A CASE FOR MULTI STRATEGY

September 2023

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INTRODUCTION

The past few years have served as a reminder of the scale and rapidity with which market sentiment can turn on significant (often exogenous) events, leading to heightened uncertainty and a broad deleveraging of portfolios. COVID-19 brought a sudden end to the decade-long bull market for global equities and bonds that followed the Global Financial Crisis (GFC), while the ongoing conflict in Ukraine has raised questions about the fragility of international trade and supply chains. The consequent burden of inflationary pressures have been something that most investors today have not previously faced.

Whatever form it takes, markets remain vulnerable to a sudden global catalyst capable of triggering a potentially significant correction. In this environment, there is a strong argument for investors to adopt a different approach to constructing risk-adjusted, return-seeking portfolios, particularly those heavily reliant on single asset classes. Here, we discuss the key considerations for constructing diversified Multi Strategy portfolios, anchored on a portfolio protection strategy, to help meet investors' needs – with a particular note on pricing structures.

1. Uncorrelated drivers of performance

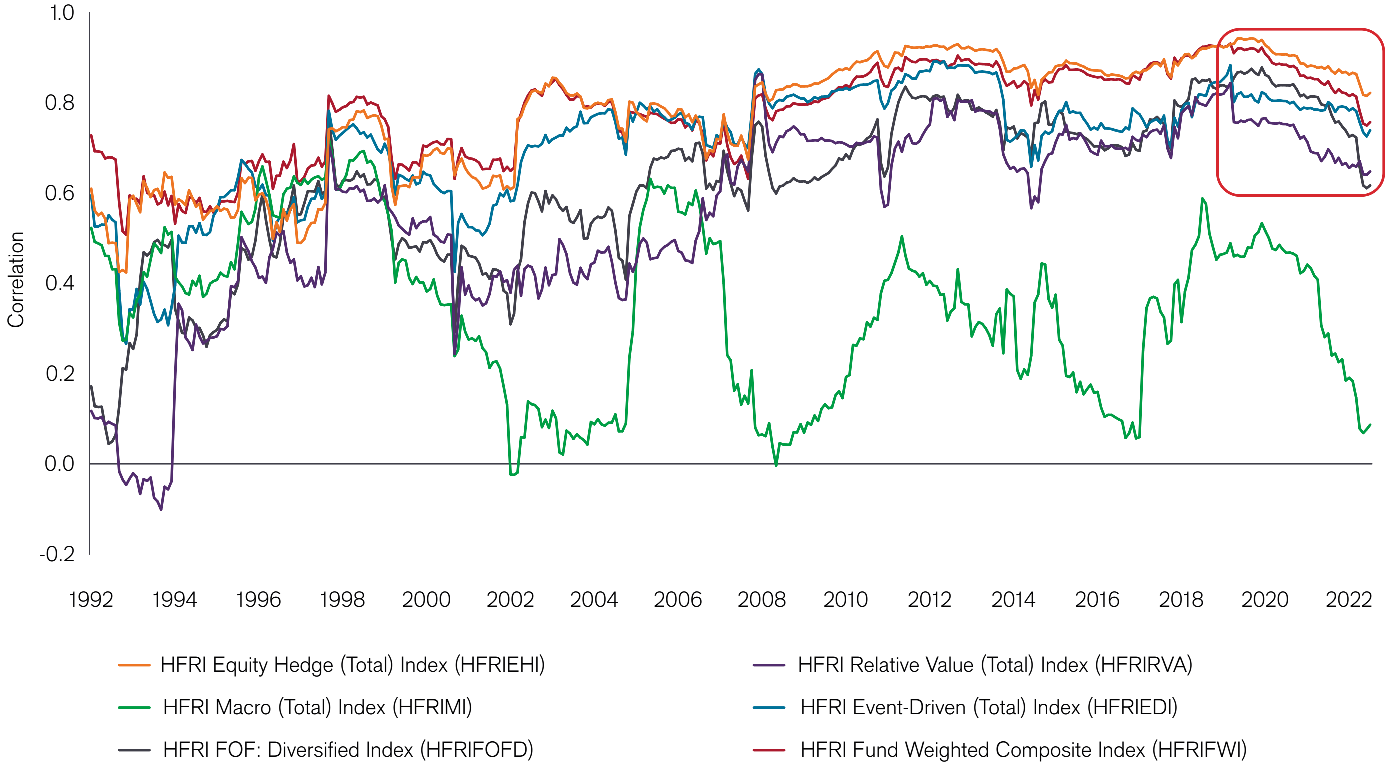
Investors have become familiar with uncertain environments. A well-diversified Multi Strategy platform may be able to offer investors a viable alternative to help broaden the drivers of performance across a balanced portfolio.

