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The Case For Alternatives In 2017

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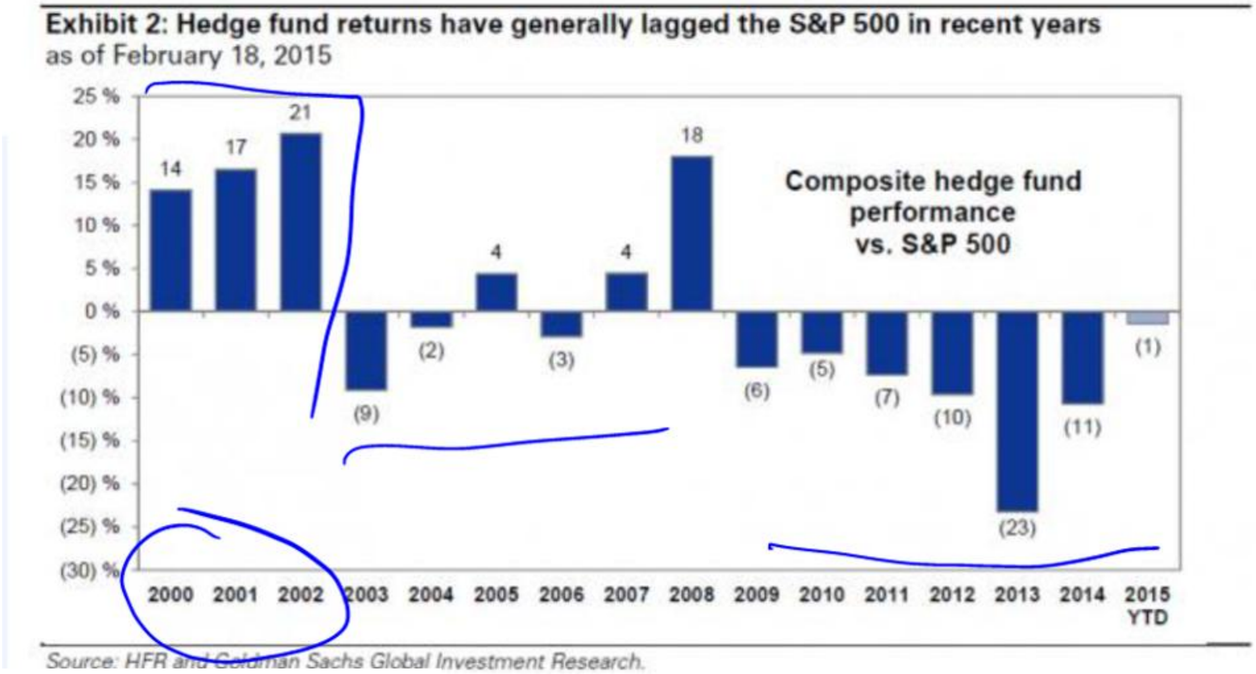
I write about all things economic and investment-related. **FULL BIO**

The present dialogue in capital markets centers primarily around valuations in the stock market, interest rate risk in the bond market, and general unknowns in the realm of both monetary and fiscal policy. These are fair and not insignificant issues to ponder, and yet in the quest for a proper equity/fixed income allocation, the underlying assumption that the alternative investment universe is a relic of the past is getting further and further baked, I believe to the detriment of those who buy this. The bias against hedge funds and the overall subject of idiosyncratic investment methodologies is severe, evidenced by nearly daily media reports against that investment universe, but also detectable in much of the public pension space where high profile institutional investors (e.g. Calpers, the largest public pension fund in the country) have gone public with their plans to decrease or eliminate exposure to such strategies. My thesis herein is that a strong tactical allocation to hedge funds and the broader alternative universe is warranted in the present environment, and that ironically, the current climate so opposed to the space is a big part of the reason why.

The most fundamental issue to address in making a strategic case for alternatives, let alone a tactical one in 2017, is what exactly an "alternative investment" is. We define such at The Bahnsen Group as "those investments which derive their source of risk and their source of return largely outside of the traditional stock and bond markets." In other words, the fundamental issue is non-correlation. There is a certain absolute return objective many alternatives are likely to have, but in theory any investment objective attempting to exploit risk premia – any attempt whatsoever regardless of beta – is subject to the potential for a negative absolute return. While long-only equity markets are intrinsically exposed to positive and negative annual fluctuations (roughly one year negative and three years positive in every four year cycle, on average), alternatives can be said to seek the reduction of such volatility, and indeed that potential positive performance in negative equity years may be a benefit to allocating capital to the space, but it is not, in and of itself, the defining characteristic of the asset class. Rather, from our perspective, the attempt to diversify the sources of risk and reward in a portfolio is the objective of alternative investing. Therefore, it stands to reason that highly levered equity hedge funds which may very well outperform equity markets due to good stock picking and/or the use of leverage are very possibly not what we would define as "alternatives." The key piece is *beta* – and to the extent a hedge fund manager runs a high beta portfolio, regardless of return variance due to leverage, we have not found alternative sources of risk and reward with such a strategy.

