

A Case for Multi Strategy

“Equity-like return with one-half the equity volatility” or “equity-like return with bond-like risk” were some of the taglines used to market hedge fund strategies in the late 1990s and early 2000s. In hindsight, those promises were often too good to be true. If investment results, as reported by Hedge Fund Research, Inc. (HFRI), are an accurate indication of investor experience, except for the early adopters, the hedge fund industry – as a group – has been a disappointment. Despite that, many U.S. public plans currently allocate about 8%¹ to liquid alternative or hedge fund-like strategies, and endowments and foundations even more. Most, if not all, chief investment officers of these plans are seasoned, battle-scarred investors who are well aware of the past shortcomings of hedge funds: high equity beta, coincident drawdown with equities, high credit beta, illiquidity, high fees, gating at the most inopportune time, lack of transparency and limited capacity. Why, then, do these sophisticated investors continue to allocate to liquid alternatives, especially when many have badly lagged the performance of public equities in recent years?

In our opinion, these investors continue to allocate to liquid alternative strategies because they have the willingness and, more importantly, the ability to identify those strategies that can generate returns that are very different from both listed and private equities, as well as listed and private debt. They recognize that certain diversifying alternative strategies can deliver on what should have been the primal objectives of hedge funds: low equity beta, equity drawdown protection and consistent absolute returns on par with the required rate of return of institutional investors. In what follows, we posit well-constructed multi strategies (or ‘Multi Strategy portfolios’) anchored on a portfolio protection strategy can deliver on the original objectives of institutional hedge fund programs.

Key Takeaways

- ▶ Despite recent disappointing results, U.S. public plans allocate about 8% of plan assets to liquid alternative or hedge fund-like strategies.
- ▶ For a Multi Strategy portfolio to generate consistent returns unrelated to equity markets, the underlying investment strategies must be sensible, persistent, and additive.
- ▶ During stress periods, when equities fall sharply, most hedge funds have failed to provide a ‘hedge’ against large losses due to moderate-to-high correlations with equities. For that reason, we believe an explicit portfolio protection strategy is integral in diversifying Multi Strategy portfolios.

¹ Source: Public Plans Database. Data as of fourth quarter, fiscal year 2019. The allocation percentage includes the following categories: hedge funds (6.4%) and miscellaneous alternatives (1.4%).



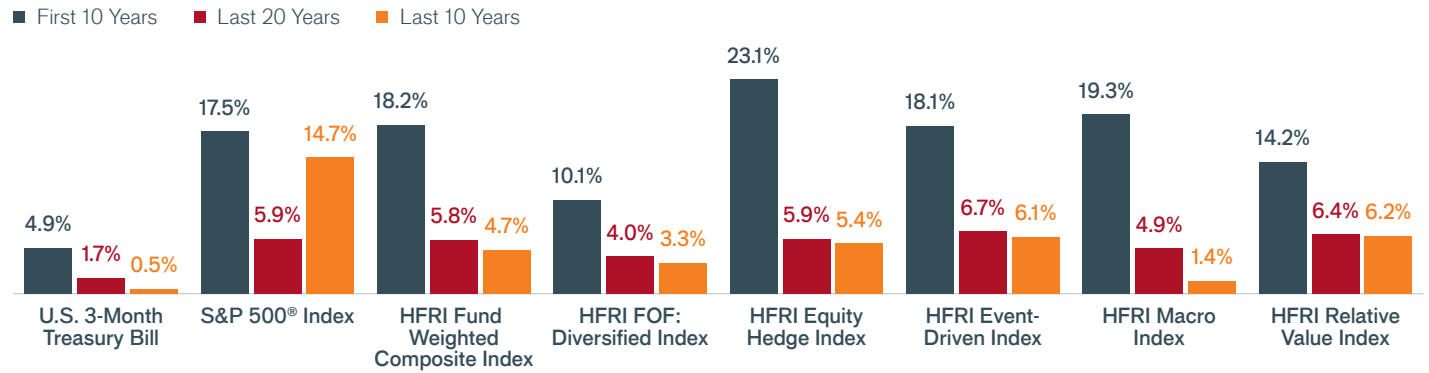
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Exhibit 1: Comparing Hedge Fund Returns by Period



Annualized Total Returns. 'First 10 Years' data is from 1/1/1991 to 12/31/2000. 'Last 20 Years' data is from 7/1/1999 to 6/30/2019. 'Last 10 Years' data is from 7/1/2009 to 6/30/2019. Source: Bloomberg

The Recent Past Hasn't Been Kind to Hedge Funds

It appears there were two discrete periods to hedge fund investing: for the early adopters of hedge funds, the '90s represented the zenith in terms of investment results. For the vast majority of investors, who earnestly began investing in hedge funds in the 2000s, their investment results have been disappointing.

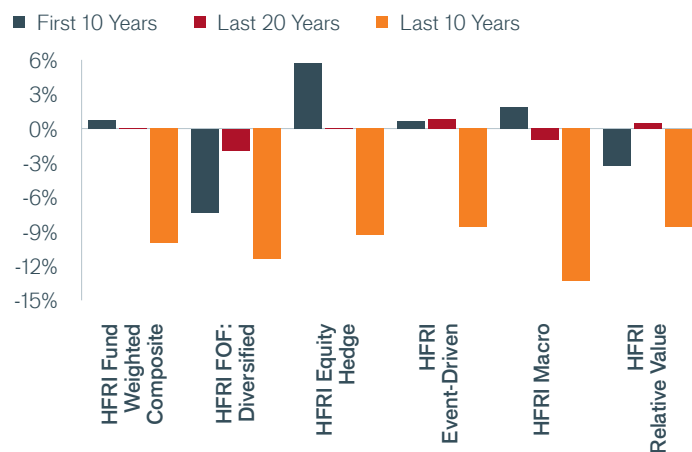
As illustrated in Exhibit 1, the difference in investment results between these two periods could not be in greater contrast: for the first 10 years of the analysis period (1991-2000), the annualized return for the HFRI Fund Weighed Index topped 18% per year; after institutional investors broadly embraced hedge fund strategies in the early 2000s, subsequent returns dropped by more than two-thirds. And this pattern of disappointing results cut across all major hedge fund categories, with the HFRI Equity Hedge Index experiencing the largest compression in returns.

When compared to the S&P 500 Index, the relative investment results have been downright poor, especially for the past 10

years ended 30 June 2019. As shown in Exhibit 2, the HFRI indices underperformed the S&P 500 Index by about 10% per year. Given these results, it was natural for investors to ask: "What happened? What changed between the '90s and the 2000s for hedge fund strategies?" But an important question that ensues from past experience is this: "Should institutional investors continue to invest in hedge funds as a distinct asset class or investment strategy?" Despite past disappointing results, institutional investors appear to answer with a resounding 'yes,' as evidenced by the growth of hedge fund assets in Exhibit 3.

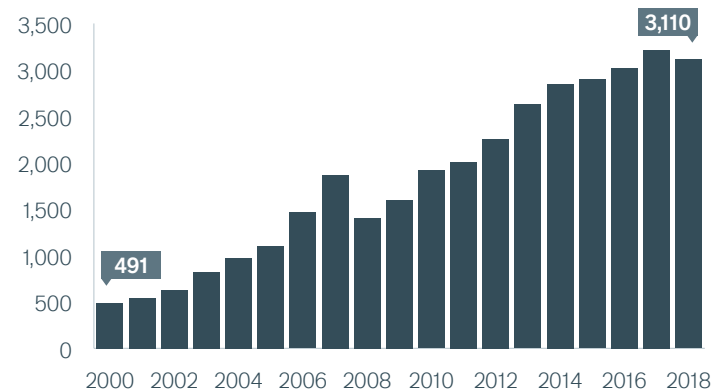
Between 2000 and 2018, hedge fund assets under management grew at an annualized compound rate of 17.4%. The primary reasons for investing in hedge funds – low equity beta, equity drawdown protection, and consistent absolute returns on par with the required rate of return of institutional investors – remain as true today as they did back in the '90s. The fact that many hedge fund strategies lost their way during the past 20 years did not obviate institutional investors' need for alternative diversifying strategies.

Exhibit 2: Hedge Fund Excess Returns vs. the S&P 500 Index



Annualized Total Returns displayed over the noted time periods from 1/1/1991 to 6/30/2019. Source: Bloomberg

Exhibit 3: Hedge Fund AUM Growth



Beginning of Period AUM in Billions USD.

Source: Barclays. "Crossing currents: 2019 Global hedge fund industry outlook. 28 February 2019.

