Volume 25 / Issue 3

July/August 2016

Bloomberg Markets

Asset Management

A Pioneering ETF Investor Says Gold Flashed A Buy on Emerging Markets

By JON ASMUNDSSON

To track flows into and out of ETFs around the world, go to **{FFLO <GO>}**.

99) Settings — ETF Flows

View Highest/Lowest — Cha[illegible]ow% — Market All — Period YTD — History — In Millions of USD

	Country	Flow % of Assets	Netflow	Flow%	Assets	#Funds	Inflow	In/Out	Outflow
	Highest								
10)	Argentina		+49	+62.3	79	1	49		
11)	Chile		+125	+32.2	387	2	158		-34
12)	Colombia		+256	+25.5	1,003	4	274		-19
[illegible]	[illegible]		+55	+25.1	219	1	59		-4
[illegible]	[illegible]		+174	+17.5	999	18	327		-153
[illegible]	[illegible]		+99	+16.9	584	77	160		-61
[illegible]	[illegible]		+134	+15.1	890	13	155		-21
[illegible]	[illegible]		+73	+13.9	527	19	147		-74
[illegible]	[illegible]		+4	+13.5	29	1	4		
19)	Egypt		+756	+13.3	5,682	35	1,423		667
	Lowest								
20)	North America*		-3,304	-7.5	43,794	145	4,756		-8,060
21)	Germany		-383	-8.1	4,740	28	1,638		-2,021
22)	Philippines		-29	-8.9	326	4	73		-102
23)	Bangladesh		-2	-9.1	20	1	0		-2
24)	Mexico		-3	-10.8	27	2	1		-4
25)	Italy		-739	-12.2	6,051	40	1,123		-1,863
26)	Middle East Region*		-12	-18.3	65	5	2		-14
27)	Spain		-850	-22.8	3,725	18	279		-1,129
28)	Kuwait		-2	-31.5	6	1	1		-3
29)	Austria		-127	-36.1	351	5	79		-206

*Regionally Focused Funds

To view flows as a percentage of assets, click here and select Flow % of Assets.

WHEN STEPHEN CUCCHIARO looks at gold, he sees a stable frame of reference instead of a volatile asset whose price zigzags up and down.

"Gold is just a lump of metal sitting on a shelf," says the president of 3Edge Asset Management, a Boston-based registered investment adviser that started in January and now oversees more than $162 million. Most of the gold on the planet has already been dug up, he says, so the supply is relatively fixed. Gold doesn't tarnish, wither, or produce interest income—it just sits there. "So think of gold as being the only stable asset, with everything else revolving around it, and all of a sudden you get an interesting perspective," he says. ►

Cucchiaro says certain metrics can collect information about other variables, including investor behavior.

One thing that perspective revealed earlier this year was a bullish signal for emerging markets, Cucchiaro, 63, says.

To connect gold and emerging markets takes a bit of back story. It starts in the early 1970s, when Cucchiaro was a math major at MIT studying a field called complex systems. He became fascinated with how to analyze and model systems that have a lot of interconnected variables whose interactions often can't be described by simple linear relationships. "Only when you understand those interconnections—and only when you understand at a detailed mathematical level the time delays between a change in one variable and another—do you get the benefit of understanding the whole dynamic system," he says.

After graduating from MIT, Cucchiaro studied finance at the Wharton School at the University of Pennsylvania. There, he says, he began to realize that global capital markets are a perfect example of a complex system. John Sterman, director of MIT's System Dynamics Group, says he shares Cucchiaro's view. "Everything interacts: there are important feedback interactions—these are nonlinear," he says.

That has implications when applied to finance. "All complex systems, whether they're in science or nature or physics or evolution, tend not to be at some restful state of equilibrium but tend to bounce across different states of disequilibrium," Cucchiaro says. In such a framework, assets such as U.S. stocks, oil, and the Japanese yen would almost always be under- or overvalued to some degree. Economic and fundamental forces push those valuations up or down, and investor psychology—particularly herd behavior—can sometimes stretch them to extreme levels. "I realized that was an opportunity to add something new—to take what I had learned in other fields and apply it in finance," he says.