The typical benchmark for absolute return-orientated hedge fund strategies has been cash, commonly the 3-month LIBOR. Yet many investors compare performance with the S&P 500 Index which has, rightly or wrongly, become a proxy for the opportunity cost of investing into a hedge fund.

Many hedge fund strategies have historically offered limited diversification benefits because they were too highly correlated with equities (Exhibit 1). They also often provided limited transparency to the underlying asset exposures.

Our research and investing experience indicates that sound Multi Strategy portfolios manifest the best qualities of well-diversified hedge fund programmes. They can provide investors with exposure to economically intuitive, statistically independent investment opportunities, with the potential to integrate explicit strategies aimed at mitigating large potential drawdowns in risk assets, most notably equities.

Exhibit 1: The performance of many hedge strategies has increasingly correlated



Source: Bloomberg, Janus Henderson Investors, December 1989 to June 2023. Shows correlation of rolling three-year total return for the indicated indices, relative to the S&P500 Composite TR Index.
Past performance does not predict future returns.

2. Sensible, Persistent, Consistent, Transparent[1]

For a Multi Strategy portfolio to generate consistent returns unrelated to equity markets, we believe the underlying investment strategies must be sensible, persistent, and additive. By sensible and persistent, we mean there must be a good economic rationale to why the investment opportunity exists today, and an understanding of how long it might persist into the future. To be additive, we believe that alternative investment opportunities must offer a breadth of performance drivers with relatively low correlation to one another, rather than just providing a clear alternative to 'core' asset classes, such as equities.

From an investor's perspective, transparency is also important. It is unacceptable for hedge fund managers to hide behind a veil of secrecy in either good times or bad.

The bank risk transfer strategy example in exhibit 2 illustrates a potential risk premium that we believe matches these parameters. For as long as a bank's balance sheet risk is restricted by regulation one should expect to collect a premium by providing liquidity and risk transfer services (sensible and consistent). The source of risk premium is also idiosyncratic and generally independent of other risk premia (additive).

Bank risk transfer

The opportunity to harvest risk premia from European stock dividends first emerged in the aftermath of the GFC. At that point, banks, faced with a raft of new regulations were scrambling to rid their balance sheet of risky assets.

At the same time, record-low interest rates worldwide had left investors struggling to generate sufficient income. To meet the demand for investments that could offer a higher yield than deposits, banks crafted structured notes, usually linked to a major stock market index. To offset the risks created by the sale of these notes which – due to tighter regulations – could not be held on their balance sheets, banks typically purchased equity forwards.

These factors created the opportunity for a bank risk transfer strategy – selling equity forwards to (and collecting the associated risk premium from) banks that sold structured notes to yield-hungry individual investors[2].

That market continues today, with banks still seeking to satisfy requirements for capital allocation based on risk retained on their books (the output floor), although the scale and attractiveness of the opportunity will vary over time. However, demand for significant risk transfer (SRT) is likely to grow after Basel IV regulations came into force in early 2023, with new standards set for credit and operational risk.

