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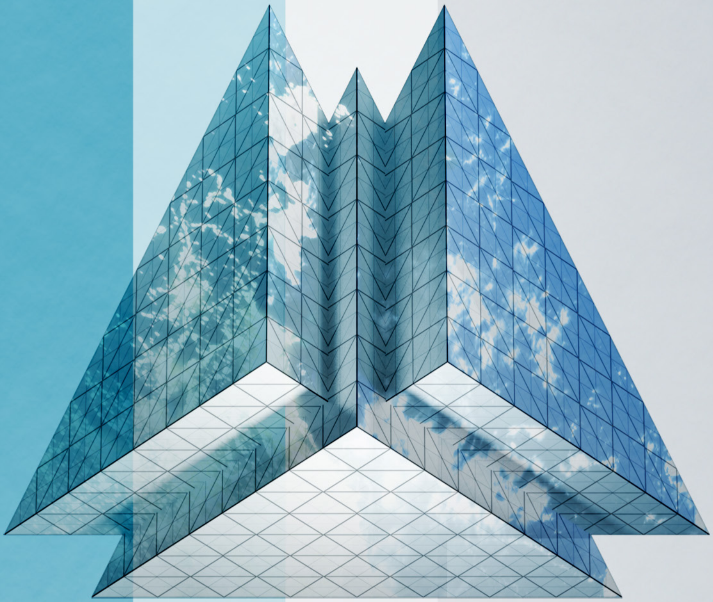
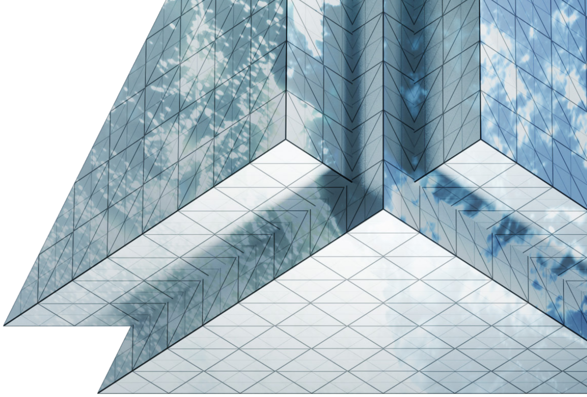


MARKET GPS

ALTERNATIVES OUTLOOK 2020



ARE ALTERNATIVES THE SOLUTION TO THE NEXT STAGE OF THE CYCLE?

Many investors are questioning whether now is the time to increase allocations to Alternatives. We believe seeking genuine diversification is prudent, but Global Head of Multi-Asset and Alternatives Michael Ho cautions that diligence is required when selecting the appropriate route.

In the last 15 years, Alternative investments have grown in popularity among investors. A recent study by BCG Consulting Group shows that assets under management (AUM) in Alternatives have been growing faster than those in all other investment categories, with the exception of passives. The same study shows projected growth within Alternatives is likely to be fastest in liquid alternatives, infrastructure, private debt and private equity. It seems that holding a core allocation in passives alongside a satellite-alpha allocation – in which alpha is primarily allocated to Alternatives – continues to gather momentum.

Alternatives is far from a cohesive category, and questions from clients globally often focus on where true diversification can be found outside of traditional asset classes. There is also interest in our views on absolute return strategies generally, how suited Alternatives are to the late stages of the economic cycle and which Alternative styles are best suited to the conditions ahead. Here we seek to address a number of these points.

> "The increasing number of retirees means that society's sensitivity to investment loss is increasing and the potential consequences more pronounced."

MICHAEL HO, PH.D.
GLOBAL HEAD OF MULTI-ASSET AND ALTERNATIVES

Selectivity required

When assessing the merits or otherwise of Alternatives, it is important to recognise this is far from a cohesive group. There is no 'one-size-fits-all' approach, and it is difficult to generalise. Indeed, in our opinion, when taken as a whole, Alternatives are not attractive at present. This is borne out over 25 years of performance from the hedge fund industry, synonymous for many with Alternatives. Statistical estimates show returns have trended down over the period, with estimated alpha currently at -2% per annum. A more disturbing development is that more than 90% of variation of returns (the driver of performance) is explained by exposure to the S&P 500® Index.[1] This illustrates that hedge funds as a whole may not currently provide the diversification benefits for which they have historically been used.

We believe investors can benefit from Alternative strategies that invest across a diversified suite of alternative risk premia and hedge fund strategies, rather than relying on equity beta. Over time, Alternatives should realise close to zero net exposure to traditional equity and fixed income markets.

Private equity – misunderstood?

So, can private equity deliver the solution? Again, in our view, it is far from clear that this provides the diversification and alpha that people traditionally associate with the asset class. One of the main issues is the smoothing of NAVs due to the limited marking to market of portfolio investments. A recent study by Brigham Young University[2] utilises secondary market transactions to look deeper into sources of returns. It shows that, on this basis, private equity has delivered high equity beta (greater than 1) and low alpha (not statistically different from 0). The historically high total returns associated with private equity investments and buyout funds tend to originate from extremely high leverage, hence the high equity beta.

