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The perfect storm: Why alts make sense

High equity prices, low bond yields and geopolitical risk all make this once-shunned allocation a new staple

By **Jeff Benjamin**
Mar 30, 2014

The modern financial advice industry may have never experienced a time when the case for allocating assets into alternative strategies made perfect sense.

Until now.

With the equity market at an all-time high, bond yields hovering near record lows, volatility spiking and global geopolitical risks rising, diversifying into products and strategies designed to hedge risk can mean that clients can sleep soundly at night.

"This market is completely overvalued, or at least fairly valued, by almost every measure, and you know quantitative easing is coming off, so everyone has to reallocate. But how can you reallocate to bonds in this market?" said Bob Rice, managing partner at Tangent Capital Partners.

Indeed, while he intentionally oversimplifies the scenario, the notion of a portfolio being limited to allocations in stocks, bonds and cash is so restrictive and antiquated that it almost seems foolhardy to refer to it as traditional.

The financial services industry — and much of the financial advice industry — has moved well beyond the traditional 60/40 portfolio concept toward models that could be called contemporary or necessary. And importantly, they include allocations to alternative strategies.

So no matter how hard some corners of the advice industry still try to ignore it, there really is no alternative to embracing alternatives.

"The market risks involve a mixed bag across multiple asset classes that I call the four horsemen: Fed policy, a slowdown in China, geopolitics and negative corporate guidance," said Christian Hviid, managing principal at Point Guard Capital.

"Of course, you can't just throw money at alternatives," he said.

More investors and financial advisers are getting the message.

A recent survey of wealthy investors conducted by MainStay Investments found that 61% of respondents are using alternatives in some form, with an average portfolio allocation of 22%.

The survey results found that investors were turning to alternatives for diversification, investment growth and/or to protect principal.

And a report by Barron's in January looked at average asset allocations made by 40 of the largest wealth advisory firms and found a 20.4% average allocation to alternatives.

In addition to alternatives, the firms averaged 51% in stocks, 26% in bonds and nearly 3% in cash.

"A lot of people think of alternatives as risky, but I've always thought alternatives should be the third leg of a stool in order to mitigate risk," said Bradley Alford, chief investment officer at Alpha Capital Management.

What might have once been a question of "if" is now a question of "when, where and how," and that is where much of the fun begins, because along with more demand for alternative strategies has come a virtual flood of options and opportunities in the form of registered products, also known as liquid alternatives.

In 2004, 116 distinct mutual funds were categorized as alternative, and they totaled less than $22 billion in assets, according to **Morningstar Inc.**

Through last month, that number had reached 429 funds across multiple alternative categories, with assets totaling more than $144 billion.

More significantly, net inflows into the category topped $40 billion last year, up from $14.6 billion in 2012. And through the first two months this year, the flood has continued, with net inflows exceeding $8.5 billion.

"A lot of the more savvy advisers are realizing this can't go on forever in the equity markets, and the bond market concerns are also a big factor," said Josh Charlson, director of alternative funds research at Morningstar.

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To industry veterans and true believers, it makes perfect sense.

"You can't just sit there and ride the wave, baby, because the historical numbers for bonds and balanced funds are basically at the window, and what happens when they revert to the mean?" said Thomas Meyer, chief executive of **Meyer Capital Group**.

He cited last year's sudden May-June interest rate spike after the **Federal Reserve**hinted that it planned to start reducing its quantitative-easing program as an example of continuing market risk.

"The Fed gave the markets a look into the future, which is something that doesn't happen too often, but it proved that you don't want to be sitting there in a restricted bond fund that can't short or go to cash," Mr. Meyer said.

Nadia Papagiannis, director of alternative investment strategies for global third-party distribution at Goldman Sachs Asset Management, underscored Mr. Meyer's point regarding market risk.

"We don't believe interest rates will rise gradually," she said. "We believe there will be big spikes."

One rub against some hedging strategies is that, often by design, they can lag performance during bull market runs.

But it is the longer-term averages on which investors and advisers should focus, Ms. Papagiannis said.

For example, during the four periods of rising Treasury yields between 1997 and 2013, the Barclay's Aggregate Bond Index generated an average return of 2.3%, while the Hedge Fund Research Index returned an average 29.3%.

Over the same 16-year period, the S&P 500 experienced three multiyear rallies and two multiyear declines. The trough-to-peak rallies gained an average of more than 116%, which compares with an average of 68% for the HFRI.

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During the two down-market periods, the S&P 500's peak-to-trough declines averaged 48%. The HFRI declined over the same periods by an average of 12.5%.

When rates are rising, Ms. Papagiannis likes allocations to merger arbitrage and managed-futures strategies, she said.

Steven Karsh, principal and director of research at Innovest Portfolio Solutions, started using alternative strategies in 1996, and he said that it is important to focus on what investors are getting for the amount of risk they are taking.

"When you look at a month like January of this year, when the S&P was down 3.5%, that helps us make the case for commodities in the portfolio because commodities were up 0.3% in January," he said.

In addition, Mr. Karsh is OK with his allocation to lower-performing hedging strategies because he is paying attention to the volatility as measured by standard deviation.

The HFRI, with a standard deviation of 6, represents just 40% of the volatility of the S&P 500, which has a standard deviation of 15.7.

"I'll take 67% of the return of the S&P if I'm getting only 40% of the volatility," Mr. Karsh said.

Hedging strategies are designed to represent a minority percentage of an overall portfolio.

Realizing that alternatives will rarely represent more than 25% of a portfolio might help advisers accept the muted performance and higher fees that come with a registered mutual fund in the alternatives arena. There is, however, little that can be done about the added research required.

"As the saying goes, you'll spend 90% of your time looking at alternatives, and it will make up just 10% of your portfolio," Mr. Alford said.