THE CASE FOR ALTERNATIVES

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THE CASE FOR ALTERNATIVES

The world in 2023 is one dramatically changed from where it was 12 months earlier. A weakening of globalisation's centripetal forces, war in Europe and renewed rivalry between economic blocs has seen the world move towards fracturing orbits of influence. These changes have had strong inflationary implications, affecting competition, supply chains and leading to significant energy price volatility.

Balanced against this are the powerful forces of changing demographics, unaddressed government debt, and technological advances. After decades of disinflation, our operating environment may have changed for the foreseeable future. Not necessarily to one of persistent inflation, but more likely one where inflation is unable to find a persistent stable equilibrium.

This new paradigm has come at a time when changes in correlations have posed significant challenges for portfolios built around longstanding negative correlations between equities and bonds. Successful asset allocation models of the future 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

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, some more liquid than others, with differentiated drivers of performance, relative to equities and bonds. This provides investors with a wide range of tools that can potentially be used to:

- 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 in the investment trust space and the availability of absolute return strategies in UCITs structures.

The expanding range of listed alternative assets has resulted in a significant deepening in market liquidity, offering the prospect of attractive income streams and exposure to many emerging areas of potential growth. And yet, investors' allocation to alternatives remains disproportionately small, relative to the major asset classes of equities and bonds. The average UK IFA, for example, allocates only 7.1% to alternative assets[1], the majority of which is held in long-only assets as property or infrastructure.

"The average UK IFA allocates only 7.1% to alternative assets..."

[1] Source: Portfolio Construction & Strategy (PCS), as at 31 December 2022. Note: Average UK advisor allocation based on data shared with the PCS team by UK IFA clients.

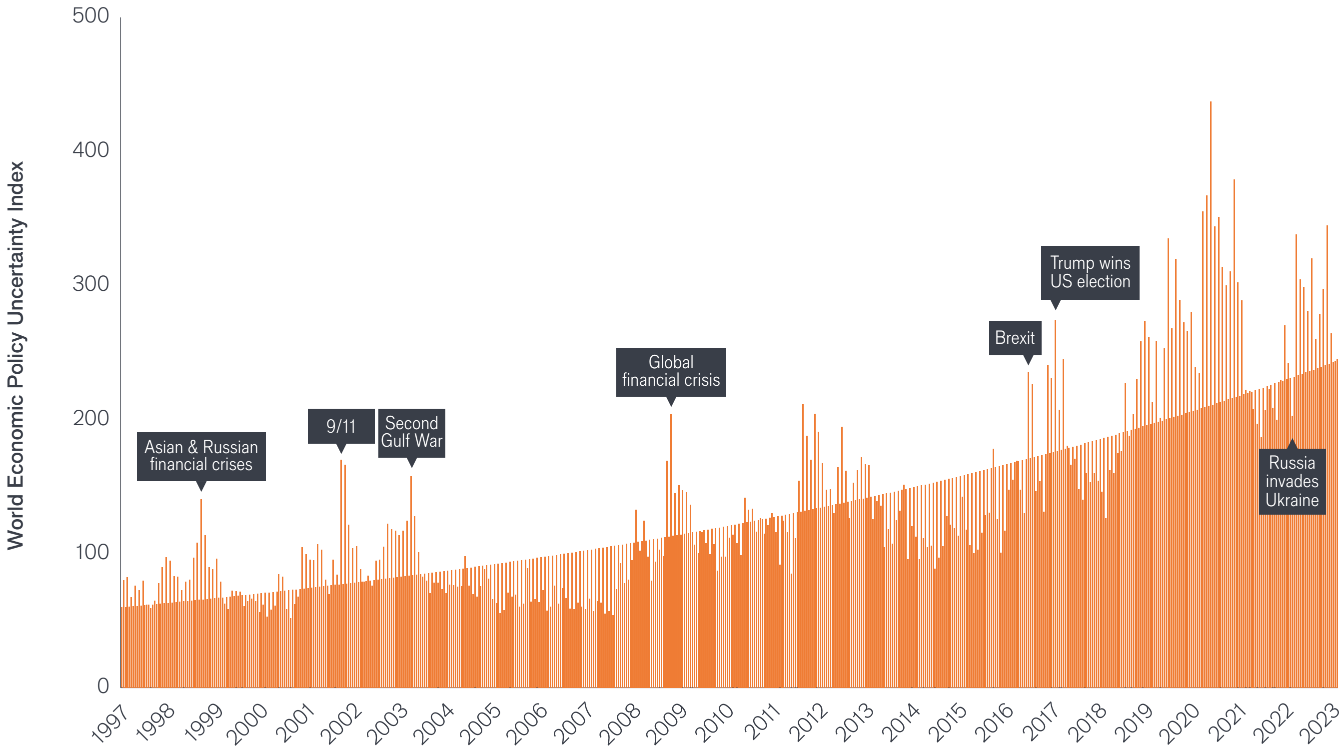
The end of the era of co-operation?

