risk for compensation. I'm holding a bond that's predicated on natural disaster risk, right? There's that. And all of a sudden, should I? Should I? Should I have a compens, you know, you're providing insurance effectively. So you can see the risk transfer argument there, and you could also see the correlation argument, where it has nothing to do with the stock market, right? And so you have a low correlation to equities, low correlation to bonds, and in addition, low correlation to macroeconomic factors, whether a hurricane hits or not this upcoming fall season has nothing to do with the tariffs that are being proposed right now, right? It has more to do with some butterfly wing right way, somewhere in Malaysia or what have you. And so access to reinsurance premiums through a structured bond format becomes very interesting from an investable standpoint. And I subscribe to this. We currently don't hold this. This is something we're doing due diligence on ourselves, because it is something that's worth considering for our model portfolios. Whether we end up there or not, I don't know, but this is something we're giving serious consideration. Whether you should do it or not for your situation. I don't know, but this is something that you know, if you're thinking about it, I would encourage you to do due diligence on because there is an enhanced portfolio diversification piece to this, and the stability, from the standpoint of it really is uncorrelated with the market, and so you see the difference between this argument and holding gold or something like that for a portfolio weight.

Briana Corbin 22:10
If you're looking for more personal advice, take a look at this episode's sponsor, McLean asset management. You can learn more at McLean. Am.com that's m c, L, E, A, n, a, m.com, McLean, asset management is there to help you on your path to the retirement that you deserve. And don't forget to check the show notes to get your free e book on retirement income planning

Wade Pfau 22:37
in terms of the lack of correlation that now maybe a concern people might have, this does depend on actuaries being right about the expected frequency and severity of the catastrophes. Yeah, no, you're absolutely right. I watched the news recently, it seems like the rate of catastrophes is increasing, which you could make just a bad investment. If we get more catastrophes, you could,