Cucchiaro set out to develop an investment approach based on complex systems. After finishing Wharton in 1977, he worked as a management consultant, an economist, and an entrepreneur, starting one company that he sold to Lotus Development and leading another that Oracle bought. In his spare time, he did research, compiling information on which variables were most important in driving various markets.

He developed models based on that research and in 1994 founded Windward Investment Management. At the one-man firm, he implemented his approach using a recent innovation, exchange-traded funds.

Luis Viceira, a professor at Harvard Business School, says Cucchiaro was one of the first to see how ETFs could be used to diversify across asset ►

classes. “This is really important because people were not realizing the disruptive power that ETFs had,” he says.

In 2002, Windward, with $70 million in assets, started hiring people to build its business.

Windward’s assets grew to $3.9 billion by 2010, when Charles Schwab bought the firm in a $150 million deal. “The original intent was never to sell the company, but we received a very attractive offer that was hard for my partners and I to turn down,” Cucchiaro says. “We became part of Schwab Corp.”

After a “very sharp trademark attorney” noticed that the Windward name wasn’t properly registered, Cucchiaro says, Schwab changed the name to Windhaven. (Cucchiaro, whose hobby is sailing, was a member of the U.S. team that would have competed in the U.S.-boycotted 1980 Olympics.)

Windhaven’s assets rose to $19.7 billion in June 2014, when Cucchiaro left the firm. “It allowed me to step back for the first time in many years and reconnect with my children and my hobby,” he says. “It also gave me time to develop brand-new intellectual property, which is the basis of 3Edge.”

CUCCHIARO SAYS THAT one of the things he thought about during his time off was the unprecedented way that central banks have intervened in global markets since 2008. “You can’t go back in history and find a time when we had 30 percent of the world’s government bond markets yielding negative interest rates,” he says. Central banks in effect pushed up asset prices in the hope that doing so would spur economic growth. “That second part didn’t happen,” he says. “So we have market prices that got elevated beyond the fundamentals.” That, in effect, reduces future returns by pulling them into the present. One implication, Cucchiaro says, is that a buy-and-hold strategy of stocks and bonds probably won’t do as well as it may have in the past. “So part of our approach is to identify asset classes that are not only undervalued but where there’s a catalyst that we can identify.”

That’s where gold and emerging markets come in. Emerging markets tend to outperform developed economies at times and then lag at other times, says DeFred “Fritz” Folts III, chief investment strategist at 3Edge. For the past several years emerging markets have underperformed a lot. As a result, they started to appear undervalued, and some investors jumped in. “People got into that trade in 2014,” Folts says. “It was a very disappointing place to be.”

Meanwhile, continued dollar strength was one of the most widely held expectations in the market. “Everyone came to a consensus view,” Cucchiaro says. The U.S. Federal Reserve was the only major central bank trying to raise rates; all the others were trying to ease more. Dollar appreciation was in effect putting the brakes on emerging markets. “The strong dollar will siphon capital out of the emerging markets,” Folts says. Emerging markets may be undervalued, but it didn’t mean that they were going to turn around anytime soon.

ALL OF THAT started to change after the Fed raised rates in December. Markets became very unstable, and the Fed signaled that it wouldn’t boost rates four times this year as originally projected. “All of a sudden, the dollar started to stabilize and then weaken,” Cucchiaro says.

To assess the value of the dollar, you can measure it against the euro, the yen, or a basket of currencies. But what if all of the currencies are depreciating in some way? “It’s like the worst-kept secret in the world that people want their currencies to depreciate,” Folts says. With all central banks essentially trying to weaken their currencies to help their economies grow, it might look like not much is happening as currencies oscillate in a range against one another.

That’s where you can bring in gold as a frame of reference for paper currencies, Cucchiaro says. “We’ve seen gold since it peaked in 2011 steadily go down, down, down—and all of a sudden, at the turn of the year, it started to come up,” he says.

The rise in gold, Cucchiaro says, suggested weakness for the dollar and hence that developing economies might start to turn upward. “This was a big signal that it was now time to start nibbling away at emerging markets,” he says. ●

Asmundsson is <GO> editor of *Bloomberg Markets*.

3EDGE
ASSET MANAGEMENT

ONE INTERNATIONAL PLACE, 44TH FLOOR | BOSTON MA 02110

TEL 844-903-3343 | WEB 3edgeam.com

DISCLOSURES: