Janus Henderson
INVESTORS

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THE ROAD TO ALTERNATIVES

ASSESSING THE ROLE OF LIQUID ALTERNATIVES IN PORTFOLIOS

Portfolio Construction and Strategy Insight

PORTFOLIO CONSTRUCTION AND STRATEGY TEAM

Matthew Bullock
EMEA Head of Portfolio Construction and Strategy

Sabrina Geppert
Senior Portfolio Strategist

Mario Aguilar
Senior Portfolio Strategist

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Key Takeaways:

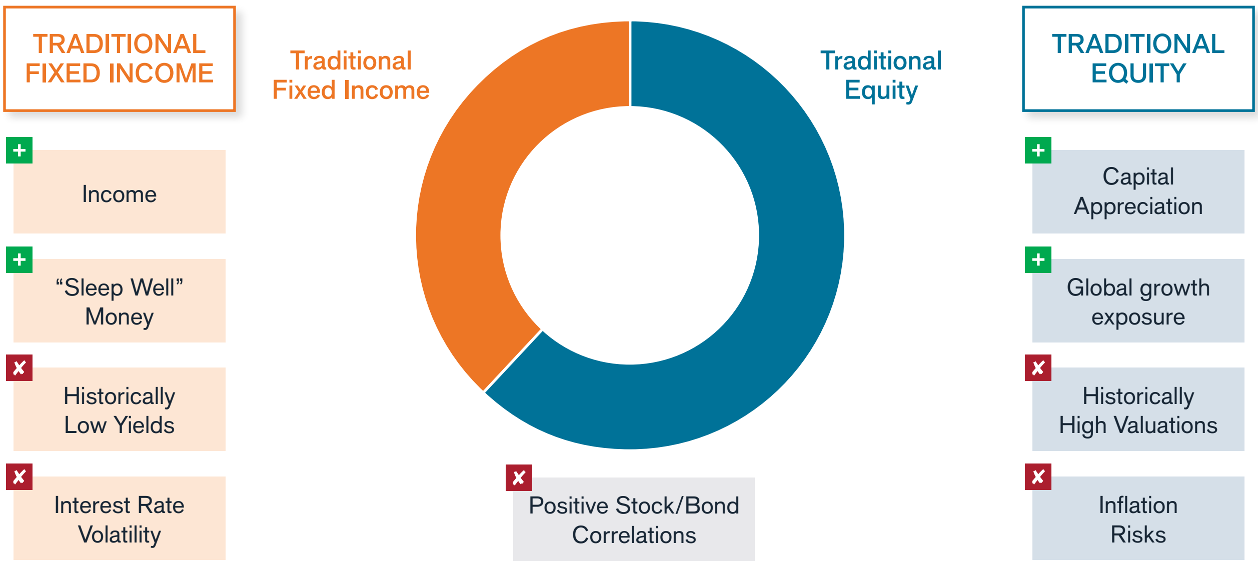
- The recent challenges for traditional fixed income and equities make liquid alternatives a popular option for advisors' portfolios.
- The growing popularity is leading investors to implement liquid alternatives without a clear role in a portfolio.
- An intentional use of alternatives with clearly defined personal goals increases the likelihood that a strategy can deliver on expectations.
- Based on the key characteristics of alternative strategies, we have built a goals-based framework to achieve a long-term, successful liquid alternatives allocation.

In recent portfolio consultations, clients have become increasingly worried about traditional asset classes and recognize liquid alternatives as a potentially differentiated source of risk and return, but they are often hesitant how best to implement liquid alternatives. Here, the Portfolio Construction and Strategy (PCS) Team examines the opportunities of liquid alternatives as a response to today's challenges and the importance of an intentional and objectives-based framework when including liquid alternatives in a portfolio.

The 60/40 portfolio – not dead, but it needs to evolve

Given current concerns about traditional bonds (e.g. hawkish central bank policies) and stocks (e.g. historically high valuations), we think that clients need to re-calibrate their expectations for a traditional 60/40 allocation and should consider strategies that work as a diversifier and differentiator to traditional asset classes. Liquid alternatives, with their broad variety of strategies, diversified source of returns and capacity to lower overall volatility are, in our view, a truly compelling alternative.

