Absolute return & uncorrelated strategies

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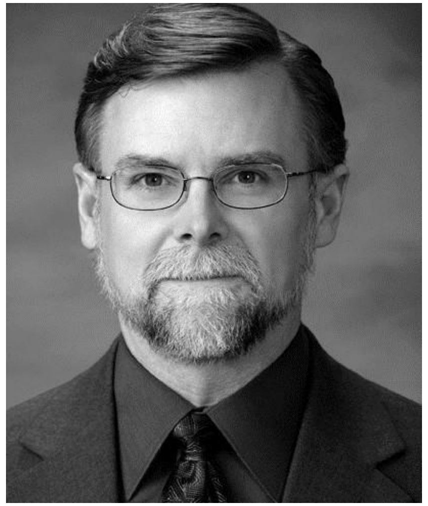

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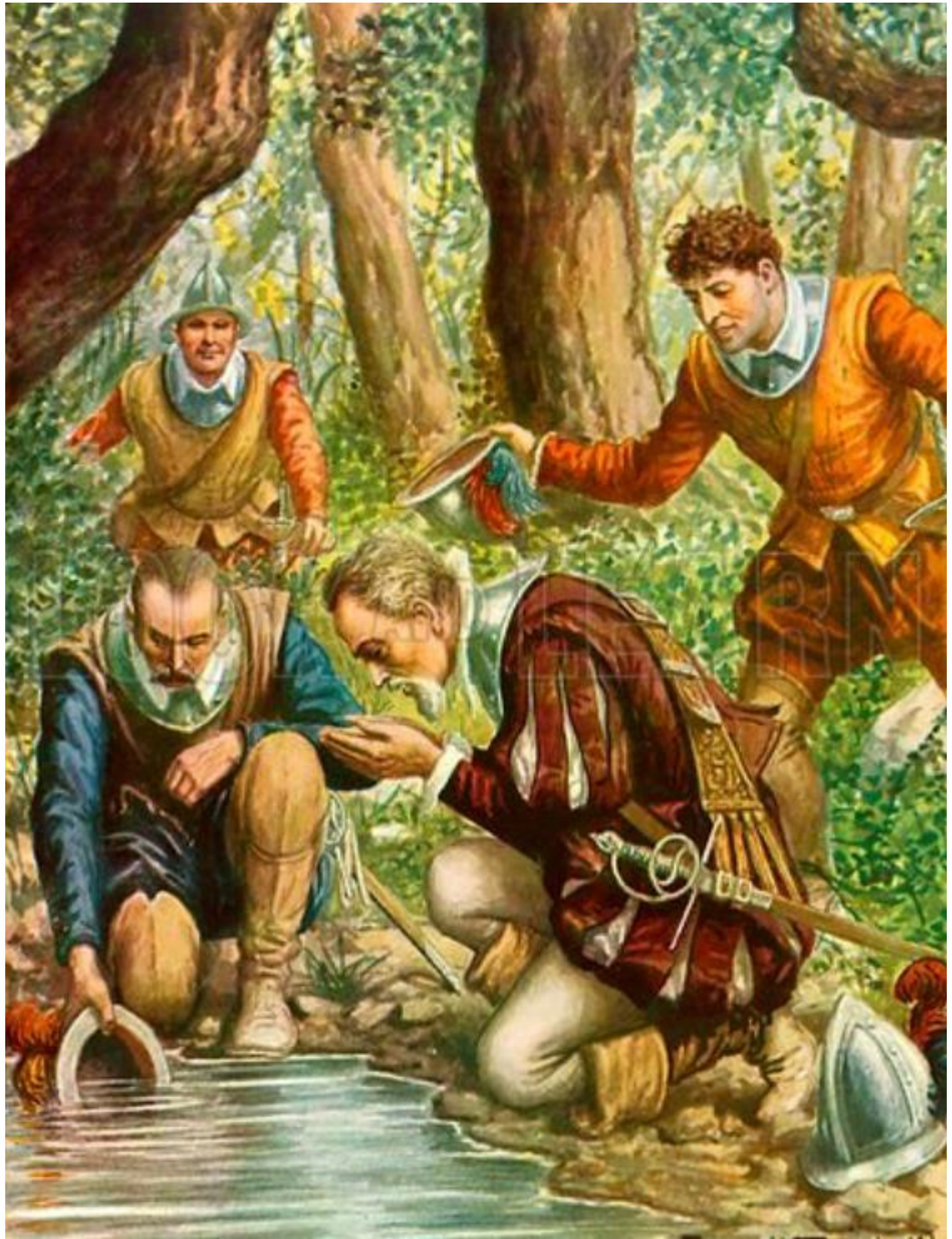
Ponce de León searched for the fabled Fountain of Youth



Winner of the Graham and Dodd award

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PERSPECTIVES

The Myth of the Absolute-Return Investor

M. Barton Waring and Laurence B. Siegel

In meetings with clients and colleagues in the past few years, we have noticed that many otherwise hardheaded and clear-eyed investors are excited about "absolute return" investing. The notion is spreading like wildfire. Many institutional investors have already added, or are planning to add, an absolute-return "asset class" to their policy mix. At a time when pension funds, foundations, and endowments are under

both sensible and true to the sense of the term eluded us. That experience further piqued our interest in the idea.

So, let us explore the term a bit. It is widely used, and because words are chosen to a purpose, one can find some of that purpose by observing the context in which a term is used.

One important bit of context is that the word pair "absolute return" has been used most by those

The Waring/Siegel approach

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- Waring and Siegel break the world into two camps
  - Relative return investments
  - Absolute return investments
- Their distinction focuses on correlation . . . independent of time
- I break the world into two different camps
  - Journey investments
  - Destination investments
- My distinction focuses on results at a point in time . . . and ignores correlation

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One important bit of context is that the word pair "absolute return" has been used most by those managers who resist the practical and theoretical successes of relative-return investing and who are looking for terminology that supports their rebellious spirit. The term captures this spirit: If benchmark-relative investing is considered inadequate or wimpy by these rebels, then absolute-return investing implies that managers can take the opposite approach, one that is not benchmark relative. (Real men do not use benchmarks!)

Claims made - some are true, some are false

- Claims
- Absolute return investments
  - Uncorrelated or relatively uncorrelated investments exist
- Destination investments
  - Break the dysfunctional/slavish comparison to performance benchmarks

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The Way Hedge Funds Ought to Be

We cannot salvage the term "absolute return," but we can salvage the concept of the hedge fund—that is, of a fund that takes both long and short positions as originally envisioned by Alfred Winslow Jones.[14] To do so requires us to acknowledge that,

Waring/Siegel final conclusion

So, the term "absolute-return investing" has no meaning. It misleads the listener into thinking it has substance that it does not have, and in our opinion, the term simply should not be used.

A quick review of alts - retail versus institutional

- I'm restricting myself to RETAIL

- You're retail if
  - $1 million account minimum
  - Your end-client has investable assets of <= $30 million
  - Your products are distributed through
    - RIAs
    - BDs
    - Trust departments
    - Insurance companies

Timeline - retail alts product structure

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- Mutual funds (daily access)
- Closed end funds
- Business development companies (BDCs)
- Structured notes
- Private non-traded REITs
- Low minimum limited partnerships
- Feeder funds
- Interval funds

The problem with retail alts

- Grew too far too fast
- Misunderstanding of why they exist
- Execution failure - common and easy
- Liquidity
- Knockout

Grew too far too fast - Demand

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- Generally . . . no significant change
- More recently . . . concern over extent to which interest rates have gone negative

Grew too far too fast - Supply

- Huge increase in supply
- Mutual fund companies losing
  - Business to ETFs
  - Margins to fee competition
- Institutional investment managers
  - Disappearance of defined benefit pension plans
  - Di minimis growth across foundations/endowments

Grew too far too fast - Facilitators

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- Creation of powerful new intermediaries
- Feeder funds
- Alts TAMPS
  - “Aims to Democratize Alternative Investments”
  - iCapital, Artivest, CAIS, iFunds, Conway, Harbor, Alto, PPB Capital
- Repackagers
  - FS Investments
  - Invesco (Caryle)

Why do facilitators exist?

- Pick the investments
- Complete the paperwork
- Deliver lower account minimums
- Perform due diligence . . . so as to fend off
  - Regulators
  - Litigators
- While still allowing the adviser to feel in control

I asked advisers why alts exist

- They said . . .
- *“Because they are uncorrelated”*
- *“Because they make money in up-markets and in down-markets”*

What's wrong with their answer?

- Unfortunately, the real answer is . . .
  - They support higher profit margins for the manufactures
  - They support higher sales commissions for the distributors
  - Not or only partially marked-to-market
  - Offer awesome storytelling

- It doesn't benefit the client . . . there is no . . .
  - Higher return
  - Lower risk
  - Superior diversification

The problem of knockout

- When you're forced out of an attractive investment position
- One that you would benefit from . . . if you just had the ability to stick with it . . . through the current drama

Causes of knockout

- Lenders supporting the position pull their money
- Investors in the product pull their money
- You pull your money because
  - Lack the required patience
  - Misunderstood
    - How to measure success
    - Tracking
    - Transitory nature of a liquidity pricing shocks

Seeking beneficial alts - The challenges we face

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- A lot of bad product out there
- Liquid alternatives
- False over-priced betas
- A different type of execution failure

- Primarily a problem with daily-access product

I am the greatest critic . . . and the greatest advocate for alts

- Let me back up

- Answer the question "Why do alternatives work?"

- It staggers me how rare it is for advisers to adequately ask and answer
    - *"Why does it exist?"*
    - *"Why will it work?"*

Do alternate betas actually exist?

- Permanent, perpetual, durable risk factors that are non-diversifiable
- That are not captured (harvested) elsewhere
- These are NOT
  - Stocks
  - Bonds
  - Currencies
  - Commodities

- We <u>can't</u> just recombine these and create a new risk factor
- Alchemy is a fun story . . . but a false reality

Alternate betas do exist - in rare and limited instances

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- Physical reinsurance
- Financial market reinsurance
- Illiquidity premium
- Targeted risk premiums
  - COVID-19
  - Carbon emissions

- Permanent, perpetual information advantage, one that continually renews itself

Alternate alphas also exist

- Exist

- Rare
- Temporary
- Transitory
- Self-extinguishing

- The simple act of harvesting the alpha opportunity serves to eliminate the opportunity

Alphas - the fishing analogy

- If your objective is to catch fish . . .
- Fish in the right place
  - Large number of fish
  - Big fish
- Avoid competitors
  - Less to go around when faced with too many other fishermen
- Use better fishing equipment than your competitors
  - What's your edge . . . and is it sufficient
- Leave, move on . . . to another fishing pond
  - Before the fish are all depleted

So what is an alternative investment?

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@CharlieBilello	The Negative Bond Yield Matrix													
Country	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year	50-Year
Switzerland	-0.71	-1.04	-1.05	-1.05	-1.03	-0.98	-0.92	-0.89	-0.95	-0.87	-0.61	-0.49	-0.31	-0.19
Germany	-0.73	-0.81	-0.84	-0.82	-0.78	-0.75	-0.71	-0.66	-0.63	-0.52	-0.36	-0.22	-0.02	
Netherlands		-0.78	-0.79	-0.78	-0.71	-0.64	-0.59	-0.52	-0.48	-0.40	-0.26	-0.16	-0.01	
Denmark		-0.83	-0.78		-0.73			-0.62		-0.48		-0.26		
Japan	-0.19	-0.21	-0.24	-0.26	-0.27	-0.28	-0.28	-0.26	-0.22	-0.19	0.00	0.15	0.29	
Austria	-0.61	-0.75	-0.69	-0.69	-0.61	-0.56	-0.48	-0.44	-0.38	-0.29	-0.03	0.10	0.34	0.49
Finland		-0.73	-0.72	-0.70	-0.65	-0.60		-0.40		-0.26	-0.05		0.21	
Sweden		-0.62			-0.64		-0.45			-0.22	-0.05	0.23		
France	-0.62	-0.71	-0.75	-0.72	-0.64	-0.57	-0.49	-0.41	-0.33	-0.24	-0.07	0.29	0.62	0.81
Belgium	-0.63	-0.63	-0.73	-0.70	-0.64	-0.56	-0.42	-0.34	-0.30	-0.18	-0.05	0.32		
Slovakia	-0.39				-0.36	-0.63		-0.17	-0.08	-0.13			0.69	1.01
Ireland	-0.56		-0.52	-0.50	-0.43	-0.33	-0.24		-0.09	-0.01	0.36	0.55	0.91	
Slovenia	-0.07	-0.30	-0.51		-0.35		-0.24	-0.17		-0.03		0.70		
Spain	-0.49	-0.50	-0.48	-0.40	-0.26	-0.20	-0.08	-0.02	0.09	0.24	0.66	0.67	1.14	
Portugal	-0.40	-0.54	-0.38	-0.29	-0.23	-0.09	-0.02	0.08	0.19	0.28	0.66	0.84	1.18	
Malta	-0.29		-0.25		-0.25					0.30		0.91		
Cyprus	-0.07		-0.04		0.08		0.28			0.50				
Italy	-0.15	-0.04	0.33	0.57	0.85	0.99	1.11	1.26	1.30	1.54	2.06	2.24	2.59	2.80
Bulgaria	-0.20		0.30		0.18		0.37			0.45				
United States	1.76	1.60	1.56		1.56		1.65			1.76			2.31	

- *30% of all investment-grade securities now bear sub-zero yields, meaning that investors who acquire the debt and hold it to maturity are guaranteed to make a loss*

So what is an alternative investment?

- It's the single most important thing we can do for our clients today
- Interest rates at a 600-year low
- P/E ratios at a 90-year high
- Current bull market has been running since March 2009 . . . long in the tooth

Steps leading to success

- Legit?
- Beta . . .
  - Genuine?
  - Overpriced?
- Alpha . . .
  - Genuine?
  - It’s temporary, are you ready to move on?
- BD or a TAMP . . . if so, the cost and selection process might severely handicap the result
- Liquidity, understand and provision for trauma-event
- Knockout, avoid
- Expectations, set and maintain

In brief

If you don't have seriously SUPERIOR selection ability . . . just stay away

What about tactical asset allocation

Is it an alternative?

Is it an absolute return strategy?

Is it uncorrelated?

Lack of tracking

- This is one of the two biggest sources of disappointment with TAA
- Essentially . . . the S&P 500 is up and my TAA portfolio is down

Consider a specific example

- A simple generic example of TAA that I discussed during prior Friday discussions

Step 5 - Identifying the data set and quantitative rule

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- Monthly returns spanning the time period Jan 1919 through Feb 2020
- 29 asset categories
  - 7 - U.S. stocks
  - 9 - international stocks
  - 6 - U.S. Treasuries (maturities from 90-days to 30-years)
  - 2 - U.S. investment grade corporate bonds
  - 1 - International government bonds
  - 1 - broad-based diversified commodities
  - 3 - precious metals
- Quantitative rule
  - Once each month select the 7 assets that are trending the most strongly and equal weight them

Slide from prior Friday discussion

Step 5 - Identifying the data set and quantitative rule, continued

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- ## Quantitative rule
  - Once each month select the 7 assets that are trending the most strongly and equal weight them

Slide from prior Friday discussion

			Simple quantitative rule	
Alternative investment time periods	**Intended to serve client needs located this far in the future**	**Comparative performance benchmark**	**Intermediate-term, investment grade, U.S. corporate bonds**	**The 7 asset classes that are trending most strongly, equal-weighted**
7 ½ years	5 to 10 years	25%/75% stocks/bonds	30%	70%
12 ½ years	10 to 15 years	50%/50% stocks/bonds	20%	80%
17 ½ years	15 to 20 years	75%/25% stocks/bonds	10%	90%
22 ½ years	21 years and greater	100% stocks	0%	100%

Step 5 - Identifying the data set and quantitative rule, continued

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22 ½ years	21 years and greater	100% stocks	0%	100%

Correlations between TAA and S&P 500

- These correlations mean that it is extremely likely that the S&P 500 will be up and your TAA portfolio will be down

	1 month	3 months	6 months	1 year	3 years	5 years
Correlation between the S&P 500 and the TAA portfolio	0.59	0.61	0.61	0.57	0.54	0.48

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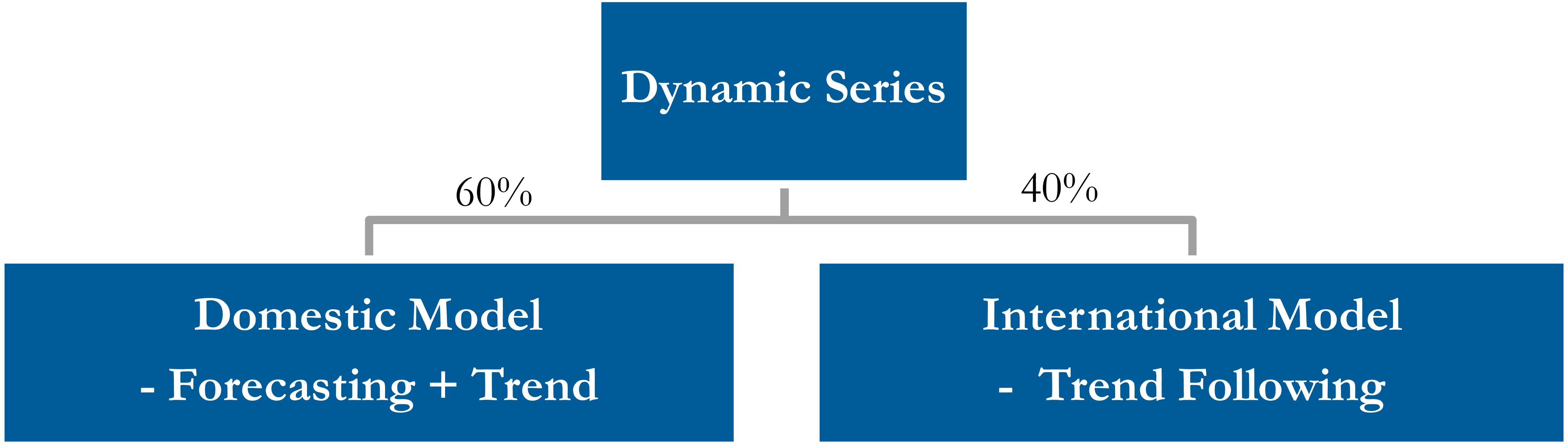
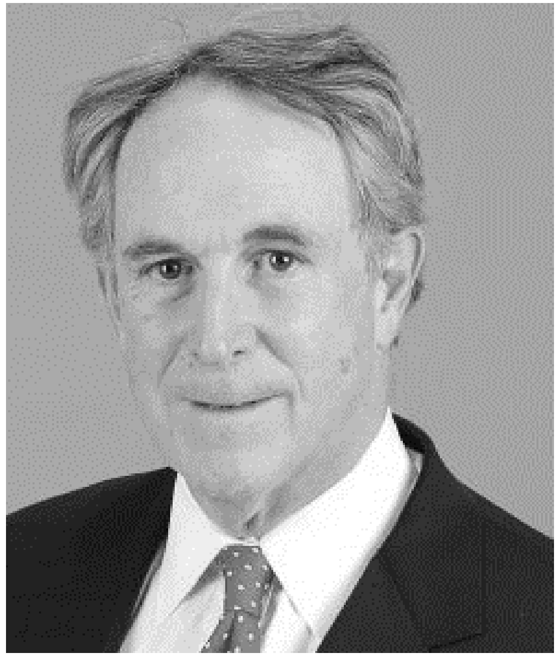
This is pretty darn attractive as a practical, low cost, dependable "alternative investment"

My preferred Julex TAA strategy



Benefits of Multi Strategies:
- Better risk-adjusted return
- Model risk mitigation

For more information contact



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