THE CASE FOR ALTERNATIVES

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THE CASE FOR ALTERNATIVES

The start of 2022 has been marked by renewed uncertainty, as markets responded to a hawkish pivot on monetary policy, led by the US Federal Reserve (Fed). Heightened volatility, inflationary pressures and concerns over valuations have left many investors considering their options.

This has come at a time when changes in correlations between asset classes are posing challenges for portfolios purely reliant on traditional asset classes, such as equities and bonds. The concept of how investors perceive asset allocation and portfolio construction is changing, posing questions about what form the next evolution of multi-asset investing will take, and how to build better portfolios for the future.

Successful asset allocation might require new techniques and instruments to dynamically adjust exposures as market conditions evolve, while maintaining a focus on finding the appropriate balance of risk and reward to meet investors' goals.

In this Case for Alternatives, we consider some of the factors driving interest in alternative allocations and give a brief insight into some of the options open to investors.

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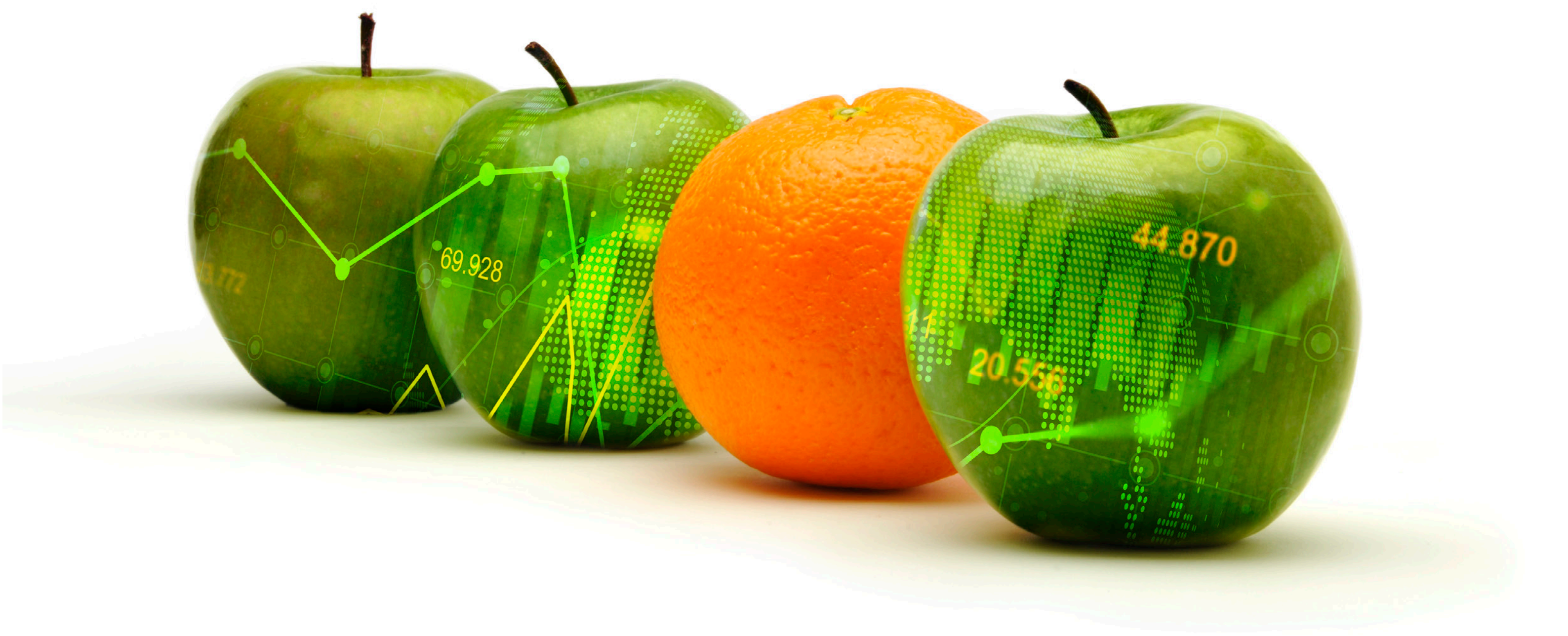
THE WORLD OF ALTERNATIVES

Liquid alternative assets cover everything from commodities, real estate, currencies and hedging strategies, to futures, structured products, absolute return strategies, and other securities less correlated to the market, such as renewable energy, infrastructure and logistics. Each asset type offers unique investment opportunities and risks, with differentiated drivers of performance, relative to equities and bonds, providing investors with a wide range of tools that can be used to potentially:

- Reduce interest rate sensitivity
- Lower overall portfolio volatility
- Access alternative income sources
- Deliver lower beta versus equities
- Tap into truly differentiated drivers of performance

Alternatives have matured over the past 30 years, gaining greater acceptance from both investors and regulators. This process has accelerated over the past decade thanks to exchange-traded commodities, investment company launches and the growing availability of absolute return strategies.