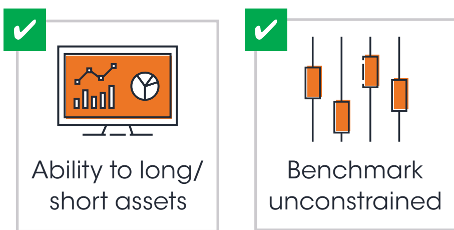
Don't abandon your 60/40 ship, but do adjust your sails



Source: Janus Henderson Portfolio Construction and Strategy Team, March 2022.

Defining true alternatives

Unlike typical long-only diversifiers with equity-like volatility (e.g., REITs, commodities), liquid alternatives are designed to deliver absolute returns over the longer term generally incorporating the ability to go short while also not being constrained to typical benchmarks. Among the more commonly known types of liquid alternatives are equity market neutral, long/short equity, global macro, multi-strategy or event-driven strategies.

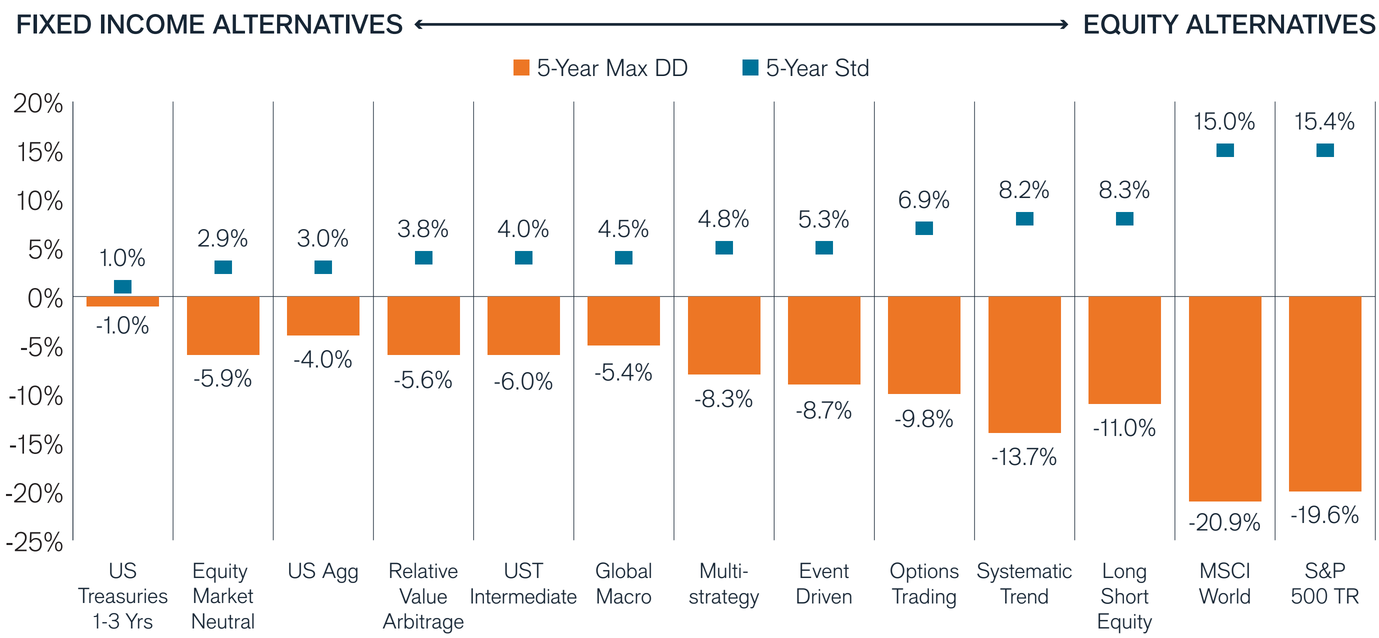


These characteristics help to provide a defined role for liquid alternatives as a true diversifier in client portfolios, not just offering a larger investment opportunity set, but with a lower beta and lower correlation to traditional, typical diversifiers.