Common global prosperity over the past few decades has been driven by a belief that co-operation can bring mutual benefit, through trade, technological development, and collaborative projects to address unbalanced global dynamics, poverty, health, welfare, education, the environment, etc. An increasingly confrontational stance between the world's major economies, however, has seen integration and stability give way to new geopolitical fault lines, with 2022 marking a specific turning point following Russia's invasion of Ukraine (Exhibit 1).

Global trade will continue to be tested in 2023, as the world struggles to adapt to this new multi-polar environment, characterised by a more regionalised focus, higher (or less stable) inflation, and a baseline of interest rates that is likely to be higher than we have become used to in modern times.

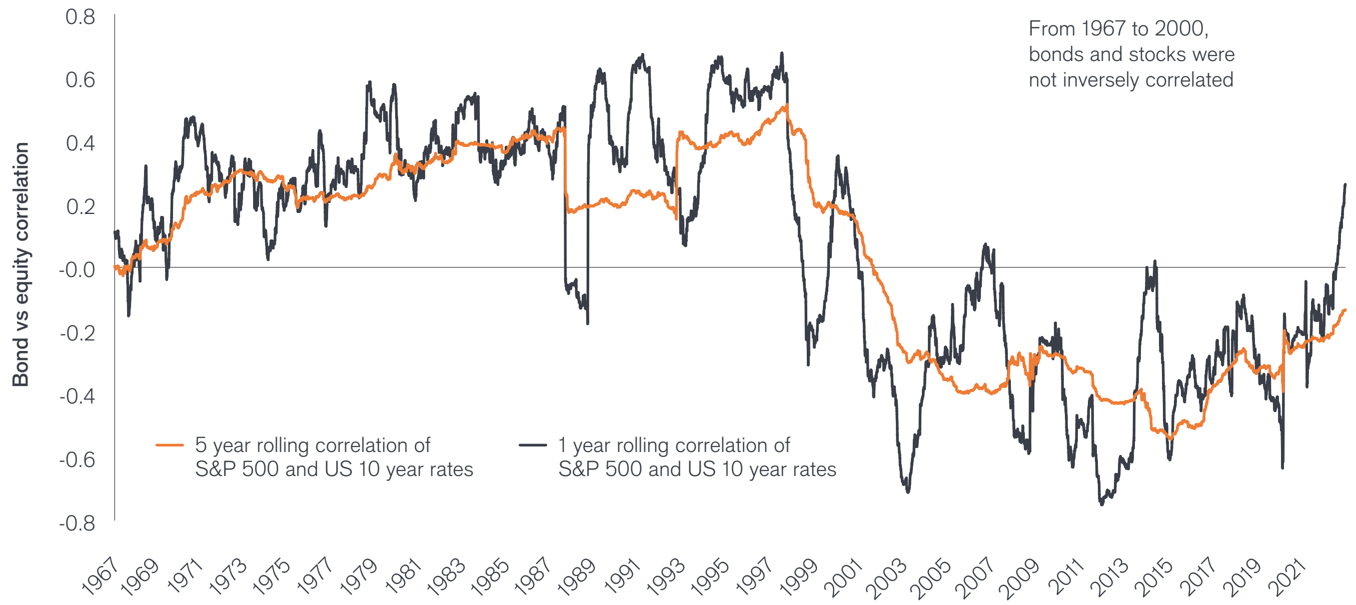
These changes come with potentially significant implications for global growth, business models and investment markets. Heightened uncertainty inevitably comes with consequences for investors' priorities, and how they seek to construct their portfolios.

Exhibit 1: Geopolitics has entered a more confrontational, regionalised phase



Source: Refinitiv Datastream, Fathom Consulting; data from www.PolicyUncertainty.com, showing monthly data for a current price GDP-weighted average of national EPU (economic, policy, uncertainty) indices for 21 countries. Each EPU source reflects the relative frequency of domestic media articles that discuss economic policy uncertainty. Covers 1 January 1997 to 1 March 2023.

Exhibit 2: Diversification is not what it used to be



Source: Janus Henderson Investors, Refinitiv Datastream, 1 January 1993 to 31 March 2023.

Note: Data shows rolling correlation of the S&P500 vs US 10-year interest rate swap, using daily total returns. Data has been inverted to approximate S&P500 vs US 10-Year Treasury price, as opposed to US 10-Year Treasury yield. **Past performance does not predict future returns.**

Is traditional asset allocation dead?

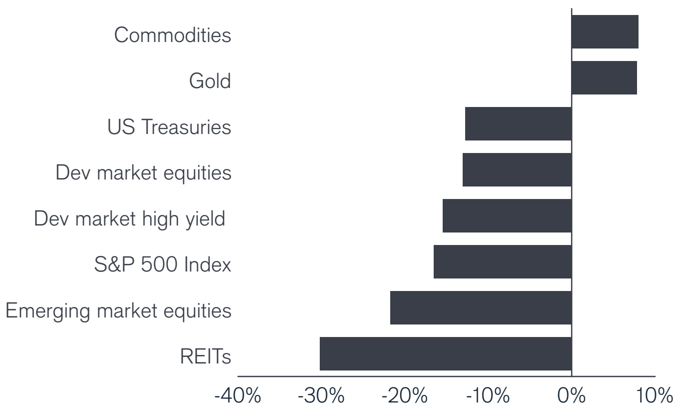
For more than two decades, investors have relied on the reverse correlation between equities and bonds to build natural diversification and risk mitigation into their portfolios. This sympathetic partnership, the foundation for balanced '60/40' strategies, has historically delivered attractive risk-adjusted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

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 one-year correlations turning positive in 2022 (Exhibit 2).

While the onset of the pandemic saw a familiar flight to the perceived safe haven of government bonds, the scale of government and central bank intervention, combined with fears about the health of the global economy, has injected uncertainty into the longstanding relationship between asset classes. This was apparent in 2022, when major asset classes came under pressure in tandem, meaning that bonds were no longer diversifying investors' equity exposure (Exhibit 3).

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 best positioned to offer true diversification for investors.

Exhibit 3: Performance correlated across major asset classes in 2022



Source: Refinitiv Datastream, 31 December 2021 to 31 December 2022. **Past performance does not predict future returns.**

Note: Commodities is the Bloomberg Commodity Total Return Index. Gold is the S&P GSCI Gold Spot price. Developed Market high yield is the ICE BofA Developed Markets High Yield Constrained Index. US Treasuries is the ICE BofA US Treasury Index. Developed market equities is the MSCI EAFE US$ Index. Emerging markets equities is the MSCI EM US$ Index. REITs is the FTSE EPRA Nareit Developed US$ Index. Total returns in US dollars.

Where can bond yields go from here?