Hedge Fund Strategies Lost Their Way in Return Expectations and Diversification Objectives

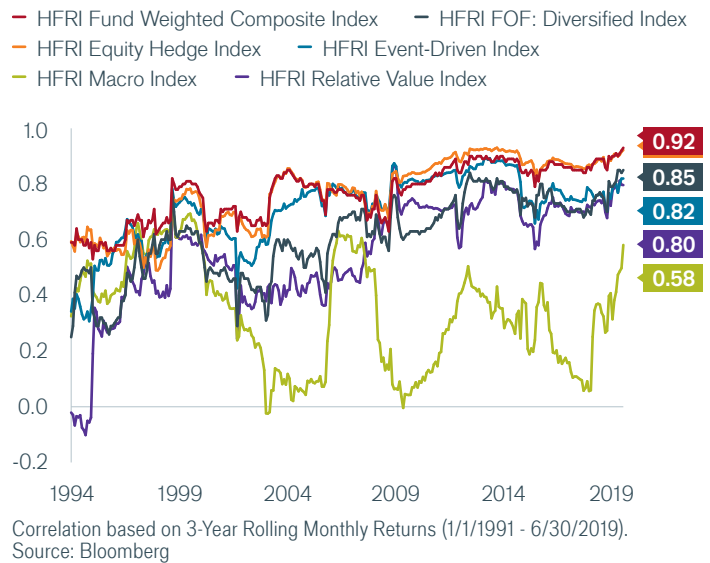
The typical benchmark for absolute return-oriented hedge fund strategies has been cash – historically, the 3-month LIBOR. Notwithstanding, many investors instinctively compare them against the S&P 500 Index because public equities have been a source of funds for hedge fund allocations; and, right or wrong, the S&P 500 Index return has been viewed as the opportunity cost of investing in hedge fund strategies. During the 2000-2002 period, when technology-media-telecomm stocks were in a freefall, some hedge fund managers reinforced this benchmark mismatch by comparing their investment results to the S&P 500 Index because their returns were less negative than that of public equities. That is an unjust comparison because hedge funds were never meant to generate “equity-like” returns, but rather returns that were orthogonal to equity returns. And they lost their compass when they failed to correct misconceptions about long-term expected returns that one should expect from hedge fund strategies.

Moreover, many lost their bearing with respect to portfolio diversification when they became too highly correlated with equities and witnessed high coincident drawdowns during periods of market stress.

As demonstrated in Exhibit 4, except for global macro strategies, the correlation between equities and all major hedge fund categories has been steadily increasing since the mid-'90s. For the three years ended 30 June 2019, both the Fund Weighted Composite and Equity Hedge indices showed a high correlation statistic of 0.92. Unfortunately, positive correlation with equities wasn't the only issue that plagued investors. They also had to contend with positive correlation across hedge fund categories.

Over the full time period shown in Exhibit 5 (1/1/1991 - 6/30/2019), the average pair-wise correlation between the HFRI Equity Hedge (EH), Event-Driven (ED), Relative Value (RV) and Macro indices was moderately high at 0.6.

Exhibit 4: Hedge Fund Correlation with Equities



In the early 2000s, when pension consultants began constructing hedge fund programs for their investors, most took their cue from index providers and structured along the four main categories: EH, ED, RV and Macro. A simple structure would allocate equally across these four categories and hire from four to six distinct strategies in each category. Investors with a smaller asset base, who could not afford to construct a direct hedge fund program, would typically hire from two to four funds of funds to gain exposure to hedge fund strategies. Funds of funds, in turn, would generally follow a similar portfolio structure recommended by pension consultants. Looking at the correlation statistics below, it is plain to see why the vast majority of institutional direct hedge fund programs and funds of funds failed to limit equity beta exposure and failed to provide drawdown protection during times of market stress. They were too highly correlated with equities (Exhibit 4) and with each other (Exhibit 5).

Based on past experiences and lessons learned, institutional investors have been segmenting the hedge fund universe into two broad categories: diversifying strategies and return-seeking

Exhibit 5: Hedge Fund Category Cross-Sectional Correlation

(1/1/1991 - 6/30/2019)	S&P 500	HFRI Fund Weighted Comp	HFRI FOF: Diversified	HFRI Equity Hedge	HFRI Event-Driven	HFRI Macro	HFRI Relative Value
S&P 500	1.00						
HFRI Fund Weighted Comp	0.74	1.00					
HFRI FOF: Diversified	0.56	0.88	1.00				
HFRI Equity Hedge	0.75	0.96	0.82	1.00			
HFRI Event-Driven	0.70	0.91	0.79	0.86	1.00		
HFRI Macro	0.30	0.63	0.68	0.53	0.48	1.00	
HFRI Relative Value	0.53	0.75	0.66	0.71	0.80	0.35	1.00