Be clear with your intentions

Without clearly defining the role and job that alternatives should serve in the portfolio, there is a higher probability of disappointment. If we take a risk-based approach to asset classes, considering standard deviation and maximum drawdown (two common risk measures that determine the real-life results for clients), we see the dispersion in risk characteristics for alternatives relative to equities and bonds.

Taking a risk-based approach



Source: Portfolio Construction and Strategy Team, Morningstar, as at 31 December 2021. Morningstar categories: US Funds Long-Short Equity, US Funds Multistrategy, US Funds Systematic Trend, US Funds Macro Trading, US Funds Options Trading, US Funds Event Driven, US Funds Equity Market Neutral, US Funds Relative Value Arbitrage. **Past performance does not predict future returns.**

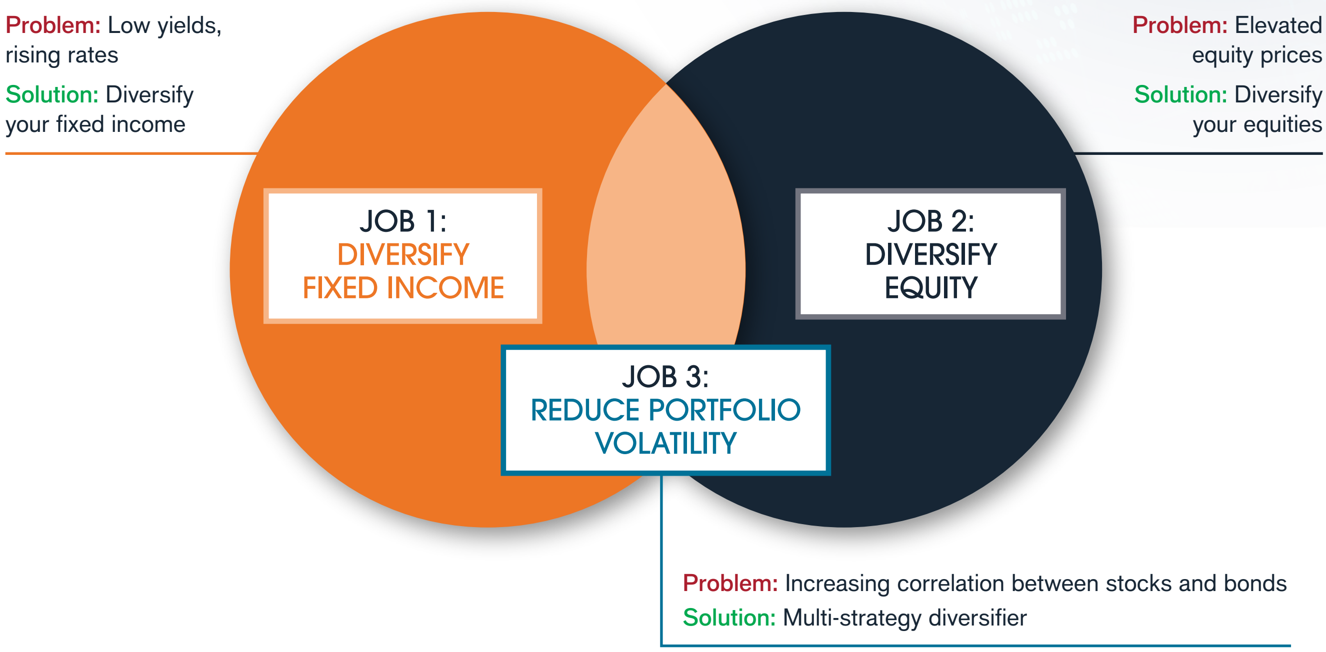
Clearly, some alternative strategies are closer to fixed income risk while others are closer to equities. While relative value arbitrage and market neutral strategies on average have a five-year risk profile that is comparable to investment grade and government bonds, systematic trend and options trading strategies range closer to equities – and this relationship is key to successfully identifying which alternatives serve which roles in a portfolio.

