Insights
Multi-Asset Solutions

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Objective Based Investing for Challenging Markets

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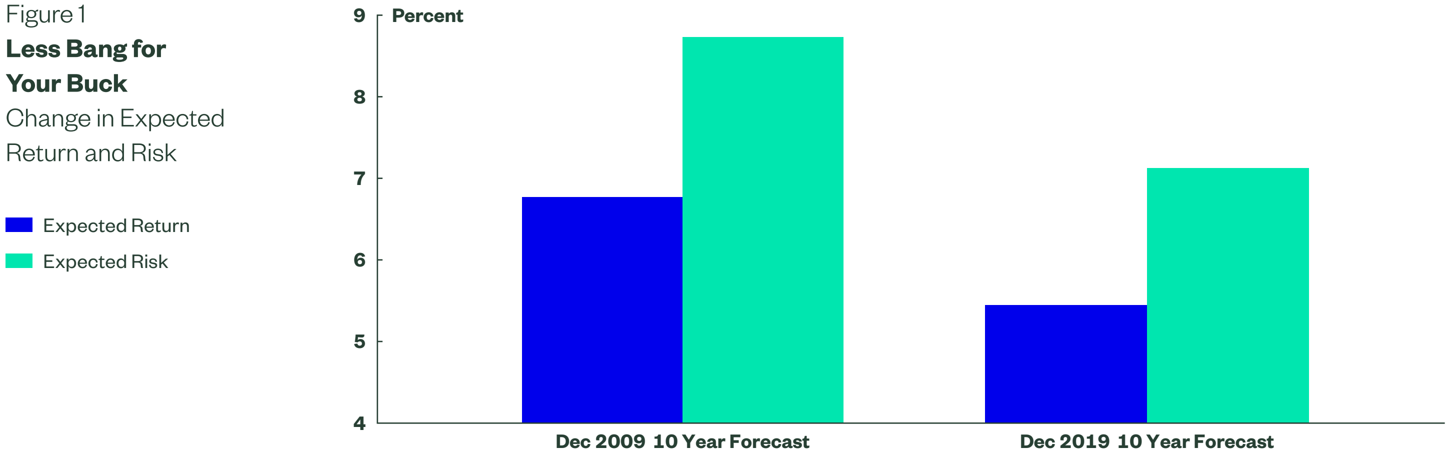
In an environment of lower expected returns, investors are looking for new assets that can help them meet investment objectives. This has led many to turn to alternative investments. While there are benefits to including alternatives, there are also a host of challenges. In this paper we look to provide context for the increased attention alternatives are gaining. We'll also explain some of the challenges investors face and provide some guidance on what investors should consider.

Lower Expected Returns

Every three months, we estimate future long-term returns for different asset classes (long term being 10 years). Our estimates for equities, for example, allow for dividend yields, earnings growth rates, inflation and changing earnings multiples. For fixed income we consider the shape and level of the yield curve, as well as credit spreads and default rates.

The Figure 1 below traces how these long-term return estimates have changed over time for a simple balanced portfolio with 70% equities and 30% bonds. In June 2009 we estimated a long-term return of 7.32% pa. By June 2019, this has reduced by almost 2% pa to 5.38% pa. Looking further forward we believe that future returns for simple balanced portfolios will be substantially lower than the returns we have seen over the last decade.

Figure 1
Less Bang for Your Buck
Change in Expected Return and Risk



Asset Class	Weight (%)
Global Developed Equities	35
Australian Equities*	35
Australian Government Bonds**	30