Know your sources of return

It is not, however, all bad news. Part of the beauty of Alternatives investing is its variety, and there are managers who have been able to deliver value-added alpha. HFRI Indices show that an approach based on lower equity beta, less than 25%, has proven beneficial. Many low equity beta strategies have a relative value or macro investment style. It is reassuring that skill-based investing does still exist and, indeed, if market volatility picks up as expected in 2020, investors may be well served by following this approach.

Risks of a 2020 bear market?

We instead look at structural drivers to identify mispricings of risk. Moving into 2020, we believe that at this late stage in the cycle we are vulnerable to shocks, particularly in the corporate sector, and there are market dynamics at play that could put pressure on traditional asset classes.

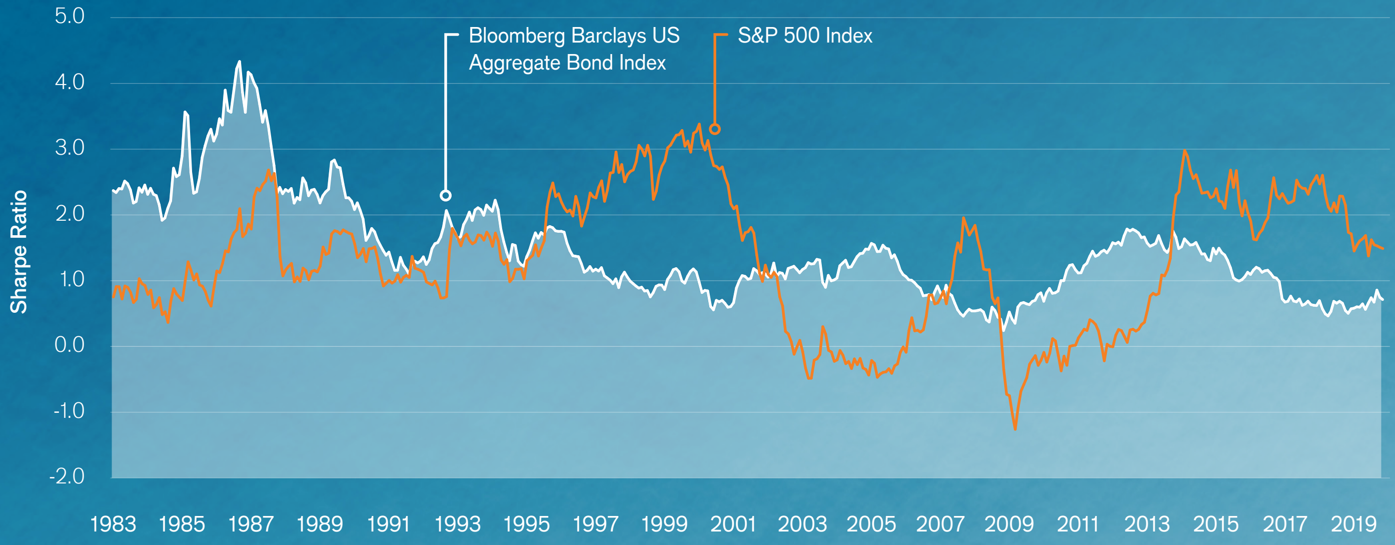
Post the Global Financial Crisis (GFC), price-to-earnings multiples for equities have risen sharply. At the same time, corporate leverage has increased. These are byproducts of the vast amount of stocks bought back by corporations. Indeed, corporations have been the biggest buyers of US stocks

Absolute return investing – still a valid approach?

Many people believe that absolute return investing has not delivered what it promised since the GFC. Key contributing factors have been the high and consistent returns generated by the S&P 500 Index and the low dispersion of stock returns. Equities were buoyed by the extraordinary monetary policy that began in 2009 and tapered off in 2018. This brought in a period of consistent returns comparable to the 1990s (see Exhibit 1). In this environment, with simple passive investments able to deliver twice the level of return versus the level of volatility, why would anyone want to invest elsewhere?

Danger lies in extrapolating this indefinitely. History shows that simple passive investments can be subject to periods of extreme volatility. In recent memory, the events of 2008 and 2000-2002 were extremely painful, particularly for retirees. During subsequent periods, retirees who were fully invested in stocks would have experienced nominal losses on a trailing 5-year basis (see Exhibit 1). The situation today has been exacerbated by the further aging demographic of the developed world. The increasing number of retirees means that society's sensitivity to investment loss is increasing and the potential consequences more pronounced.

EXHIBIT 1: EQUITY AND BOND INDICES ALSO TRACK VOLATILITY



Source: Robert J. Shiller and Datastream at November 2019. Chart shows trailing 5-year return annualised Sharpe ratio. Past performance is no guarantee of future results. Index performance does not reflect the expenses of managing a portfolio as an index is unmanaged and not available for direct investment.

It is important not to be fooled by the monetary accommodation of the last decade and its impact on asset class returns. Establishing a diversified portfolio of returns, be that via a specific absolute return strategy or other Alternative or Multi-Asset exposures, may prove beneficial in the low growth environment of the foreseeable future.

since 2009, amassing US$3.6 trillion worth of equities, according to Bank of America Merrill Lynch Research (see Exhibit 2).