Another way of saying this is that our use of alternatives seeks, not to eliminate or even reduce risk, but to *change* it. We seek to replace traditional stock and bond market risk with *manager* risk. We seek to find risk premia not from an "asset class" per se, but from an asset manager. The incomparable Alexander Ineichen did yeoman's work on this subject fifteen years ago, seeking to position hedge funds not as their own investment category, but rather as a human exploitation of given asset classes (for good or for bad). There is, of course, risk in this – human talent risk. But where our defense of this subset of the investment universe would come from right now is in the space that represents the pursuit of non-correlation, of risk premia outside traditional conventions, of alpha rather than beta as the generator of investment return.

The alternative-skeptic community cannot be blamed for their disdain of alternatives if one seeks to measure alternatives by traditional benchmarks. Indeed, since March of 2009 one could persuasively argue (with the gift of hindsight, of course) that alternatives have not been needed. Beta has been a winning trade, led by a generational earnings recovery for the ages and the multiple expansion that came with easy monetary policy. Charts like the one here pointing to the under-performance of the hedge fund universe to the S&P 500 throughout the post-crisis recovery miss a significant point: The objective of alternatives is not to outperform the S&P 500 during a bull market; the objective is to lower volatility and maintain a more attractive return profile during a full market cycle.



HFR, Goldman Sachs Global Investment Research

Hedge fund returns have generally lagged the S&P 500 in recent years

And indeed, when one factors in periods of “flat” markets, let alone “negative” markets (note the 2000-2002 performance above), investors have benefitted from selection of effective alternative managers into a balanced portfolio. The contemporary argument is that the opportunity set in alternatives has been dissipated, and there is truth to the argument. Selectivity is more key than ever, and the mere pursuit of superior knowledge is no longer the instant panacea it once was – execution around such knowledge has become key. The outsized returns generated from outsized leverage are no longer dependable or even advisable in the context of a balanced and moderate risk/reward profile. Therefore, our defense of alternatives depends upon the selection of disciplined and talented managers who respect markets – indeed, who even hear them - and yet have the ability to provide an attractive risk/reward trade-off to our already balanced traditional portfolio. When the fee is buying alpha and not beta, the discussion of fees becomes obsolete. 2015 and 2016 saw several very high profile managers create stigmatizing levels of *negative alpha,* which is different than a drop due to elevated beta levels. A manager’s poor decision around, say, Valeant Pharmaceuticals, need not invalidate the opportunity set in the vast array of alternative strategies available to sophisticated investors.

And this brings us to 2017. A ten-year bond yield in the 2.2% range as we enter a likely Fed tightening cycle has investors defensive around duration risk. High yield credit spreads in the 375 basis point range suggests credit is expensive, and unlikely to offer the risk-adjusted returns investors have enjoyed throughout most of the recovery. An earnings multiple in the S&P 500 of about 18 (higher than that on trailing basis) may not speak to a full-blown bubble, but it certainly does not speak to a cheap market either. Traditional asset classes have simply seen their risk-reward characteristics change, with return potential decreased and risk potential increased. This does not suggest an exit from traditional exposures, the timing of which is futile as history has made perfectly clear. But tactically speaking, and in a backdrop of so much media and public pension about alternatives, we believe that a properly understood alternatives inclusion will offer an attractive outcome for investors seeking to smooth volatility and improve their risk-reward trade-offs. Contrarianism suggests that the masses generally do the wrong things at the wrong time, and we see no reason to make an exception to this with the alternative investing discussion. Our commitment ought to be to idiosyncratic investment strategies administered by talented alpha-generators. The risk of poor manager selection can be mitigated by due diligence, but also by manager and strategy diversification. We particular find various relative value arbitrage strategies attractive right now. Mispriced securities and mispriced relationships exist up and down the capital structure, and talented managers exist to exploit these opportunities. We would certainly not see this as risk-free, but we would see it as a categorically different risk than that of equity market beta.

And therein lies the objective we have – to reduce the beta risk of a client portfolio when stock and bond valuations suggest a diminished opportunity set, even if that risk reduction comes via a replacement of risk into that of human talent and execution. The end result is a more diversified client portfolio, operating with lowered variance around the desired return, and an outcome over a full market cycle that we believe will be significantly enhanced on a risk-reward basis. Will we change our outlook on hedge funds and alternatives at some point? Very likely, yes. The catalyst? When the media starts running reports about the "renaissance of hedge funds."

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