A framework for implementing liquid alternatives

By turning a risk-based approach into a goals-based approach we can simplify the process of adding alternatives to client portfolios.

In our portfolio consultations, we have heard from many clients that the complexity around alternative strategies is one factor that is limiting their use. We think our clients can benefit from a framework for determining what specific job an alternative should be playing in a portfolio, allowing clients to solely focus on the goals they aim to achieve.

PCS alternatives framework: from risk-based to goals-based alternatives investing



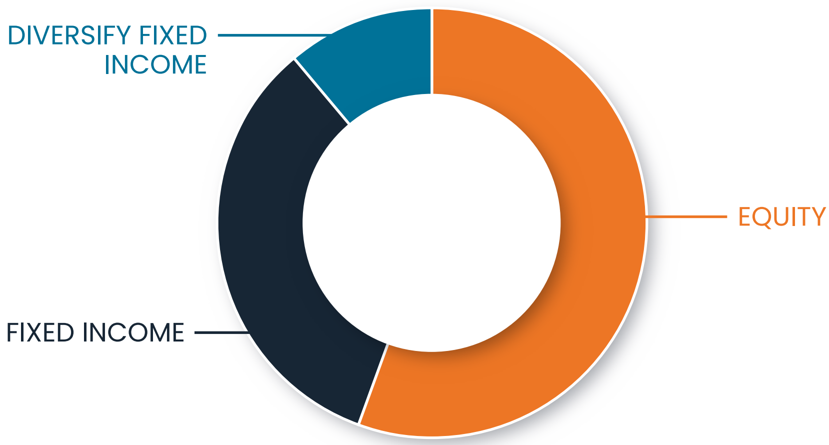
Source: Janus Henderson Portfolio Construction and Strategy Team, March 2022.

Clients in recent times have expressed concern over rising interest rates and elevated equity valuations, although clients' needs may vary. The focus is usually one or the other, depending on personal views or where a portfolio is overweight. Our alternatives framework examines the key metrics that may be used for determining whether an alternative strategy can successfully perform this role, and to which portion of the portfolio the alternatives position might be best allocated.

JOB 1: DIVERSIFY FIXED INCOME

Typical fixed income diversifiers: Relative Value Arbitrage, Equity Market Neutral

Relative Value Arbitrage	Seek out pricing discrepancies between pairs or combinations of securities, regardless of asset class. These vehicles tend to exhibit little market directionality and offer low beta to higher-risk indices.
Equity Market Neutral	Attempt to reduce systematic risk created by exposure to sectors, market caps, investment styles, currencies, and/or countries. They commonly try to match short positions within each area against long positions. They typically display a low beta to equities.