Alex Murguia 23:03

you can throw in the you could throw in the quote, unquote global warming. And I'm not saying it like, you know, sometimes there's no global warm where there is global warming. I'm just throwing it out there that you can make the case there could be increased natural disasters. Interestingly enough, the best time that you'll find to invest in these is right after a natural disaster, simply because these companies really their premiums go up a lot. And so it's almost like the highest expected return is right after one of these. But yeah, you're absolutely right there. There's one of these that's an issue of risk that you're taking off. And so it's not a free lunch in that sense, where it gets interesting individually itself. Would I own a catastrophe bond and nothing else? No would I own an allocation into catastrophe bonds within a portfolio? I would definitely give it its proper due diligence, because I think it's worth reviewing from that managed vantage point. Now, are there? Is there an ability for somebody to invest in this? There are some liquid and semi liquid options available. There's catastrophe bond, ETFs that are out there. X ILS is one of them, again, not an endorsement, just if you're looking at due diligence, you can start there and go from there. And they offer daily liquidity. There's interval funds, which is, I would look at that more so than daily ones, you know, offered through stone reach, which provide quarterly redemption. This is interesting, because they're they're just able the investment mandates are different from a liquidity, from a liquid daily liquidity, through non daily liquidity. And I think to get the full effects of this, you kind of need to let go of the daily liquidity requirement. But again, that's just an opinion, not a matter of fact. So you see these things being offered more and more to investors. You're seeing advisors get into this space more and more and again, not because, ooh, it's trendy or anything like that. Yes, but because through technology, you're able to now offer certain investment vehicles with a level of liquidity that you didn't have before. And again, the role of any portfolio manager is not to try to guess where things are going consistently over and over again. Ultimately, that's a fool's errand to me, the role is to expose yourself to asset classes that are bringing in certain returns expectations per unit of risk, going back to what the common theme of all of this, and this is something that would merit consideration based on how it's set up. Now, there are some catastrophe bonds out there that offer bond solutions as well through interval funds, again, gold stone rage, Fermat capital is the largest dedicated catastrophe bond manager out there. There's a lot of them out there that you can start doing due diligence on the role in the portfolio, as you can imagine, you know, and well, is the diversification benefit now, within that you can buy the bond directly, or you can get what's called quota shares. Quota shares are really for higher net worth investors. And what you're doing here is that an insurance company is just looking at their balance sheet, and they're trying to offload the risk directly, not through a bond, because a bond you could you know, effectively, the dividends are at play, and things along those lines, you're helping fund that company. But here you're actually taking on the risk hand in hand with the insurer. They're looking at their balance sheet and they're saying, Hey, does anyone want to take this 100 million dollar liability for me, right? And then the company could say, I'll take 10% of that. Another company says, Yeah, I'll take 20% of that, and they're on the hook as if they're the reinsurer themselves. From that standpoint, they're really participating in the balance sheet directly of that insurance company with those catastrophic you know, linked to the catastrophe bonds. Now, again, that's linked to, that's to your point. Now Wade, that's linked directly to the underwriting performance, not necessarily the market behavior. And so if you're doing quota shares here, there's an extra level of risk to your point. And here they, you know, they're trying to get it right. How many hurricanes should we expect? You know, they probably have more meteorologists on their on their staff than, uh, economists at this point, you know, because they have to kind of really stay ahead of the curve. You know, how in many advisory firms you see CNBC on the on the on the waiting room. Here you have the Weather Channel all day, all the, all night kind of thing. Now, again, this diversifies the portfolio a little bit more, because you're almost like a private equity investor in the balance sheet of this company. And again, the risk transfer is even more pronounced, because your losses, you can, you can go to zero, you know, in a heartbeat. You know, simply because if you get three back to back hurricanes in the heart of South Florida, that's, that's, that's hard to that's hard to cover, right? And so you do get the alternative yields with real asset characteristics here. So it's a very interesting play, albeit This is more pronounced, if you will. Are there any options that investors have? There's no public or eat, at least that way. You know, when I did my perusal, there's no public ETFs or mutual fund company options Correct. You know, currently available because you're getting here at the participation level. So it'd be nearly impossible to be able to create that kind of infrastructure. What you do is they're called the investment problems for this is called sidecar investment vehicles, where Stone Ridge themselves will will use this to buy, you know, to get to, to participate in the balance sheet of that reinsurer, if you will. But again, the minimums are very high, and you're going to be locked up for multiple year periods if you want this kind of exposure. Now, is there anyone that offers anything like this to folks? Yeah, Swiss Re and Munich Re. Again, these are big levels. They offer investor back side cars, reinsurance side cars, but again, you're talking at high, level. So this is just for direct institutional investors. You have, sometimes you have Stone Ridge and 12 capital, where they manage hybrid funds, and they'll have some quota share exposures within that. And so you can look at it if you really want it bad enough, from that standpoint and from a due diligence perspective. But again, catastrophe insurance is an interesting play, much like private credit that we've talked about in previous episodes, where private credit catastrophe insurance, are things that are at least from my vantage point, from a portfolio construction standpoint, are very interesting. Me, I think those are things that merit strong consideration within a portfolio, whether it's your portfolio or not, that I can't answer, because you have to look at everything else. But within a portfolio that's probably diversified, is there potentially a home for those? I potentially, think the answer is yes, but like anything, it depends, and that's, that's where we'll we're landing on Wade, with regards to the arc on private equity. Now, we didn't get into crypto and all of that, because I think that just merits an arc in and of themselves, in and of itself, that at some point we'll get to just not now.

Wade Pfau 30:40
Okay, so crypto something to look forward to at some unspecified future date. There you have it. But from here, yeah, we'll we'll be getting soon into our series from the Q and A sessions related to that YouTube Live we had on June 2. So please stay tuned for that, and thanks for your attention during our series on alternative investments. And thank you, Alex for all the research you've done to prepare for this as well.

Alex Murguia 31:08
No No worries. Wade, all right, everyone, thank you so much, and we look forward to catching you next week on

Wade Pfau 31:15
retirement style. There it

Alex Murguia 31:17
is. Bye, everyone.

Briana Corbin 31:20

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