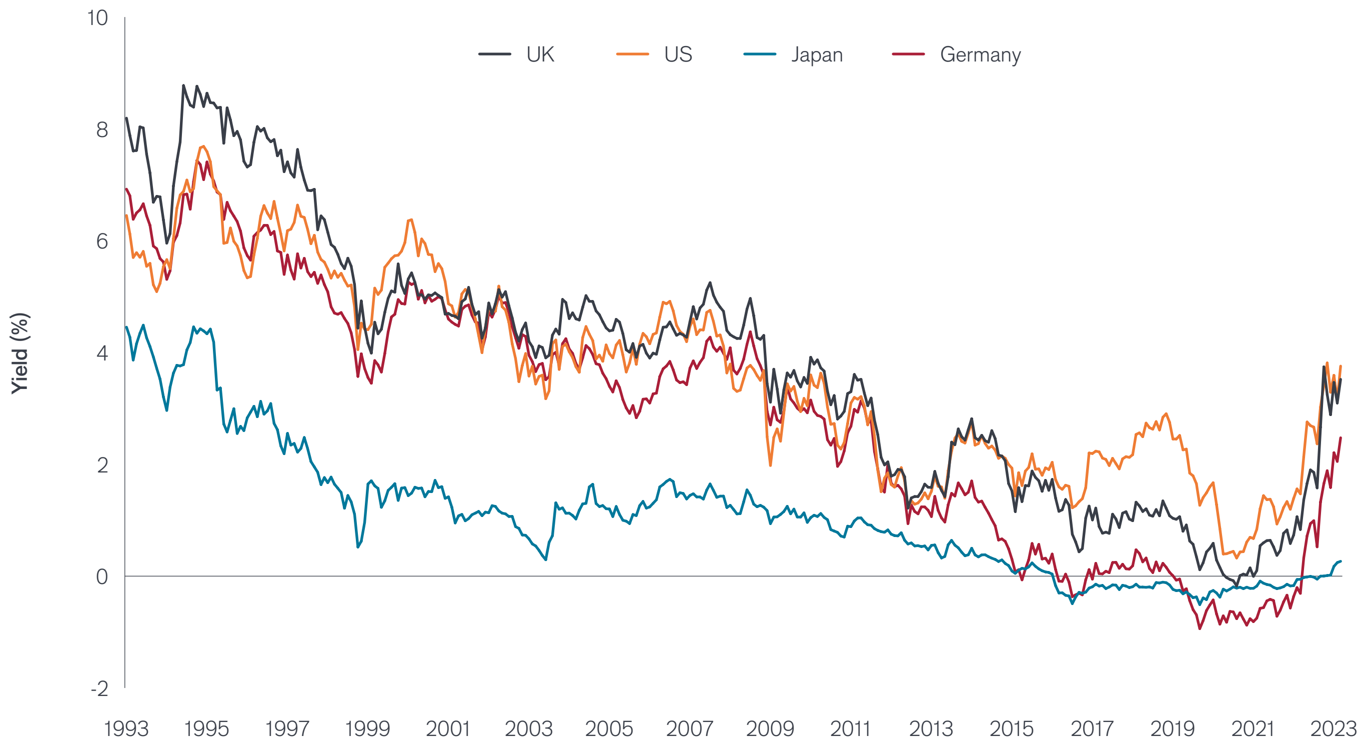
Government bonds yields saw a relatively steady downward trajectory between the early 1980s and 2020 (Exhibit 4). A combination of trending lower inflation and low growth led bond yields to begin a steady decline, and inversely, rising price returns in fixed income. However, while 2022's meteoric rise in yields improved the risk profile of many aggregate bond indices, the mismatch between potential returns and interest rate exposure remains.

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 2023. How might risk premium be repriced? This transition period, from a multi-decade environment of downward-trending rates to a rising rate environment, changes the relationship between asset classes. Few people managing money today have experience of that environment.

