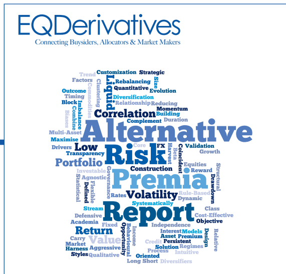

A New Take On Traditional Alternatives

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Despite generally strong returns and improving economic conditions in the United States since the financial crisis, many investors remain mindful of the inherent risks in financial markets. Record low levels of volatility since the 2016 presidential election are enticing investors to step back into equity markets, just as 10-year expected returns hover around 4%-5%[1]. The fixed income picture tells a similar story; high grade fixed income portfolios currently offer 2%-3% returns over the same period. Investors are, in turn, preparing for the possibility of a return to more normal market conditions – increased levels of volatility and increased uncertainty around the potential for positive returns of traditional asset classes.

Many investors have already turned to liquid alternatives as a hedge against such rising market risk (i.e. volatility and drawdown). Historically, alternative strategies have solely been within the purview of hedge funds and proprietary trading desks. However, since the financial crisis, alternatives have seen steady adoption. With a proliferation of funds across categories, these strategies have provided access to features that were previously available to a small cadre of investors.

The rationale for having an allocation to alternatives is the dual goal of dampening portfolio volatility and providing uncorrelated returns to traditional asset classes. However, many "alternative" strategies can still exhibit high correlations to the traditional asset classes upon which they are based. The table below illustrates the challenge of uncovering alternative strategies that can, in fact, deliver low correlation and diversification when you need it most — during times of market stress. The Multialternative peer group compiled by Morningstar is widely recognized as a go-to category for well-diversified alternative investments. It is clear that not

Correlation to S&P 500® Index	3 Yr	5 Yr	Crisis (Jan '08 – Dec '09)
US Fund Multialternative Peer Group			
25th Percentile	0.79	0.79	0.91
Median	0.68	0.67	0.89
75th Percentile	0.37	0.54	0.84
Credit Suisse Hedge Fund Index	0.64	0.69	0.71

Source: Morningstar, as of 6/30/2017

1: As measured by Shiller P/E, as of 6/30/17

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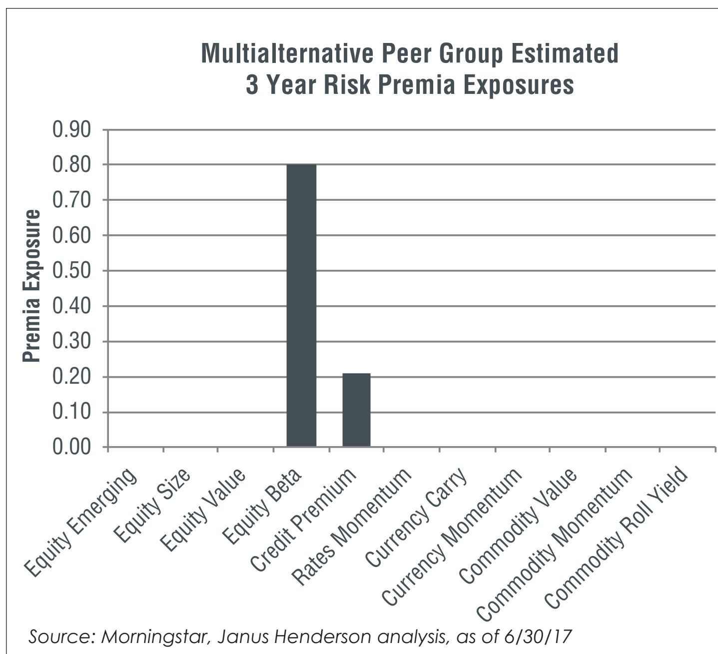
all alternatives are created alike; there is huge disparity among managers in the same category in terms of correlation to the S&P 500® Index. When ranked by correlation, the top quartile nearly doubled the bottom quartile over three- and five-year periods. Even more concerning, investments that appear to have lower correlation during low risk periods have experienced dramatic increases in correlation (more than double) during periods of high volatility. Investors ought to evaluate an investment's ability to deliver the desired return characteristics of low volatility and low correlation in both high- and low-risk market regimes.