Source: Bloomberg

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growth strategies. Objectives for these two categories have become clearer. Diversifying strategies are generally expected to exhibit low equity beta (less than 0.3), protect against equity drawdown and target an absolute return of cash plus 4.0% to 6.0%, net of fees. Return-seeking growth strategies may exhibit higher equity beta but their return objective must be much higher than that of diversifying strategies. For the remainder of this paper, the focus will be on Multi Strategy portfolios that can serve as a core, diversifying alternative strategy, and a case for why they deserve consideration for a prominent role within a diversifying liquid alternatives allocation in institutional portfolios.

A Case for Multi Strategy as a Diversifying Alternative Strategy

Well-constructed Multi Strategy portfolios can address past shortcomings of hedge fund programs. Despite disappointing results, the past 20 years of hedge fund investing experience has been invaluable in evaluating and designing truly diversifying strategies that can meet the return objectives of institutional investors. Our research and investing experience indicate sound Multi Strategy portfolios must:

1. Include sensible, persistent, additive and consistent investment opportunities.
2. Incorporate explicit portfolio protection to guard against material equity drawdowns.
3. Minimize netting cost.

Properly constructed Multi Strategy portfolios manifest the best qualities of well-diversified hedge fund programs. They invest in statistically independent and economically sensible investment opportunities, incorporate explicit portfolio protection against large equity drawdowns, and provide diversification to the rest of the plan assets by intentionally limiting exposure to equity beta. Finally, they minimize fees and netting cost that are so prevalent in direct hedge fund programs and funds of funds.

Sensible, Persistent, Additive, Consistent² and Transparent

As noted earlier, most hedge fund strategies have historically provided limited diversification benefits because they were too highly correlated with equities and with each other. To make matters worse for investors, they often provided limited or no transparency to the underlying investment strategies, even during periods of persistent underperformance. For a Multi Strategy portfolio to generate consistent returns unrelated to equity markets, the underlying investment strategies must be sensible, persistent, and additive. By sensible and persistent, we mean there must be a good economic intuition as to why the investment opportunity exists today and will continue to persist into the future.

Bank Risk Transfer: Risk Premium from European Stock Dividends

The divergence first emerged after the financial crisis of 2008, when banks, shackled by a raft of new regulations such as Basel III and the U.S. Volcker rule, scrambled to rid their balance sheet of risky assets.

At the same time, the plunge in interest rates worldwide left investors yearning to earn more on their capital. They began clamoring for a product that would offer a higher yield than bank deposits.

To quench the burgeoning demand, banks crafted structured notes, which are typically linked to a popular index of stocks like the Euro Stoxx 50. By one account, there is about \$120 billion (notional amount) of structured notes today that reference the Euro Stoxx 50 index.

To hedge the risks from note sales, banks typically buy equity forwards ... Banks also manage their risks by buying stocks and selling future dividends.

Both moves put downward pressure on dividend prices. Based on current trading levels, Euro Stoxx 50 dividend futures are pricing in more than 3% in dividend cuts ... while forecasts by analysts at Goldman Sachs expect the opposite to happen. The Goldman analysts are calling for European companies to increase their dividends ... close to 5%.

This divergence is more pronounced in Europe than anywhere else in the world. In the U.S. ... dividends for S&P 500 Index companies are forecast to grow at an annual rate of 3.6% according to Goldman and S&P 500 dividend futures are pricing in growth of 2.5% a year, a far narrower gap than in Europe.¹

One way to pursue a bank risk transfer strategy is to sell equity forwards to (and collect the associated risk premium from) banks that sold structured notes to yield-hungry individual investors and that, due to new and stricter regulations, cannot hold risk associated with structured notes on their balance sheets.

¹ Anita Raghavan, "A Way to Play European Stock Dividends," Barron's 31 March 2019.

² Also referred to by the acronym SPAC. Barclays Global Investors popularized this investment concept in the 1990s and early 2000s.

To be additive, we believe investment opportunities must be independent, unrelated to one another and to the equity markets. Finally, from an investor's perspective, it is unacceptable for hedge fund managers to hide behind the veil of secrecy in good times and bad. The example of a bank risk transfer strategy exemplifies a risk premium that we consider to be sensible, persistent, additive, consistent and transparent.