Higher interest rates have put pressure on borrowers. While credit spreads have remained resilient in the face of a slowing economy, lower-rated borrowers with exposure to the economic cycle may be more at risk. Ultra-low rates and government initiatives enabled high-yield issuers to avoid the wave of defaults that many had feared at the onset of pandemic-related lockdowns. But given the direction of higher yielding corporate spreads this is an area that may come under greater scrutiny.

A concern for many investors is that rising interest rates could derail objectives for their portfolio. Investors may be able to re-create or even improve on the diversification benefits of bonds by incorporating alternatives with a lower correlation.

Exhibit 4: The long-term downward trajectory for bond yields ended in 2022

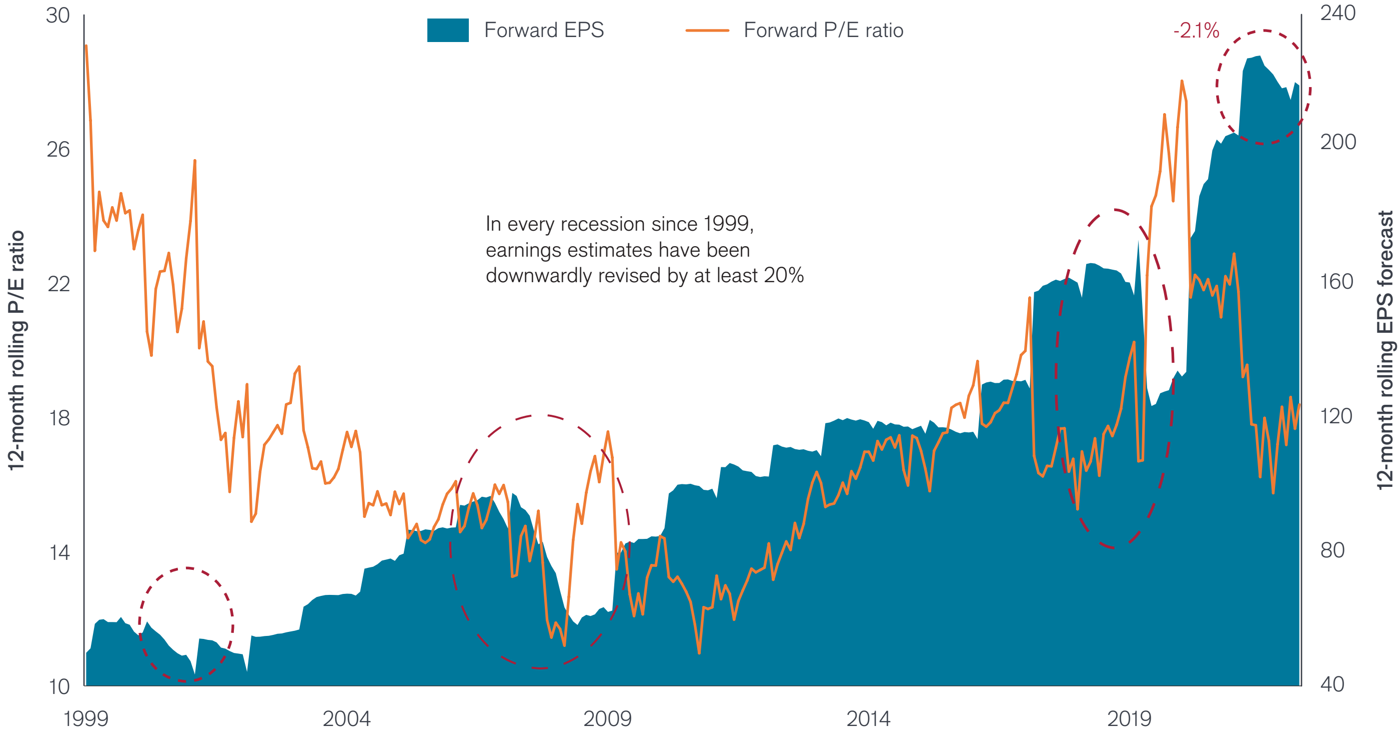


Source: Janus Henderson Investors, Refinitiv Datastream, 1 January 1993 to 4 April 2023. Shows yields on 10-year government bonds issued in the US, Germany, Japan and UK. **Yields may vary over time and are not guaranteed.**