The expanding range of listed alternative assets has been accompanied by a significant deepening in market liquidity, offering potential for attractive income streams and exposure to many emerging areas of secular growth. And yet, investors' allocation to alternatives, while growing rapidly, remains disproportionately small, relative to the major asset classes of equities and bonds. UK IFAs, for example, allocate only 4%* to alternative assets, the majority of which is held in long-only assets as property or infrastructure. This preference for traditional asset classes is also firmly the case in Europe and Latin America.



* Source: Portfolio Construction & Strategy, as at 29 October 2021. Note: Average UK advisor allocation based on data shared with the PCS team by UK IFA clients.

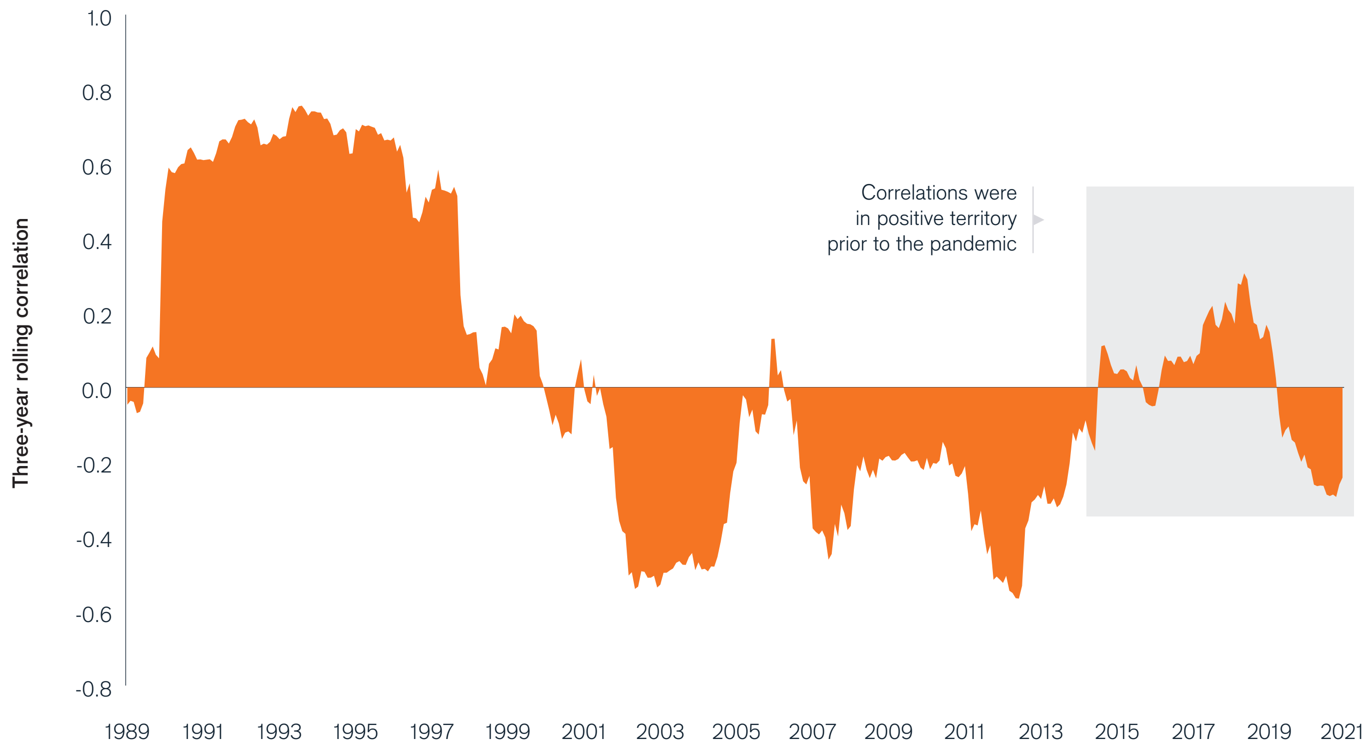
Is traditional asset allocation dead?

For more than two decades now, investors have relied on the reverse correlation between equities and bonds to build natural diversification and risk mitigation into their portfolios. This sympathetic partnership, the foundation for balanced '60/40' strategies, has historically delivered risk-adjusted performance for investors throughout the market cycle, over the longer term.