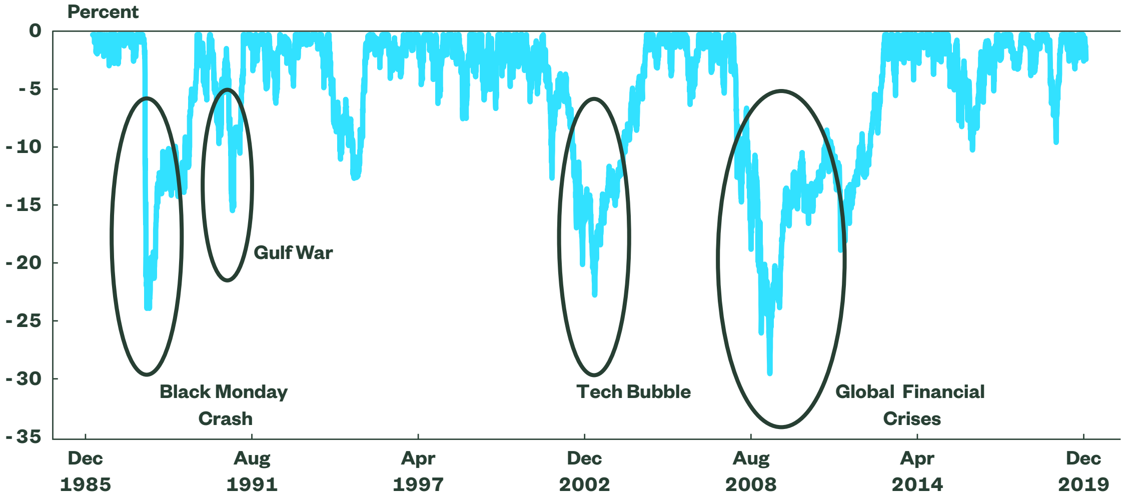
Source: FactSet Research Systems. As of 31 December 2019. Past Performance is not a guarantee of future results.
Forward earnings yield is the forward earnings divided by the current price.
* Proxied with Asia Pacific equities when Australian Equities were not available.
** Proxied with Non-US Government bonds when Australian Government Bonds were not available.
Forecasts are based upon estimates and reflect subjective judgements and assumptions. There can be no assurance that developments will transpire as forecasted and that the estimates are accurate.

Risks Remain

With lower future returns on the horizon, you might hope that future risks will also be lower. Some of our modelling does indeed suggest that the risks are falling. Specifically, our quarterly estimates include forecasts of the *variability* of monthly returns also known as volatility. The variability of monthly returns has been falling in many markets over the last 10 years, and this is reflected in our forecasts.

However, we know that investors' aren't concerned with minor variations in monthly returns. They are concerned about large and sudden falls in the value of their portfolios, otherwise known as "drawdowns". There have been many occasions over recent decades where a simple balanced portfolio would have experienced a drawdown of more than 10%. These include the "Tech Wreck", the "Gulf War" and the "GFC".

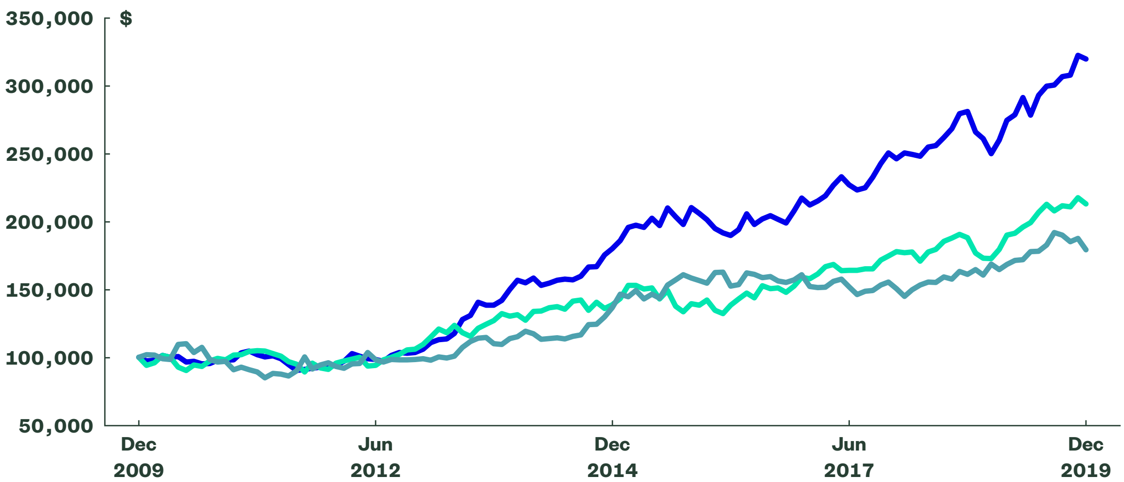
Figure 2
Drawdown for 70/30 Balanced Portfolio, Dec 31, 1985–Dec 31, 2019
Even Balanced Portfolios, When Static Can Leave Investors Vulnerable in Times of Market Stress



Source: MSCI, Barclays, State Street Global Advisors. Returns do not represent those of an index but were achieved by mathematically combining the actual performance data of 35% MSCI Australia/35% MSCI World/30% FTSE Australia GBI. The performance assumes no transaction and rebalancing costs, so actual results will differ. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Past performance is not a reliable indicator of future performance.

Notable in the Figure 2 above is the *absence* of any large drawdowns since the GFC. Not only have month to month returns been relatively stable, we have not witnessed any large market falls. Equity markets have risen steadily over the last 10 years. As interest rates have continued fall, market values have also risen steadily in bond markets.