Equity valuations – higher risk and muted returns

While the US Federal Reserve's (Fed's) hawkish turn in late 2021 through to the present impelled investors to reduce risk in their portfolios, US retail investors came into 2022 with more of their wealth in stocks than at any time in history (over 40%[2]). While uncertainty (and market weakness) saw that figure fall in 2022, investors have poured record amounts of money into US stocks in early 2023[3], with hopes of participating in any market rebound at least temporarily overcoming any bearish concerns. With 2023 earnings only marginally revised down thus far, the market may need to further temper its expectation as the economy slows and industry works through an inventory overhang.

Exhibit 5: Market expectations for corporate earnings may well be too high



Source: Bloomberg, Yale University, 31 December 1999 to 31 December 2022. 12-month rolling figure used to illustrate price-to-earnings (P/E) ratio measured against earnings per share forecasts for companies in the S&P 500 Composite Index. EPS = earnings per share, here shown at an index level. **Past performance does not predict future returns.**

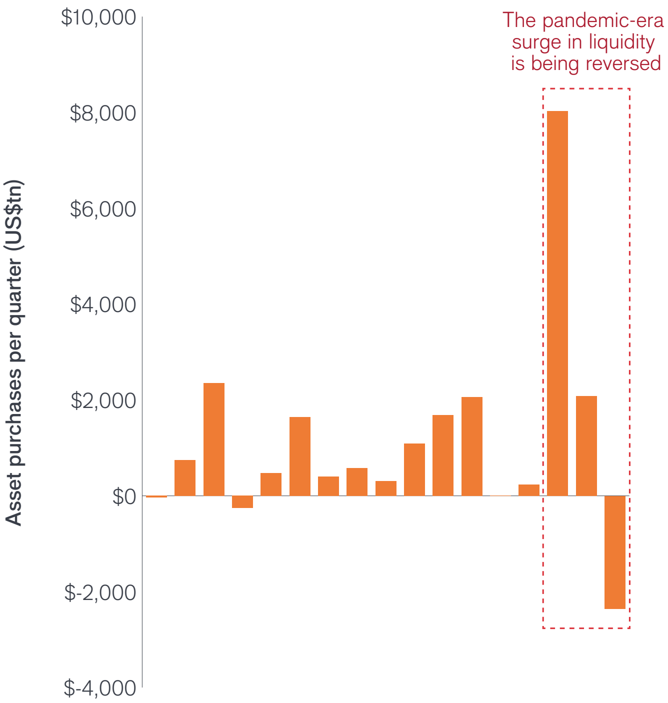
[2] Source: Allocation of US households and non-profit organisations to equities as a % of financial assets. https://fred.stlouisfed.org/series/BOGZ1FL153064486Q

[3] Source : https://markets.businessinsider.com/news/stocks/stocks-retail-investors-record-amount-spending-markets-rally-fomo-securities-2023-2

Peak liquidity is over

Valuations were persistently high during the market cycle that took us to the beginning of 2022, driven by extraordinarily accommodative monetary and fiscal policy globally. The pandemic-era surge in liquidity is being reversed as central banks attempt to starve inflation of the excess reserves it uses as fuel. Central bank bond purchases decelerated from a peak of $8.5 trillion in 2020 to negative territory in 2022 (see Exhibit 6).