Arguably, the negative correlation between equities and bonds works best when inflation and growth are low, and during periods of market uncertainty. But an era of expansionary fiscal and monetary policy has eroded the hedging benefits of holding bonds alongside equities, with correlations actually turning positive in 2015, as Exhibit 1 shows using the UK as an example. While the onset of the COVID pandemic saw a familiar flight to the perceived safe haven of government bonds, the relationship between equities and bonds, which previously benefited investors, could be under threat over the longer term as we hopefully move beyond the pandemic.

In an uncertain environment where risk and risk-free assets are rising or falling in concert with government and central bank monetary policies, alternatives may be well positioned to offer true diversification for investors.

Exhibit 1: The relationship between bonds and equities is changing



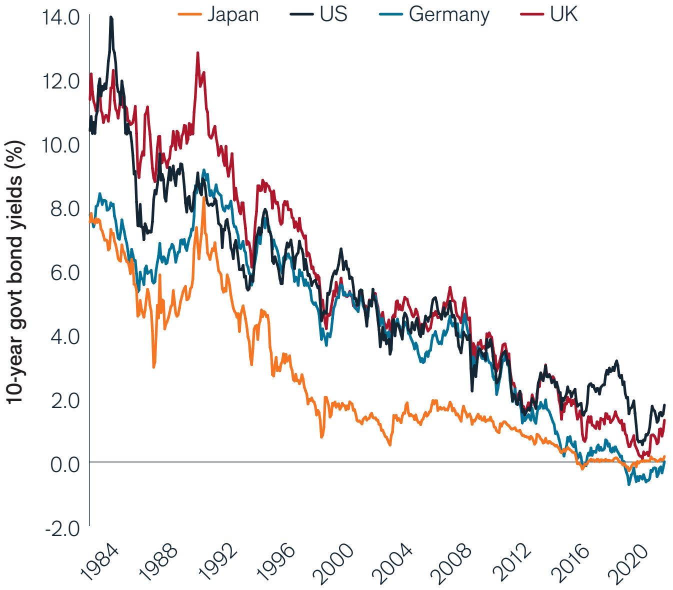
Source: Janus Henderson Portfolio Construction & Strategy, Morningstar, as at 29 October 2021.

Note: 3-year rolling correlation of FTSE UK All-Share Total Return GBP Index and JP Morgan UK 1-10 Year Government Bond Total Return Index, using monthly total returns. **Past performance does not predict future returns.**

Where can bond yields go from here?

Government bonds yields have been on a relatively steady downward trajectory since the early 1980s (Exhibit 2) and remain close to historical lows for both investment-grade and high-yield bonds. A combination of trending lower inflation and low growth led bond yields to begin a steady decline, and, inversely, rising price returns in fixed income.

Exhibit 2: Government bond yields remain historically low



Source: Janus Henderson Investors, Refinitiv Datastream, 10-year government bond yields from 31 December 1982 to 4 February 2022. **Past performance does not predict future returns.**

Most recently, an increasing hawkish stance from the Fed on the potential for earlier rate hikes, and how strictly the Federal Open Market Committee (FOMC) would adhere to its average inflation targeting framework, may have led to the bond market adopting a more pessimistic view of the economy. From here, we believe there is only limited scope for government bond yields to offset any equity market weakness, and any return is likely to be driven primarily by coupons, rather than higher prices.

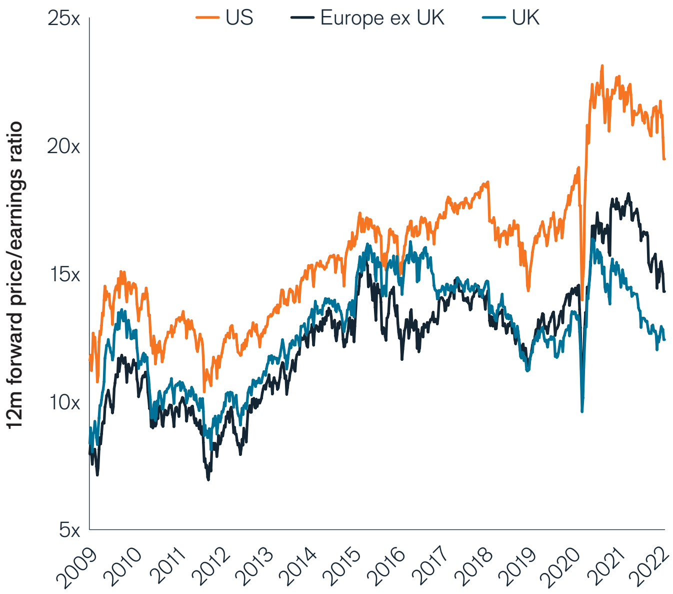
The concern that many investors share is that rising interest rates could derail objectives for their portfolio, particularly with regards to how sensitive their fixed income allocation might be to rising interest rates. Investors may be able to re-create or even improve on the diversification benefits of bonds by incorporating alternatives with a lower correlation.

Equity valuations – higher risk and muted returns

The question of how markets might behave in a rising interest rate environment is a highly pertinent one for investors as we move further into 2022. How might risk premium be repriced? If we are in a transition period, from a multi-decade environment of downward-trending rates to a rising rate environment, behaviour between asset classes changes. Few people managing money today have experience of that environment.

While the Fed's hawkish turn in late 2021 and early 2022 seems to have impelled investors to reduce risk in their portfolios, US retail investors came into this year with more of their wealth in equities than at any time in history (more than 40%)[1]. Despite the huge, short-term impact of the pandemic on investor sentiment in early 2020, expectations for corporate earnings rebounded rapidly (Exhibit 3), particularly in the US, where valuations have stretched ahead of the rest of the western world.

Exhibit 3: US equity prices rebounded sharply from the COVID shock



Source: Janus Henderson Investors, Morningstar, 12-month forward price-to-earnings ratio from 1 January 2009 to 3 February 2022. **Past performance does not predict future returns.**

Note: UK – FTSE All-Share Index; US – S&P 500 Index; Europe ex UK – Euro Stoxx 50 Index.

[1] Source: Refinitiv Datastream, Janus Henderson Investors, as at 24 January 2022. Allocation of US households to equities as a % of financial assets.

Peak liquidity appears to be over

Valuations have been persistently high during the market cycle that took us to the beginning of 2022, driven by extraordinarily accommodative monetary and fiscal policy globally. Central banks have pumped trillions of dollars into the economy through asset purchase (QE) programs since the emergence of COVID-19 (Exhibit 4).

However, central bank bond purchases have decelerated from a peak of $8.5 trillion in 2020 to practically zero in 2022 (see Exhibit 4). The Fed was the first major central bank to act, scheduling its QE program to end by March 2022, and indicating several planned interest rate hikes. The Bank of England (BoE) has also already begun to tighten its monetary policy, while the European Central Bank (ECB) has opted to take a more cautious path to policy tightening.

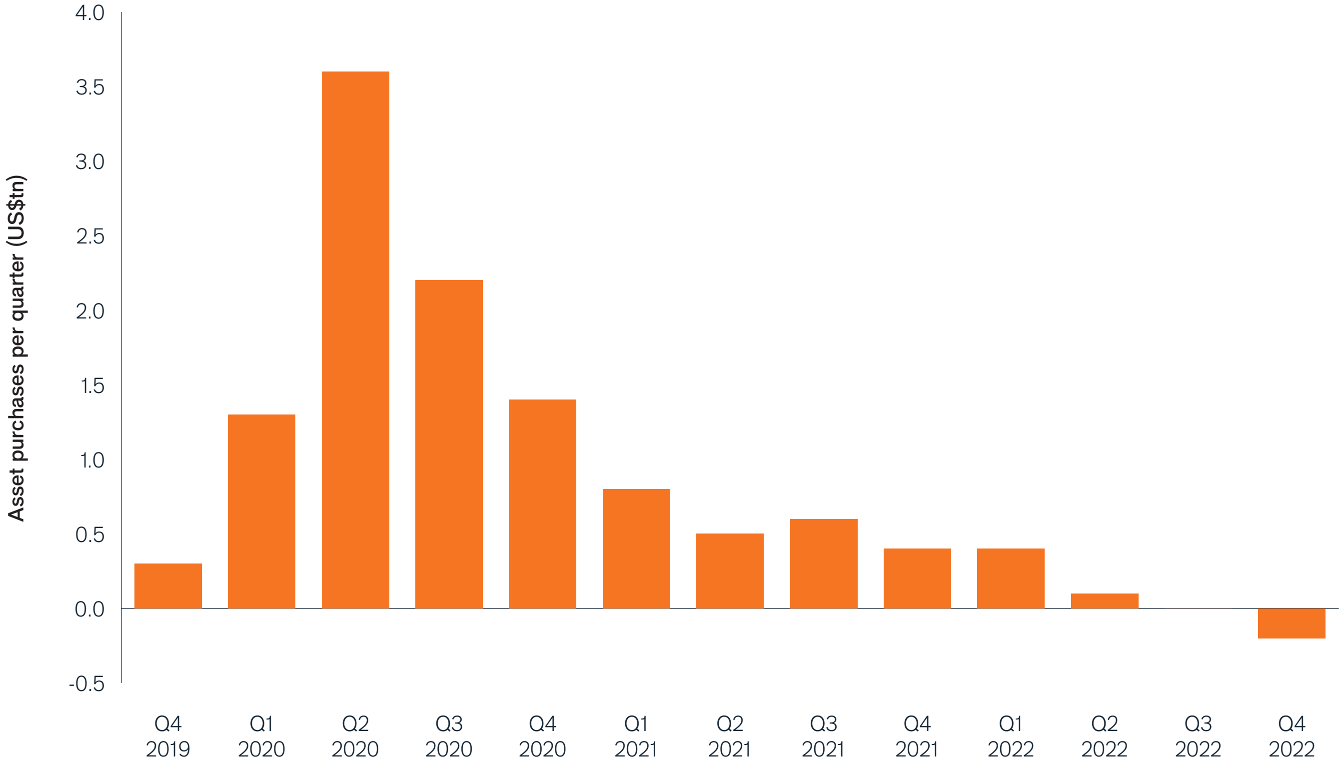
This naturally leads to questions about how markets might behave in a rising interest rate environment. Few people managing money today have experience of that environment. How might the risk premium be repriced?