This structural risk premium came about as a result of new banking regulations following the 2008 Global Financial Crisis. As long as banks are required to offload risks from structured note sales, one should expect to collect a premium by providing liquidity and risk transfer services (sensible and consistent). We expect this risk premium will persist as long as banks are limited – by banking regulators – in how much risk they can hold on their balance sheets. Finally, the source of risk premium is idiosyncratic and generally independent of other risk premia (additive).

The Need for Explicit Portfolio Protection

History has shown that during stress periods, when equities fall sharply, most hedge funds fail to provide a 'hedge' against large losses due to moderate-to-high correlations with equities. Seemingly unrelated investment strategies become highly correlated and the associated risk premia tend to widen across

the board during stress periods. In the past, to minimize the cost of portfolio protection, many in the investment management community sought to mitigate equity tail risk via implicit, as opposed to explicit, portfolio protection. They did so to mitigate the cost of portfolio insurance. Generally, the track records for implicit portfolio protection strategies have been mixed, many behaving like high-deductible insurance plans that participate in losses. For that reason, we believe an explicit portfolio protection strategy is integral in diversifying Multi Strategy portfolios and must seek to:

1. Generate uncorrelated positive returns in periods of sustained market stress.
2. Enable other strategies within Multi Strategy portfolios to weather shorter-term market stresses in order to capture longer-term return opportunities.

Generating uncorrelated positive returns in periods of sustained equity market sell-offs is one of the key objectives of diversifying strategies. And, since "the market can remain irrational longer than you can remain solvent," as quipped by John Maynard Keynes, it is important that Multi Strategy portfolios remain solvent and remain invested in other investment strategies (that may be negatively impacted by an equity sell-off) to capture long-term positive expected returns.

Our Take on Portfolio Protection

The objective of portfolio protection is to generate positive returns in periods of sustained risk premia widening to which the rest of a Multi Strategy portfolio is normally negatively exposed.

In times of market stress, correlations tend to increase and risk premia spreads will tend to widen. Such periods are likely to present a headwind to the other strategies within a Multi Strategy portfolio; albeit, potentially providing investment opportunities from the wider spreads and potential mis-valuations that result.

Portfolio protection as a strategy generally has two goals during a period of stressed markets: deliver an uncorrelated alpha to help offset the performance drag that could be expected from the other strategies during these periods, and allow the other strategies to remain exposed to positive long-term opportunities despite the short-term stress and potentially increase exposure at attractive levels.

Sub-strategies that we believe have a place within a portfolio protection strategy include (1) systematic option hedging, (2) systematic trend-following and (3)

discretionary macro. Each sub-strategy should be designed to address different market scenarios, including market sell-offs and generalized risk-off environments. While no two crises are ever the same, a number of characteristics are salient from previous episodes.

Systematic Option Hedging should protect against rapid, liquidity-induced and exacerbated sell-offs – such as 1987 or mid-2008. In this type of event, volatility pricing typically soars and underlying markets may be unable to effectively find a clearing price. This scenario may be addressed with the use of a systematic long volatility strategy.

A systematic option hedging strategy can provide 'always on,' non-timed, long volatility exposure for the portfolio. As the name suggests, its implementation should predominantly be rules-based and manifested via a portfolio of equity index options and futures. The strategy's purpose should be to capture substantial positive alpha in severe deep left tail scenarios such as the 2008 Global Financial Crisis. However, it may not provide meaningful alpha in less severe risk-off episodes such as the 2015 China devaluation.

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Systematic Trend-Following should protect against persistent, trending sell-offs. In this instance, as existing initial hedges expire, the cost of re-hedging often becomes prohibitive. This scenario can be addressed with a time series, momentum-based CTA strategy.

This element of portfolio protection is a well-documented and understood risk premium. A trend-following strategy seeks to systematically capture trends in global markets and generate positive returns over the business cycle. The convex payoff profile of a time series trend-following strategy (known as the 'CTA Smile') has historically provided highly efficient left tail protection in periods of extended market stress. Returns are a function of a number of factors, including volatility regimes through time (increasing or decreasing), the type of dislocations that manifest in crisis environments (i.e., a sudden shock or more extended market dislocation) and attribution from any particular sector.

Discretionary Macro: Catalyst events and macro factors create potentially foreseeable opportunities to forward hedge a Multi Strategy portfolio. This scenario can be addressed by buying convexity (long option or option spread) positions across a range of asset markets where that convexity seems to be priced cheaply relative to the opportunity/risk. The strategy may at times buy outright index puts to supplement the systematic option hedging with the aim of giving portfolio protection an explicit negative beta exposure.

