The Inside Adviser

Time for alternative investments to shine

Given the global outlook is clearly one of a high degree of risk, it is surprising that all forms of risk assets seem to continually defy all the negative outlooks.

Traditional asset allocations have been heavily tied to equity market growth and the continual decline in risk free interest rates over the past 30 years. However, for the next period in markets, it is likely investors will not enjoy the same tailwinds due to the current starting valuations.

Expectations for traditional fixed income to buffer equity risk is diminished given global zero-risk free rates and high bond valuations.

Traditional 60/40 type portfolios will face significant risk as bond and equity correlations increase.

Therefore, it makes perfect sense that portfolio construction philosophies should be adjusted with an increased allocation to alternative strategies to improve risk adjusted outcomes.

Larger financial institutions have always, historically, adopted a wide range of tools to meet uncertain future, which includes alternatives and portfolio hedging. For example, some astute superannuation funds have been increasing their internal capabilities around derivatives, introducing long volatility allocations and utilising defensive option strategies.

However, for retail advisers and their model portfolio teams, the menu of available solutions has been relatively narrow. This is understandable given the pre-requisites for daily liquidity, growing focus on passive SMA implementation and lower fees.

The attraction of hedge funds and liquid alternatives is their ability to participate less or actively take advantage of negative market environments. This absolute return mindset should focus on the reduction of drawdowns to allow for the power of compounding of returns.

While seemingly straight forward, finding the necessary building blocks has not been easy within the retail investment landscape. Especially, in a market where Approved Product Lists (APL) have limited choice and usually are dominated by the managers with the largest funds under management.

Compounding the challenge are some strategies that utilise leverage, borrowing, short-selling and more complex bank credit risk products which are a challenge for any investment professional to quantify.

Luckily, there are absolute return focused strategies that fit nicely into the liquid alternative bucket or provide a core portfolio building block for risk adverse portfolios for the next market phase that avoid added complexity of many opaque hedge fund strategies which can be easily understood by advisers and their clients.

Unfortunately, the best managers within any alternative category are usually not the largest.

Figure1

June 2020	1YR	5YR	1st Quarter 2020
AQR Delta	-15.04%	-3.51%	-10.90%
Man AHL Div Alts	0.88%	1.79%	-2.59%
Winton Global Alpha	-13.91%	-1.25%	-6.93%
Regal Tasman Mkt Nuetral	-12.37%	2.35%	-30.19%
Pinebridge Global DAA	1.62%	-3.68%	-14.13%
Blackrock Global Allocation	5.50%	4.89%	-12.12%
GMO Systematic Global Macro	0.21%	2.36%	3.29%
Cor Capital Fund	9.47%	6.10%	0.48%
Source: Bloomberg – Fundlab SC			

Figure 1 highlights several of the most popular liquid alternative and absolute return managers available via retail platforms. Funds that experienced large losses in the 1st quarter of 2020, should be recognised for their relatively high market beta exposure. More worryingly, anaemic returns over the longer period has raised many potential questions including scalability of strategies and continual “model decay” for long-run quantitative funds.

The failure to provide needed diversification coupled with portfolio return drag over the past 5 years underscores why many portfolio construction teams are frustrated with their liquid alternative exposures.

However, while many of the recognised names may have tainted their respective categories, dispersion among hedge fund strategies was very wide in the first half of 2020.

Figure 2 depicts dispersion among hedge fund categories (1st half 2020) recently produced by Russel Investments, highlighting issues around a limited menu of hedge fund strategies rather than the failure of an asset class.

SOURCE: Russell Investments July 2020

Figure 2 : YTD Through June 2020

While frustrations are numerous within the industry, good solutions for this market environment are available, if one were willing to look beyond labels.

Relative complexity and higher costs have always been a challenge for alternative strategy inclusion within retail APLs. Further, liquid alternatives are comprised with many differentiated strategies often not fully appreciated by advisers.

Clearly, within the liquid alternative universe, there are nuances that need to be understood in order to avoid disappointment.

Absolute Return does not need to be complex
Advisors prefer less complex and straight forward approach to managing risk. For example, while many of the largest global macro and multi strategy managers are available to investors, most advisers are not well versed in the opaque strategies which include short selling, borrowing, utilising bank OTC swap and other more complex risks.

Luckily, there are investment absolute return strategies purposely designed to protect capital and deliver returns without a high degree of equity market risk or introducing complexity to meet stable real absolute returns.

For example, "All Weather" multi asset portfolios with a focus on protecting capital is one straight forward option.

"All Weather" portfolios which are typically long – only multi asset portfolios aim to perform within all potential market environments including recession/growth and inflationary/deflationary environments.

Australia's local boutiques punch well above their weight in comparison to some of the global name brand funds. Melbourne based Cor Capital Fund's "All Weather" approach is the top ranked multi-asset portfolio for 1 and 5 year returns according to Morningstar (as at 31 July 2020).
Cor's approach to absolute returns does not utilise complex strategies which include short selling, borrowing or any bank credit risk instruments. Instead Cor focuses on providing a stable real return with an absolute return objective prioritising capital stability. The strategy avoids illiquidity premia and borrowing and instead focuses upon actively re-balancing its purposely designed portfolio to harvest volatility and provide a welcomed alternative source of return.

Recent market volatility has presented ample opportunity for added return. As of July 31, 2020 –   Cor Capital Fund 1-year return net. of fees was 11.62%.

For investment teams seeking to reduce exposure to equity risk premia and gain higher rates of return than cash and bonds, all weather approaches that are designed for defending capital and withstanding market surprise, may be an attractive solution.

Avoiding complexity in an increasingly uncertain world is a welcomed relief.

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