Passives – opting for price over diversification?

Interest in alternatives compared to traditional investing has grown steadily over the past few years, but much of it has been focused on reducing cost, rather than improving diversification. The low-cost passive/ETF industry in particular has gained significant momentum, helped by an environment of low borrowing costs for companies and the flood of stimulus from QE, which has pushed up asset prices to record levels. This has been a halcyon period for passives, attracting investors, given their relatively low fee structure, with few periods of significant drawdowns to undermine sentiment. 'Buying the index' has resulted in generous returns, because the economic and monetary environment has been very supportive.

But there are inherent risks to this strategy. Investments that have no basis in fundamentals are a potentially risky place to be when risk aversion takes hold. In this environment, investors looking to sell their investments can struggle to find buyers, either leaving them holding intrinsically unattractive stocks, or being forced to sell at a steep discount.

Exhibit 4: Central bank asset purchases have decelerated sharply since the 2020 peak



Source: Janus Henderson Investors, Bank of America. Data based on US Federal Reserve, Bank of England, European Central Bank and Bank of Japan estimates/ projections for Q4 2021 and 2022. $tn = trillion, US dollars.

THE ‘ALTERNATIVES’ ROUTE TO PORTFOLIO CONSTRUCTION

For those considering a greater allocation to alternatives, there are key questions to consider:

- What are the new asset classes likely to play a strategic role in portfolios?
- What is the best approach when adding liquid alternatives to a traditional portfolio?
- Where do alternatives fit in my strategic asset allocation?
- How correlated are liquid alternatives’ returns to traditional equities and bonds?

The investment world is changing rapidly, and multi-asset strategies, and investors’ portfolios more broadly, will need to evolve in tandem. Investors will need ready-to-use strategies that offer a risk and return profile that differentiates from traditional equities and bonds, unconstrained by benchmarks, and with the ability to take both long and short positions in assets.

But be careful what you wish for. Some types of alternatives may be more closely correlated with particular asset classes than others. When comparing the risk and return characteristics amongst alternatives, there is a large dispersion in the outcomes, clearly creating the need for a skilled manager with the ability to understand the asset class.

The key for a successful allocation to alternatives is a clear definition of an investors’ respective goals and objectives. Investors should also take care to ensure that any allocation to alternatives aligns with their overall strategy and the duration of their investment horizon.

The Alternatives universe:

Investing in alternatives offers a range of options. These are some of the most common.

Relative value arbitrage: Strategies that seeks out pricing discrepancies between combinations of securities (usually pairs) regardless of asset class and exhibit little market directionality.

Equity market neutral: These strategies attempt to match short positions against long positions across sectors, market caps, investment styles, currencies, and/or countries, seeking to exploit price differentials.

Global macro: Strategies that invest based on an assessment of the broad macroeconomic environment, from government policies and interest rates to inflation and market trends, using either systematic or discretionary methods.

Multi strategy: Strategies that take a position in two or more alternative strategies, which typically aim to have limited sensitivity to traditional market indexes.

Long/short equity: These strategies take long and short positions in equity securities, commonly actively managing their gross and/or net position to adjust their exposure to market risk.

Options trading: Strategies that utilise a variety of options trades, including put writing, options spreads, options based hedged equity and collar strategies among others.

Event driven: These strategies seek to profit from price changes related to specific corporate actions, such as bankruptcy, emergence from bankruptcy, divestitures, stock buybacks, other atypical events.

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