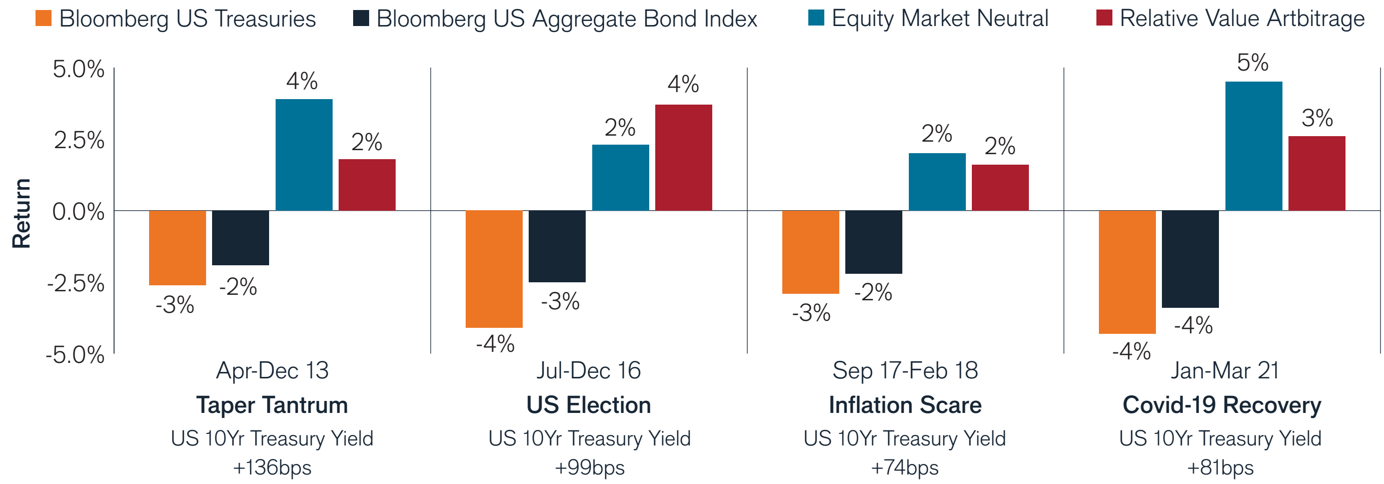


Key characteristics:

1. Low correlation to fixed income, while maintaining low beta and downside capture vs equities
2. Low overall volatility
3. Lower interest rate sensitivity.

One of the main concerns is that rising interest rates could derail objectives for clients' portfolios. During rising rate periods we have seen over the last decade, fixed income alternatives have shown favourable performance relative to government bonds and corporate bonds, which tend to be more sensitive to changes in rates.

Performance during rising rates periods



Source: Portfolio Construction and Strategy, Bloomberg, Morningstar, 31 December 2011 to 31 December 2021. **Past performance does not predict future returns.**

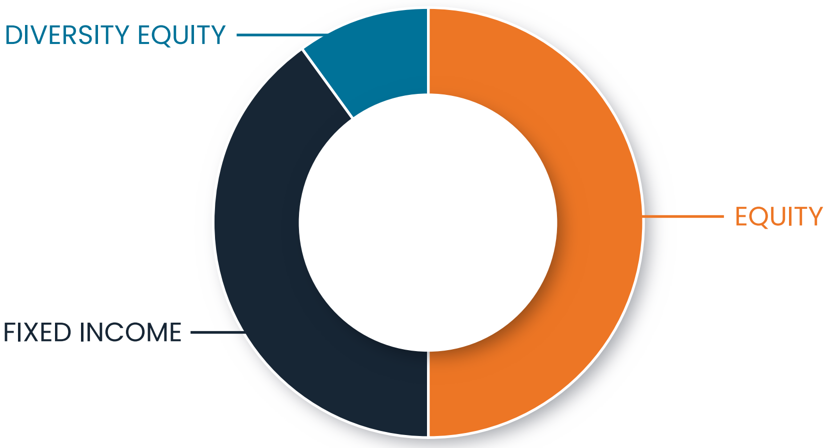
This is a typical "hero or villain" situation. Without clearly determining the goals and intentions for an alternatives allocation, clients could see performance as either a great result for alternatives compared to core fixed income, or a failure if they were compared to equities during these same time periods.

JOB 2: DIVERSIFY EQUITY

Typical equity diversifiers: Long/Short Equity, Systematic Trend, Options Trading

Long/Short Equity	Take long and short positions in equity securities, at least 75% of the gross exposure is invested in equities, may also include some derivative instruments. Typically, a beta exposure greater than 0.3 to a global or regional stock index.
Systematic Trend	Implement trend-following, price-momentum strategies by trading long and short liquid global futures, options, swaps, FX contracts and exposure to other complementary non-traditional risk premiums.
Options Trading	Use a variety of options trades, including put-writing, options spreads, options-based hedged equity and collar strategies among others. Typically have beta values to relevant benchmark of less than 0.6.

