On The Mark

November 2022

What's The Alternative?

This year has been a head-scratcher for most investors, given it has seen the worst period of returns for bonds while also seeing an equity bear market. Alternative investments have been used by institutional investors for many years to help diversify their portfolios and have proven helpful during recent market volatility. But what about the retail investor – what's their alternative?

Defining Alternatives

Alternative Investments, as defined by Investopedia, are "a financial asset that does not fall into one of the conventional investment categories," that is, equities, bonds, or cash. There are multiple alternative strategies that range in complexity, from sophisticated investment strategies like hedge funds to investing in brand-new companies and ideas (venture capital) or commodities, art, and antiques. The key characteristic is they perform differently from traditional assets.

While many strategies tend only to be available for institutional and high-net-worth investors, there is a growing number of options for retail investors. Liquid alternative strategies are generally used to help manage risk in the portfolio, but how they do it can vary depending on the strategy. Most strategies seek to help manage portfolio risk through diversification, meaning they don't move in the same patterns as traditional assets. Some seek to hedge or modify returns, meaning they limit the return pattern on the downside or upside.

Two common liquid alternative strategies are managed futures and diversified alternative strategies.

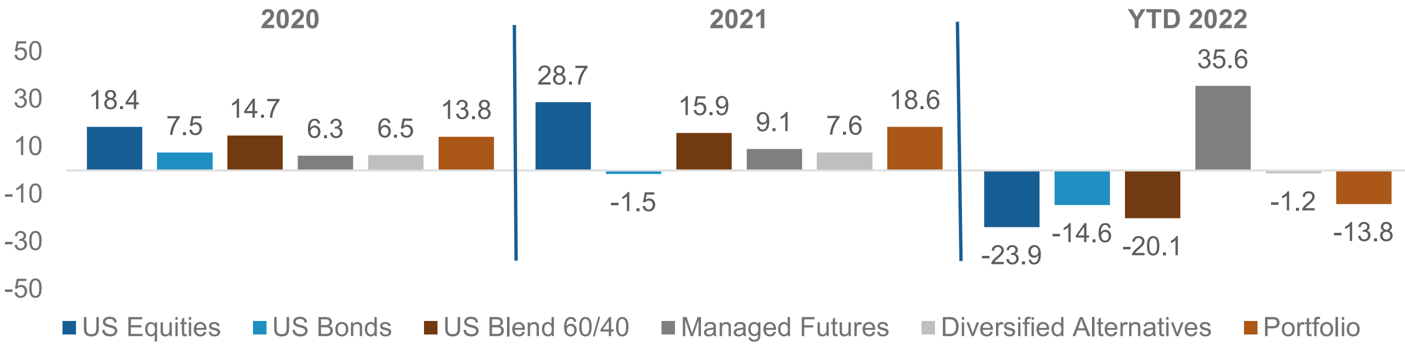
- Managed futures strategies take advantage of trends across multiple markets – equities, bonds, commodities, and currencies. These strategies can position their portfolios to take advantage of persistent upward and downward trends. They are commonly referred to as 'crisis alpha' as they have historically proven to add value to portfolios in times of significant market stress, like 2009 and 2022.
- Diversified alternatives typically contain a mix of complementary alternative strategies, such as long-short global macro and options-based strategies[i] that can benefit when assets fall in value. The key to the selection and mix of strategies is that they have a lower volatility experience and move in different directions to equities, bonds, and each other.

Why Use Alternatives

The key goal of diversification in a portfolio is to put together a mix of exposures that don't all move in the same direction. Not everything is going to work all the time, so having a combination of traditional asset classes and non-traditional strategies can help manage the overall risk in a portfolio over the long term. Since alternative strategies tend not to move in the same direction as equities and bonds, they can help to limit some of the downside experiences of traditional asset classes. But they likely will limit some of the upsides of the portfolio as well. In some ways, it's like paying for insurance: you dislike paying the premium every year as it's a cost, but when you need the insurance due to some event, you're happy you paid the premium.

This year the changing economic regime due to low growth and high inflation has been a headwind for equities and bonds as they moved in tandem. As inflation remains stubbornly high and the Federal Reserve remains doggedly focused on controlling inflation through raising rates, the probabilities of a recession continue to rise. This all leads to continued market volatility, which means it could be time to consider liquid alternative strategies to help manage risk in the portfolio.

Calendar Year Returns – YTD is through September 30 (%)



Source: Zephyr Style Advisor. US Blend 60/40 is 60% US Equities & 40% US Bonds; Portfolio is 60% US Equities, 20% US Bonds, 10% Managed Futures & 10% Hedge FOF Conservative. US equities represented by S&P 500, US bonds represented by Bloomberg US Aggregate, Managed Futures represented by SG Trend, Diversified Alternatives represented by HFRI: FOF Conservative

As a risk management tool, it's typical for alternatives to substitute for bonds in a portfolio. It's very clear to see the impact of this year-to-date in 2022, when both equity and bond markets saw double-digit losses. Alternatives were able to reduce the loss in the portfolio over the period. Looking back at 2021, they also added to returns, given the weakness seen in the bond market. But it's not always a silver lining which can be seen in the 2020 results, where the portfolio's return was below those of the traditional 60/40 blend due to the weaker relative returns or alternative strategies.

Alternatives may not be for everyone, but for those willing to add some exposure to help with risk management in today's environment, there are options. It's just critical to understand their role in the portfolio, understand the expectations of the strategy being used, and size it appropriately.

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[i] Long-short strategies take a long position in securities expected to rise in value and a short position in securities expected to fall in price. Global macro strategies take positions based on global economic and political views. Options-based strategies use options to take advantage of price movements in the underlying asset without having to purchase the underlying asset.

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