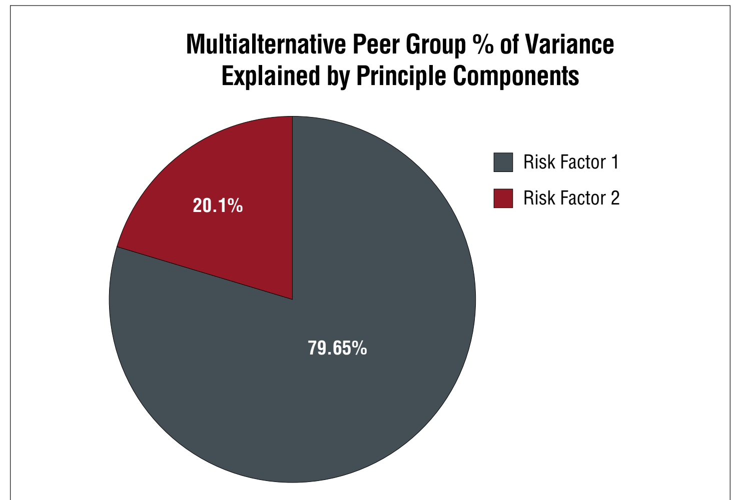
Identifying investments that can reliably deliver a certain return characteristic across market cycles can be challenging and requires looking under the hood at the drivers of return. Most strategies tend to be long market factors that have high correlations to the equity markets – equity beta, credit spread and size, to name a few. We performed a simple exercise to prove this: decomposing the returns of the Morningstar Multialternative peer group to understand the exact drivers of return utilizing a set of 11 risk premia (later described in more detail). Understanding such drivers would allow one to draw conclusions on the risk and correlation profile of this universe during crisis periods and to what extent the portfolio is truly diversified across asset classes.

The chart below shows the results of this decomposition. Unsurprisingly, nearly all of the behavior of the Multialternative peer group can be explained by two factors: equity beta and credit premium, which have near-perfect correlation with equities. Subjecting a balanced portfolio to the same analysis would yield very similar results. Thus, the returns of the Multialternative universe will largely be governed by the whims of the equity and credit markets – *not exactly alternative.*

Multialternative Peer Group Factor Decomposition



Source: Morningstar, Janus Henderson analysis, as of 6/30/17



Risk Factors Over Asset Classes

We believe the most important characteristic of a truly effective alternative strategy is its lack of correlation to traditional asset class returns. Finding such a strategy – an uncorrelated, liquid strategy that also reduces portfolio volatility – may seem daunting. However, there are well-defined strategies that have accomplished these goals by capitalizing upon behavioral biases that have been documented in financial literature. These are collectively known as "alternative risk premia" (ARP). Rather than place the time-worn emphasis on asset class returns, the concept of ARP focuses on returns derived from investment risks. Furthermore, this method of investing considers returns as a function of the level of risk taken on by an investor, rather than a goal of investing. A key to ARP investing is the ability to take both long and short positions, thus allowing ARP strategies to be profitable across many types of market environments (e.g. falling equities, rising rate market).

Because ARP strategies are predicated on the amount of risk inherent in the investment, they are not necessarily asset class specific. The factors comprising an ARP strategy can be broken into asset class agnostic buckets such as relative value, momentum and carry – a typical mix of factors is illustrated in the table below along with the factor's goal.