Adding liquid alternatives in traditional 60/40: Portfolio example with 10% of equity diversifiers

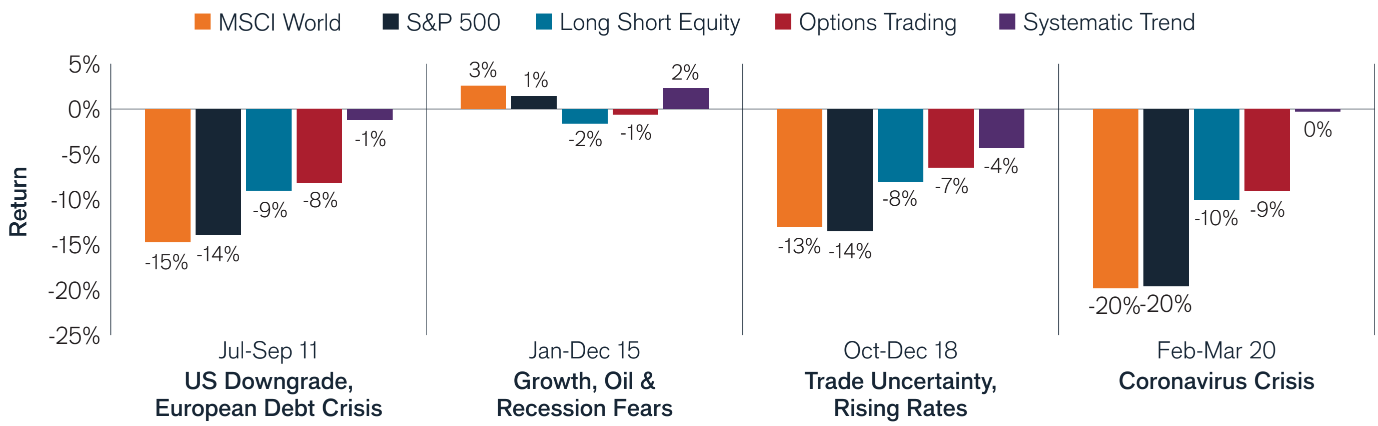


Key characteristics:

1. Offering upside which is not strictly tied to equity beta
2. Lower volatility, relative to equities.

Historically, in periods where equity markets have sold off, broader equity indices have experienced significant drawdowns, while equity alternatives have shown lower drawdown and more defensive properties. Keeping in mind that past performance should not be used as an indicator for how investments might perform in future.

Performance during equity sell-offs



Source: Portfolio Construction and Strategy, Bloomberg, Morningstar, as at 31 December 2021. Notes: Morningstar categories. **Past performance does not predict future returns.**

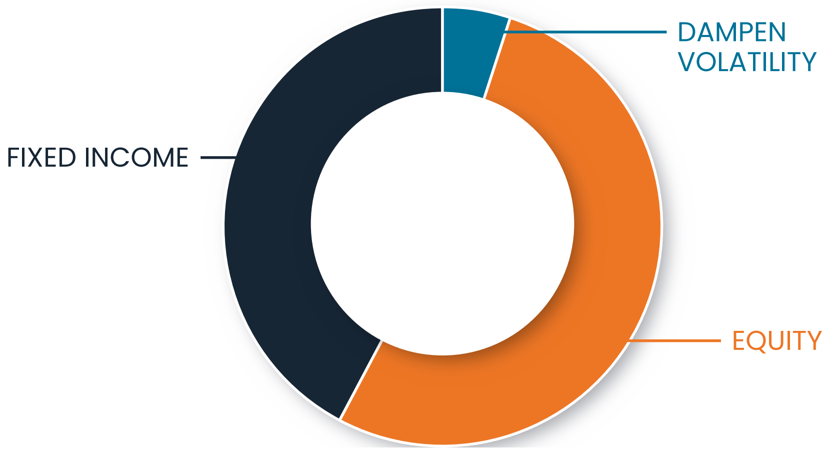
This is another "hero or villain" situation. If a client's intention has been to achieve a lower drawdown than equities with the potential to grow in value during positive market periods, alternatives have been a success. If these strategies were intended to act as a fixed income alternative, they have generally not outperformed fixed income during these stress periods, given their relatively high beta and higher risk profile.

JOB 3: DAMPEN VOLATILITY

Typical option: Multi-strategy

Multi-strategy	Exposure to two or more alternative strategies. Typically aim to have low to modest sensitivity to tradtional market indexes.