[1] Also referred by the acronym 'SPAC,' Barclays Global Investors popularised this investment concept back in the 1990s and early 2000s.

[2] Anita Raghavan, 'A Way to Play European Stock Dividends', Barron's 31 March 2019.

3. Inflation and stock/bond correlations

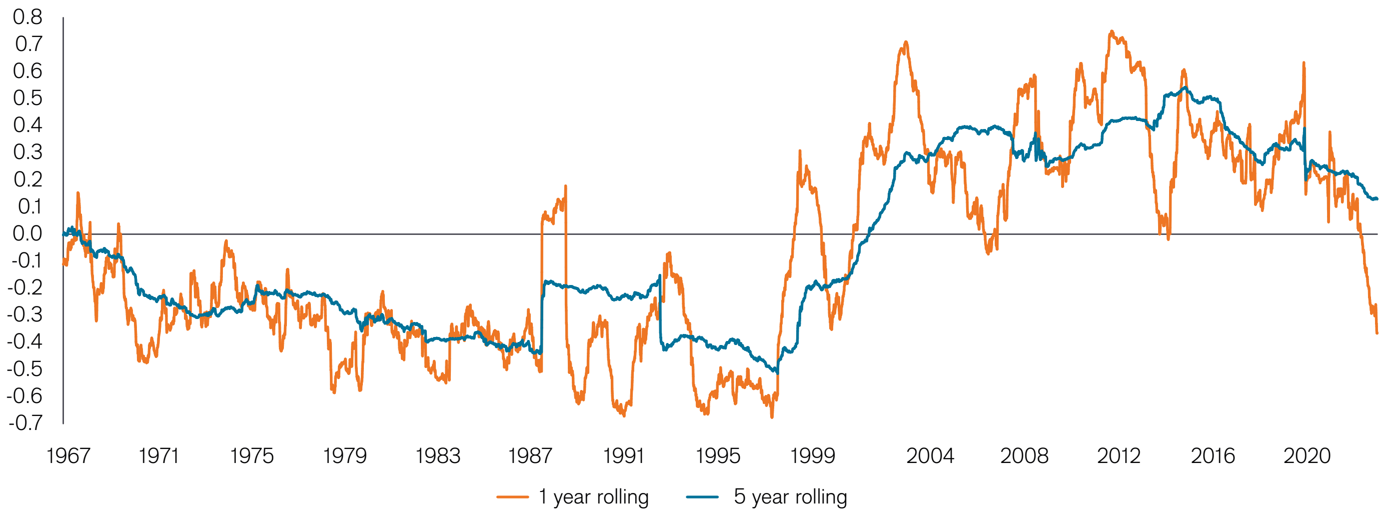
For more than two decades investors have relied on the reverse correlation between equities and bonds to build natural diversification into their portfolios. While falling bond yields had consequences for income levels, the rising hedging benefits that came from negative correlations gave investors a valuable free lunch, in terms of easily achievable diversification in a portfolio.

This all changed in 2020, when the COVID crisis took hold in the Western world. The rapid drawdown between 19 February and 23 March 2020 saw US Treasuries return 7%, while the S&P 500 dropped 34%, meaning that Treasuries hedged only a little over 20% of the equity drop.

The era of loose monetary policy came to an end in 2022, with consequences for both equities and bonds. This had a significant impact on sentiment towards both equities and bonds, with the S&P 500 Index down 16.5% and the ICE BofA US Treasury Index falling 12.8% for the calendar year.

Higher yields and falling inflationary pressures suggest that the end of equity/bond diversification has been oversold. However, as we shift from inflationary fears to growth uncertainty (and potential recession), instead of relying primarily on bonds to deliver diversification benefits, investors might consider absolute return strategies that are uncorrelated to stocks, both in theory and in practice.

Exhibit 2: Correlation of S&P 500 and yields on US Treasuries



Source: Bloomberg, Janus Henderson Investors, 6 February 1967 to 30 June 2023. Shows the five-year rolling correlation between the S&P 500 Index and the yield on US 10-year government bonds. **Past performance does not predict future returns.**

Portfolio protection

History shows that periods of acute market stress can cause pricing for otherwise seemingly diversified assets to synchronise. Unrelated investment strategies can also become highly correlated, with the associated risk premia widening across the board.

In the past, to minimise the cost of portfolio protection, many investors sought to mitigate equity tail risk via implicit, instead of explicit, portfolio protection. They did so to mitigate the cost of portfolio protection. In reality, many strategies of this kind risk behaving like an insurance plan with a high excess, where the holder also participates in the losses.

Portfolio protection generally has two goals during a period of stressed financial markets:

- Deliver uncorrelated alpha to help offset the performance drag from the other strategies during periods of market stress
- Allow other strategies to remain exposed to positive long-term opportunities during difficult periods, with the potential to increase exposure at attractive levels.

> "In times of extreme stress, all correlations go to one"
>
> **Financial market axiom**

Investors who implement protection strategies also benefit from the second-order effect of being able to access opportunities in distressed environments by virtue of capital that has been returned to them from the protective strategy. This is important, given that such opportunities typically do not exist in abundance in normal times.

The nature of tail events is that they are – at least theoretically – exceptional, tempting some risk-on investment vehicles to consider protection strategies unnecessary. In truth, tail events occur far more frequently than many would expect, and their shape and impact vary enormously. Taking a view from a fiduciary perspective, we believe that Multi Strategy models should seek to hedge risk for clients over all timeframes.

4. Fee netting benefits

In multi-manager strategies and funds of funds, the performance of the varying underlying strategies offset each other, delivering an overall net performance for investors. When it comes to incentive fees, however, investors may end up paying for the performance of one or more underlying strategies, even when the overall strategy or fund of funds has failed to generate excess returns relative to its benchmark or performance target. The impact of not netting fees can be particularly acute for portfolio protection strategies (ie. negative correlation strategies) because they are designed to generate positive returns during sustained equity market selloffs.

For Multi Strategy portfolios, however, investors should be paying incentive fees on the basis of performance at the aggregate Multi Strategy level, instead of the underlying strategy level. This means that they benefit from the fee netting associated with low or negative correlation, while potentially avoiding an additional hit to their returns during periods of underperformance. Any fee reduction represents a material saving for investors that directly impacts on total return over time.

Conclusion

Multi Strategy portfolios based on sensible, persistent, additive, consistent and transparent investment ideas, coupled with an explicit portfolio protection strategy, arguably merit consideration given today's uncertain investment background. It is not enough for Multi Strategy portfolios to deliver solely on a risk-adjusted return target; they should also look to offer true diversification in terms of the drivers of performance. And with a slew of indicators suggesting consistently higher macro and geopolitical risks for the foreseeable future, there is a strong argument for Multi Strategy portfolios to form a more prominent allocation for investors in future.

Janus Henderson Diversified Alternatives Team

The Janus Henderson Diversified Alternatives Team is made up of **27** investment professionals situated in the UK, US, Australia and Singapore, with an average of **21 years'** financial industry experience.

The team is responsible for **US$26.4 billion*** in client assets and manages a range of investment solutions aimed at delivering specific outcomes tailored to meet the needs and constraints of clients.

The team brings together a cross-asset class combination of alpha generation, risk management and efficient beta replication strategies, as well as the flexibility to create customised offerings.

Current solutions include multi-strategy hedge funds, alternative risk premia, managed futures and both commodities and equity enhanced index strategies.

- Proprietary, skill-based strategies
- Flexible, opportunistic, bottom-up management of exposures
- Explicit top-down portfolio protection
- Experienced investment team incentivised by total portfolio return
- Backed by the resources of a global asset manager

* Source: Janus Henderson Investors, as at 30 June 2023.

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Important information

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