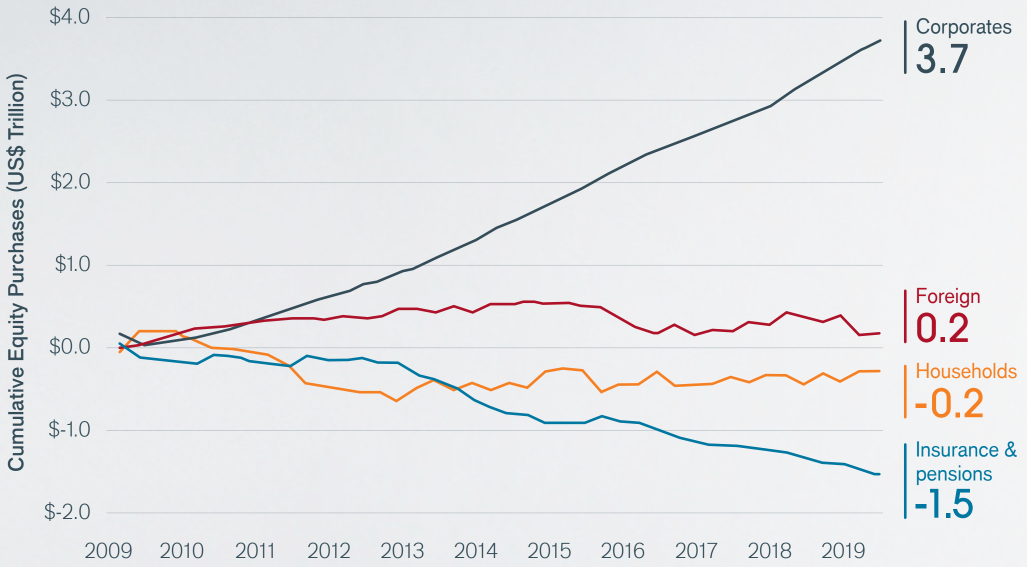
Declining bond yields have made this possible, with corporations able to increase leverage at a very low cost. There are two potential dangers of extrapolating this dynamic into 2020. First, 10-year real bond yields are already at an all-time low and pricing in an extremely negative growth scenario. We believe these yields are too low and there is no reason they should be negative in the long term outside of Japan. Second, corporate profit margins are already at all-time highs and now declining. Both factors could spell trouble for equity buybacks in the future.

We believe that the danger of a bear market comes when investors recognise more widely that earnings-per-share growth in recent years has been fuelled by buybacks. If the mechanism were to slow due to rising corporate financing costs and declining margins, then we could quickly enter the realm of bear market dynamics, in stark contrast to the constructive cycle of the past decade.

This, coupled with limited potential for returns from fixed income markets, may lead to moves away from traditional asset classes. Against this backdrop, we see value in adding diversifying sources of returns but caution that investors must fully understand a manager's source of performance and be properly informed as to what to expect in periods of market stress. While potentially timely given the current stage of the economic cycle, this is an approach with long-term merit.

EXHIBIT 2: SHARE BUYBACKS UNDERPINNING GAINS

Corporations have been the largest buyers of stocks since 2009, driving P/E multiples and leverage higher. However, with borrowing costs likely to increase and corporate profit margins declining, equity buybacks could slow in the future.



Source: Michael Hartnett, The Flow Show, Bank of America Merrill Lynch Research, 5 September 2019

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At Janus Henderson, our investment teams discuss and debate their views regularly but are free to form their own opinions of opportunities and risks in the marketplace. We feature commentary from individual portfolio managers on the Insights section of the Janus Henderson website as part of our *Knowledge. Shared* approach.

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Glossary

Absolute return
The total return of a portfolio, as opposed to its relative return against a benchmark. It is measured as a gain or loss, and stated as a percentage of a portfolio s total value.

Alpha
Alpha is the difference between a portfolio s return and its benchmark's return after adjusting for the level of risk taken. A positive alpha suggests that a portfolio has delivered a superior return given the risk taken.

Alternatives
An investment that is not included among the traditional asset classes of equities, bonds or cash. Alternative investments include property, hedge funds, commodities, private equity and infrastructure.

Beta
This measures a portfolio's (or security's) relationship with the overall market or any chosen benchmark. The benchmark always has a beta of 1. A portfolio with a beta of 1 means that if the market rises 10%, so should the portfolio. A portfolio with a beta of more than 1 will be expected to move more than the market, but in the same direction. A beta of 0 means the portfolio's returns are not linked at all to the market returns. A negative beta means the investment should move in the opposite direction to the market.

HFRI
HFRI® Indices are designed to capture the breadth of hedge fund industry performance trends across all strategies and regions.

[1] Bloomberg and Datastream. HFRI Fund Weighted Composite Index, data to 30 August 2019

[2] Boyer, Brian, Nadauld, Taylor D. and Vorkink, Keith P. (Brigham Young University) and Weisbach, Michael S. (Ohio State University). "Private Equity Indices Based on Security Market Transactions," 24 October 2018.

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