This element of portfolio protection is focused on owning protection when needed for the portfolio as a whole, but equally minimizing the cost of protection when it is not. The strategy should only buy convexity and so, in high volatility and declining volatility environments, the addition of positions has a higher bar. When volatility is identified to be cheap on a forward basis and/or to the risk environment, this strategy should look for opportunities to add exposure. This is typically with a view to a macro risk event – recent examples include the Brexit vote, the Trump election – or it may be on a more generalized view of the risk environment.

While positioning in this strategy may vary in duration and asset class, it should explicitly reference the main risk premia exposures within Multi Strategy portfolios. Unlike many macro-style strategies, it is important to remember this strategy should always be flat or long convexity. It should not sell convexity. Therefore, it explicitly hedges Multi Strategy portfolios from negatively convex exposures that risk premium harvesting naturally exposes them to.

We believe that, in a portfolio of mostly systematic processes, Discretionary Macro is an important, rules-based approach to eliminate some of the potential weaknesses of past portfolio construction. It allows judgment and forward-looking analysis to mitigate what we believe are often knowable or probable risks.

Netting Cost and Hedge Fund Fees

In multi-manager hedge fund programs and funds of funds, the results of outperforming managers are offset by the results of underperforming managers; however, there are no offsets between managers when it comes to incentive fees. Plan sponsors pay incentive fees to the outperforming managers, but do not receive an incentive fee rebate from the underperforming managers. As a result, investors may end up paying incentive fees even when the overall hedge fund program or fund of funds failed to generate excess returns above the benchmark.

Previously we stated, "... an explicit portfolio protection strategy is integral in diversifying Multi Strategy portfolios." However, netting cost can be particularly acute for portfolio protection strategies (i.e., negative correlation strategies) because they are designed to generate positive returns in periods of sustained equity market sell-offs. For that reason, in direct multi-manager programs and funds of funds, the inclusion of portfolio protection strategies can actually exacerbate netting cost. By comparison, Multi Strategy portfolios avoid netting cost

associated with low or negative correlation strategies because investors pay incentive fees at the aggregate Multi Strategy level instead of at the underlying strategy level. Notwithstanding, netting cost still exists – even for Multi Strategy portfolios – at the overall plan sponsor level if the plan invests in more than one Multi Strategy portfolio. For that reason, they minimize but do not completely eliminate netting cost at the plan sponsor level.

Beyond minimizing netting cost, Multi Strategy portfolios may represent a superior choice for smaller plans that currently gain exposure to hedge fund strategies via a fund of funds. Ibbotson, Chen and Zhu – in "The ABCs of Hedge Funds: Alphas, Betas, & Costs" (30 March 2010) – estimate hedge fund fees at about 3.8% per year. In our estimation, the all-in fee for fund of funds investors is closer to 5.0% due to the triple layer of fees: hedge fund manager fees (3.8%), fund of fund fees (~1.0%) and consultant fees. With Multi Strategy portfolios, investors avoid a layer of fees associated with funds of funds. In the current environment, where cash is yielding zero in many parts of the world and alphas are hard to come by, a fee reduction of 1.0% represents a material saving for any investor.

Conclusion

According to Barclay's 2019 Global Hedge Fund Industry Outlook, "... investors indicated they are looking for just over 7.0% [target of 7.4%] from their hedge fund allocations ...". A return target of 7.4% – in line with the required rate of return of institutional investors – is achievable for well-constructed Multi Strategy portfolios that target moderate levels of risk. However, it is not enough for Multi Strategy portfolios to deliver on the return target only; they should do so with returns uncorrelated to equities and with portfolio protection during periods of market stress. In an environment where, increasingly, risk and risk-free assets are rising or falling in concert based on government and central bank monetary policies, well-diversified Multi Strategy portfolios may be uniquely positioned to provide a hedge against tail risk when stocks and bonds together witness sharp falls. Multi Strategy portfolios based on sensible, persistent, additive, consistent and transparent investment ideas coupled with an explicit portfolio protection strategy can deliver on the original objectives of institutional hedge fund programs. And, as noted earlier, they can provide more fee-efficient exposure than direct multi-manager programs or funds of funds. For those reasons, we firmly believe Multi Strategy portfolios deserve a prominent role within diversifying alternative strategies or direct hedge fund programs in institutional portfolios.

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