Exhibit 6: Central bank asset purchases have come to an end

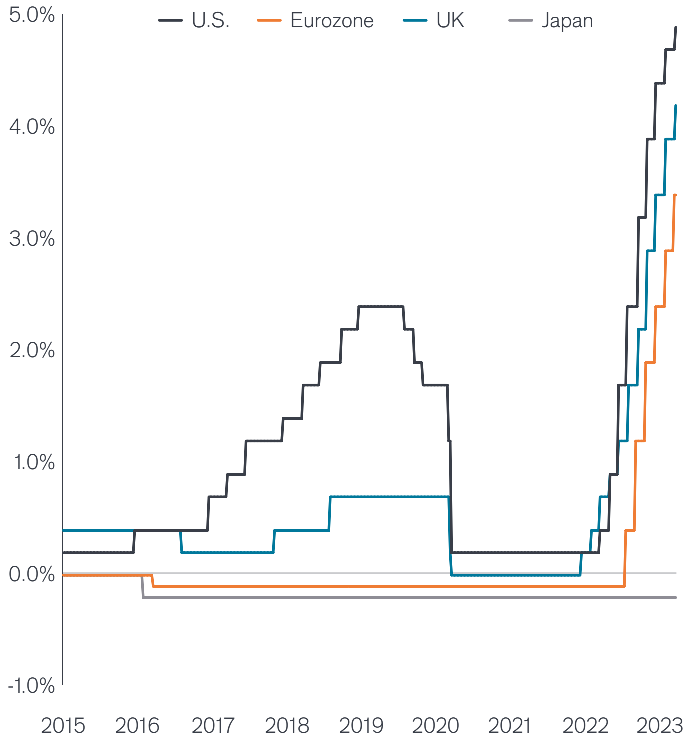


Source: Bloomberg, at 31 December 2022.

Note: Data based on US Federal Reserve, Bank of Japan, and the European Central Bank, in US dollars.

The Fed ended its QE program in February 2022 and followed that up with nine interest rate hikes between March 2022 and March 2023 (Exhibit 7), taking the Federal Funds Rate from 0.25% to 5.0%[4]. Complementing these rates increases, the Fed stopped reinvesting $95 billion of maturing securities each month in an effort to shrink its balance sheet.

Exhibit 7: Central bank policy targeted on controlling inflation



Source: Bloomberg, at 31 December 2022.

Note: Data from US Federal Reserve, Bank of Japan, Bank of England and European Central Bank.

Elsewhere, the Bank of England (BoE) raised its official bank rate 11 times, from 0.1% in December 2021 to 4.25% in March 2023[5]. The European Central Bank (ECB) remains committed to returning inflation to its 2% medium-term target, pursuing a slower, more protracted policy strategy, with six interest rate increases to date bringing the Euro Area interest rate to 3.5% in March 2023[6]. Only Japan, thus far, has remained committed to accommodative monetary policy.

Ultra-low rates and government initiatives enabled high-yield issuers to avoid the wave of defaults that many had feared at the onset of pandemic-related lockdowns. But the pace and impact of monetary policy tightening will be pertinent for investors as we move further into 2023.

4. Source: US Federal Reserve.

5. Source: https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp

6. Source: https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html

THE 'ALTERNATIVES' ROUTE TO PORTFOLIO CONSTRUCTION

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

- What strategic role are these alternative asset classes likely to play in portfolios?
- What is the best approach when adding liquid alternatives to a traditional portfolio?
- How correlated are liquid alternatives' returns to traditional equities and bonds?

The investment world is changing rapidly, and investors' portfolios will need to evolve in tandem. Investors might want to consider 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 across 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 investor's goals and objectives and the duration of their investment horizon. This can help to ensure that any allocation to alternatives aligns with an investor's overall strategy, whether that be to diversify their fixed income exposure, equity exposure, to deliver capital growth or income, or reduce portfolio volatility.

The alternatives multiverse:

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

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.

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

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.

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.

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

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

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

Trend following: Trend following strategies (also known as 'time series momentum' or 'CTAs') look to capture performance by identifying existing pricing trends in markets, either positive or negative, and then following it, in the expectation that these trends will persist for some time.

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