Relative Value	Momentum	Carry
Seeks to take advantage of price differentials within an asset class	**Seeks to capture medium- to long-term movements in various asset classes**	**Seeks to take advantage of short-term yield differentials**
• Equity Value	• Equity Momentum	• Commodity Curve
• Equity Size	• Rates Momentum	• Currency Curve
• Equity Emerging	• Commodity Momentum	• Credit
• Commodity Value	• Currency Momentum	

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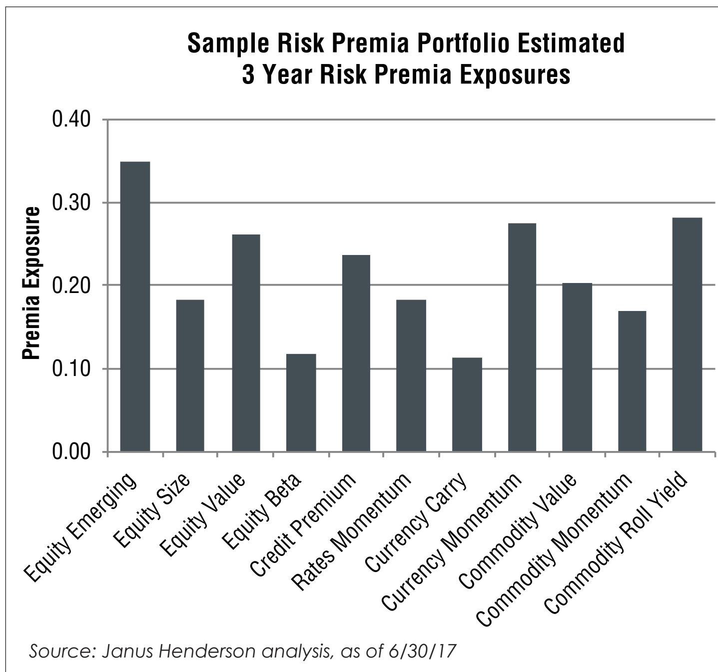
Embedded Diversification
One of the valuable tendencies of these ARP categories is their natural lack of correlation with each other. This allows two different strategies to be on opposite sides of the same macroeconomic event, providing adaptability in different market environments. For example, a "risk on" environment would typically be considered a negative environment for long-only fixed income investments. A typical long-only fixed income strategy would likely exhibit negative performance in this situation as higher interest rates would lead to lower bond prices. However, an ARP fixed income strategy – a rates momentum strategy – could achieve positive performance in the same environment by establishing short positions in Treasuries, thereby benefiting during the sell-off in interest rates.

Key to any ARP strategy is the notion of statistical independence; the portfolio should have many components with low correlations driving returns. This is illustrated in the chart below. The same 11 premia as used in the first chart on Page 17 were used to decompose the returns of a sample risk premia portfolio. The results show that the returns of the portfolio are driven by many factors, making the portfolio significantly less dependent on the moves of equity and fixed income markets.

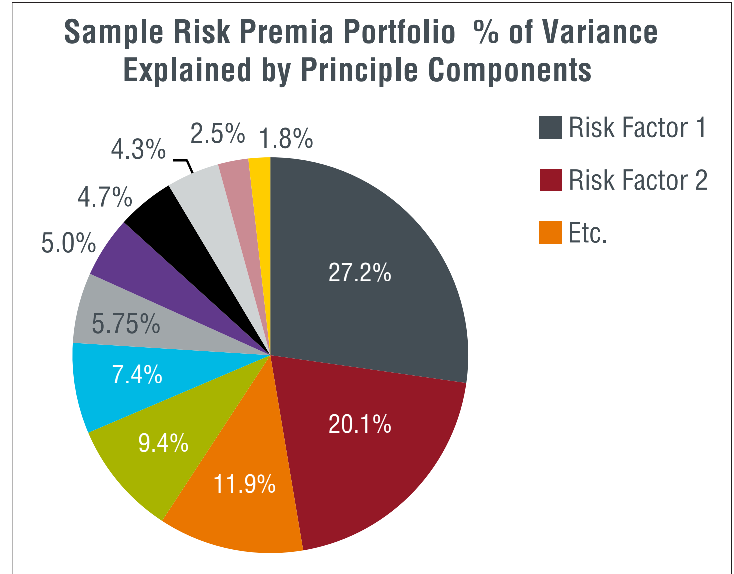
Sample Risk Premia Portfolio Return Decomposition



Source: Janus Henderson analysis, as of 6/30/17

Constructing a successful ARP portfolio requires that special attention be paid to the return properties of the underlying strategies (premia) that make up the portfolio. Managers should always consider the following characteristics of the underlying strategies in order to construct a portfolio that is able to remain uncorrelated during periods of market stress:

- Statistical independence
- Tail properties
- Coincident drawdown
- Allocations



Conclusion
Manager skill and experience is important, and the objectives that are set by the manager are the ultimate determinant of the portfolio's characteristics. Because not all ARP portfolios are created equal, all portfolios should be held to those objectives, one of which should be low correlation to traditional asset classes. A combination of statistically independent strategies – those with low correlation to one another - such as the ones described above tend to exhibit low correlations to the portfolio's core equity and fixed income segments. This characteristic further supports the primary objectives of an alternatives allocation: reducing volatility and providing uncorrelated returns to traditional asset classes.

Investors should confirm that the "alternative" portion of their portfolio is *actually* providing diversification from traditional asset classes. Given the uncertainty and potential volatility inherent in global financial markets, it is important to consider investments with a low correlation to stocks and bonds and a focus on dampening volatility.

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***Beta** measures the volatility of a security or portfolio relative to an index. Less than one means lower volatility than the index; more than one means greater volatility.*
***Correlation** measures the degree to which two variables move in relation to each other. A value of 1.0 implies movement in parallel, -1.0 implies movement in opposite directions, and 0.0 implies no relationship.*
***Credit Spread** is the difference in yield between securities with similar maturity but different credit quality.*
***Volatility** measures risk using the dispersion of returns for a given investment.*

— Risk Premia Descriptions —

***Currency Momentum** – The strategy looks to capture long-term movements in the U.S. dollar versus a basket of foreign currencies, caused by the global political, financial, social and economic factors that determine its value. A proprietary methodology is used to determine the market trend and corresponding position.*
***Credit** – The strategy looks to capture the potential systematic return associated with the default and duration risks of investing in bond markets. The basket is comprised of a diversified selection of fixed income securities, or a replication index designed with similar characteristics.*
***Equity Momentum** – This risk premium is harvested by seeking to capture directional momentum in equities through the quantitative analysis of equity index price movement. The key design principle of this investment strategy recognizes that markets behave differently in different directional regimes. We quantitatively define the current market regime with respect to directionality and employ an investment approach suited to the directional regime.*
***Commodity Value** – The strategy looks to benefit from differential inventory conditions between commodities; investing in those that are signaling low inventories and selling those that are signaling high inventories. The signal is based on a proprietary quantitative methodology.*
***Rates Momentum** – The strategy looks to capture the persistence in the movement of interest rates generally associated with the gradual but deliberate implementation of global central bank policy. A proprietary methodology is applied to the intermediate sector of the U.S. and eurozone futures markets, and is used to determine the market trend and corresponding position.*
***Commodity Roll Yield** – The strategy looks to generate return by providing liquidity to the most "crowded" section of the commodity futures curves. Typically the basket will be short the active/near contract, where carrying costs are highest, and hedges it with a deferred contract where the carrying costs are substantially less.*
***Equity Emerging** – The strategy looks to capture the potential return specifically associated with holding equities in companies of less-developed economies, whose risks may include currency* fluctuations, illiquidity, and political uncertainty. This dollar-neutral strategy is constructed by investing in a basket of emerging market equities versus a short position in a basket of developed market equities.
***Equity Size** – The strategy looks to capture the potential returns specifically associated with holding equities that we believe are more exposed to business cycle, default and liquidity risk. This dollar-neutral strategy is constructed by investing in a basket of small-cap equities versus a short position in a basket of large-cap equities.*
***Equity Value** – The strategy looks to capture the potential returns specifically associated with holding "beaten-down" equities as generally identified by low share price relative to sales, earnings and/or book value. This dollar-neutral strategy is constructed by investing in a basket of value equities versus a short position in a basket of growth equities.*
***Currency Carry** – The strategy looks to generate returns by taking advantage of short-term yield differentials between various currencies.*
***Commodity Momentum** – The strategy looks to capture the persistence in the price movement of commodities associated with investor perceptions of expanding or contracting global economic activity. A proprietary methodology is used to identify the market trend and corresponding positions.*
Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

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