Adding liquid alternatives in traditional 60/40: Portfolio example with 10% of multi-strategies



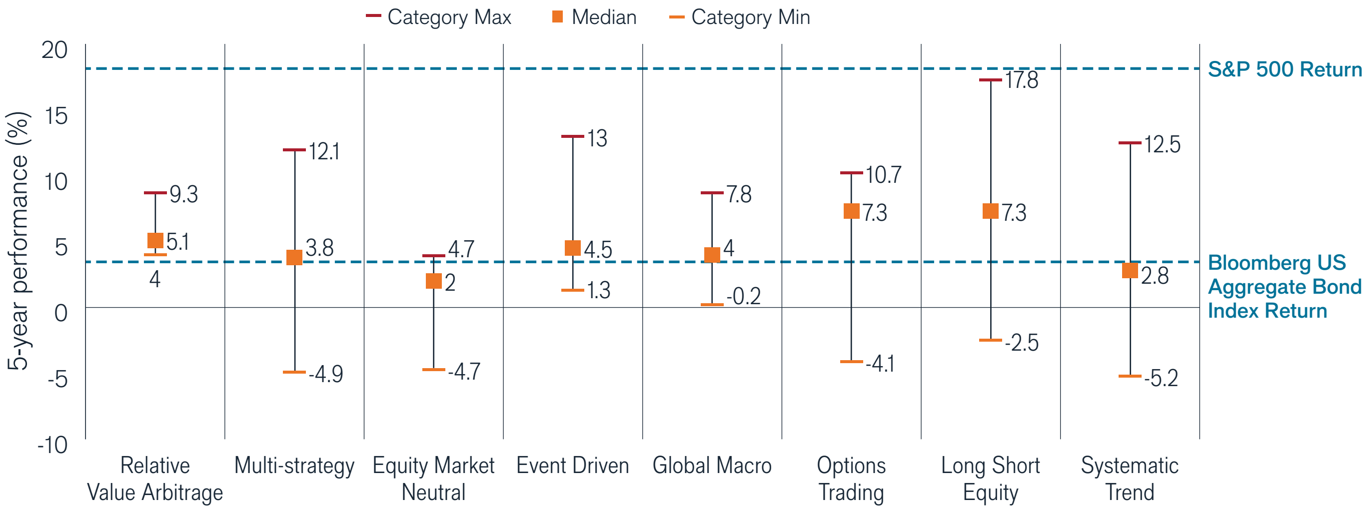
Key characteristic:

Low beta and low correlation to both equities and fixed income

Multi-strategy funds typically offer a broad exposure to a variety of alternative strategies, which as an overall vehicle delivers a low correlation to equity and fixed income assets. Well managed multi strategy funds can help to improve the overall risk-return profile of a balanced portfolio, but, clearly, fund selection can have a significant impact on your alternatives experience.

Due diligence is mandatory

The breadth and varying structure of alternative investment strategies leads to a highly diverse range of outcomes. For example, over the five-year period to 31 December 2021, multi-strategy funds delivered performance that ranged between -8.2% and 15.5%. Manager selection is important with all asset classes, but arguably to an even greater extent with alternatives, given the breadth of the category.



Source: Portfolio Construction and Strategy, Bloomberg, Morningstar, 31 December 2016 to 31 December 2021. Notes: Morningstar categories: US Funds Long-Short Equity, US Funds Multistrategy, US Funds Systematic Trend, US Funds Macro Trading, US Funds Options Trading, US Funds Event Driven, US Funds Equity Market Neutral, US Funds Relative Value Arbitrage 5-Year performance numbers. **Past performance does not predict future returns.**

There is a role for alternatives in portfolios – but it has to be defined first

In conclusion, when considering an allocation to alternatives it is paramount that a client's goals are clearly defined, and matched appropriately with a suitable alternative strategy. We believe that our goals-based framework can help clients to successfully match liquid alternatives strategies with their portfolio objectives.

About the Portfolio Construction and Strategy Team

The PCS team performs customised analyses on investment portfolios, providing differentiated, data-driven diagnostics. From a diverse universe of thousands of models emerge trends, themes and potential opportunities in portfolio construction that the team believes will be interesting and beneficial to any investor.

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