Figure 3
Growth of $100,000 for Major Markets



Source: Bloomberg, as of 31 December 2019.
Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Past performance is not a reliable indicator of future performance.

Including a diverse range of assets can help investors weather different market environments and economic cycles. Traditionally, investors have used bonds to help protect portfolio values during an equity sell-off. Our concern is that the strong performance from bond markets over the last 10 years leaves investors exposed to a sell-off in the bond market as well.

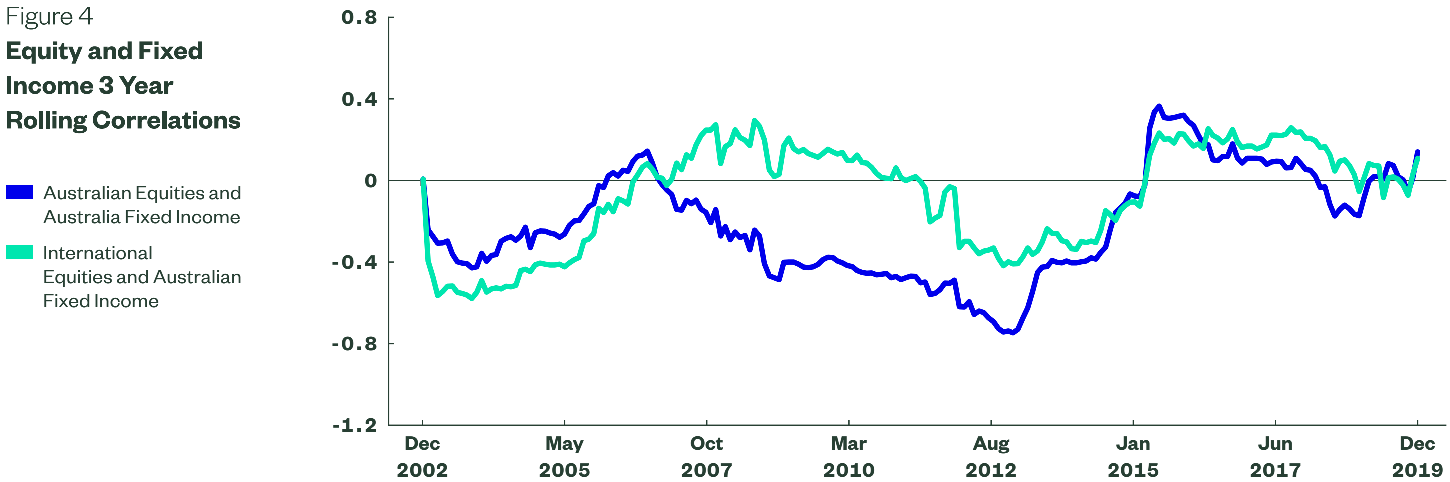
We believe that significant risks remain for simple balanced portfolios built using equities and bonds.

Diversification and Correlations

While investors have experienced strong market returns since the GFC, they learnt some hard lessons. Arguably, the most important lesson was is that correlations are not stable. This is significant because investors often rely on the diversification between asset classes to manage risk but diversification only works when correlations are consistently low or negative.

Consider the Figure 4 below, which shows three-year rolling correlations. The correlations for Australian equities and Australian bonds. range from -0.75 to 0.35, while they range from -0.6 to 0.25 for international equities and Australian bonds. Yes, they are (strongly) negatively correlated at times, but not always.

Figure 4
Equity and Fixed Income 3 Year Rolling Correlations



Source: Bloomberg, as of the 31 December 2019. Australian Equities = S&P/ASX 200 TR Index, International Equities = MSCI World Ex-Australia Index, Australian Fixed Income = Bloomberg Ausbond Composite 0+ YR Index.
The correlation coefficient measures the strength and direction of a linear relationship between two variables. It measures the degree to which the deviations of one variable from its mean are related to those of a different variable from its respective mean.

Investors who rely exclusively on diversification to manage risk are asking a lot of the bond market right now. Should equity markets sell off, these investors will be expecting strong returns from their bond portfolio to partially offset this. But that requires bond prices to increase, which means yields must fall further. With the current very low levels of yields across government bonds, that is asking a lot of the bond market.

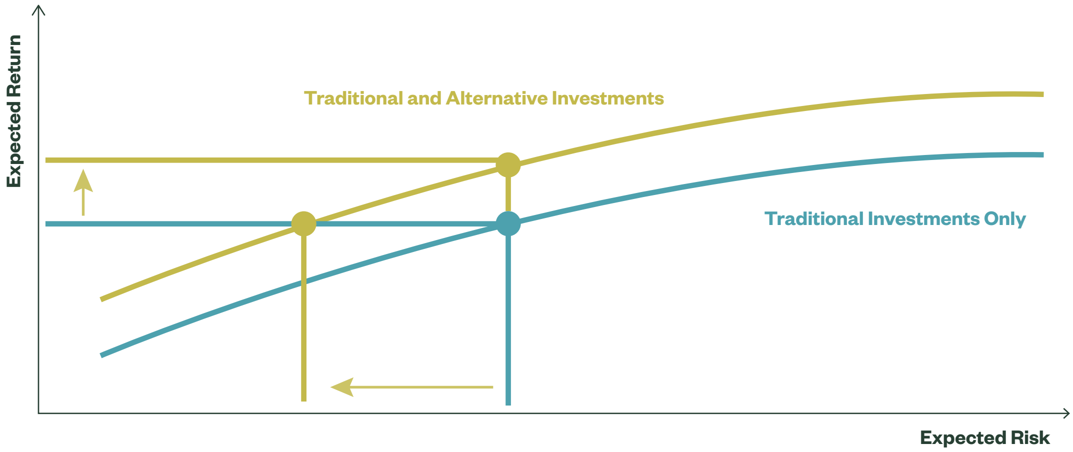
The Attraction of Alternatives

This leads us to the asset class loosely described as" Alternatives". We don't believe traditional assets alone will deliver the return or risk management characteristics that investors need, so investors globally are searching for new assets. By expanding the asset universe beyond traditional asset classes like equities and bonds, investors can construct more robust portfolios for today's environment. After 10 years where equity and bond markets have rallied, investors typically cite two attractive traits for their Alternatives investments:

- Equity like returns
- Drawdown risk management

Below we show a stylised representation of the impact that good Alternative assets can have on a portfolio.

Figure 5
Stylised Sample Portfolios
Risk & Return Expectations Over Time



Source: State Street Global Advisors. For illustrative purposes only — not drawn to scale.

The benefit of including good Alternatives is clear — they can help create more efficient portfolios. In the illustration above the "efficient frontier" has shifted up and to the left. This means for any given level of risk, including Alternatives allows us to construct portfolios with better expected returns. Similarly, where investors are targeting a set return, they can achieve this with lower expected risk if Alternatives are included.

However, finding *good* Alternative assets is not easy. The "Alternatives" asset class creates a lot of confusion for investors; even defining an "Alternative" is difficult.

Defining Alternatives

So how do you define what is, or is not, an "Alternative" investment? Unfortunately, there is no single definition for alternatives, other than by exclusion i.e., an asset that is not a "traditional" asset class like equities, bonds or cash.

Another way is to define alternatives is by what is included. The key here is understanding that Alternatives are not a homogenous asset class. Globally 40%[1] of allocations to Alternatives are made to hedge funds. But hedge funds are a diverse category including equity long short strategies, global macro, trend strategies, and event driven to mention but a few of the sub-categories. Under definition by inclusion, Alternatives would be defined as being represented by any of the below:[2]

- Real Assets
- Hedge Funds
- Private Equity
- Structured Products

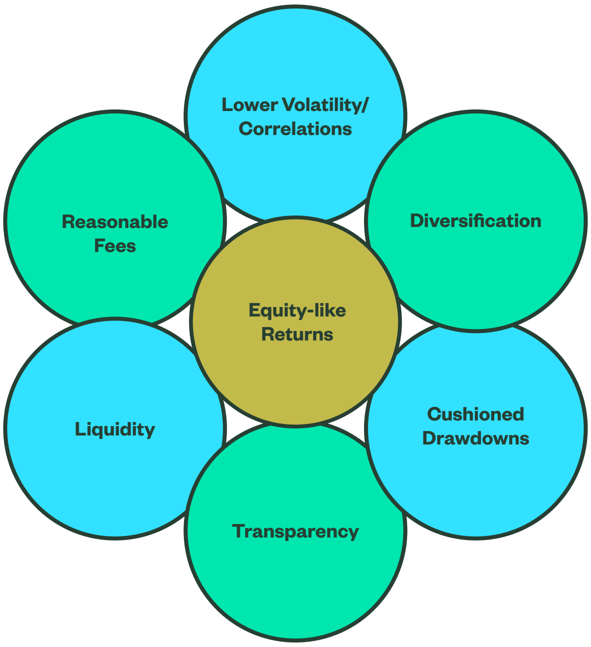
These are quite broad categories but some examples of the types of exposures that investors may find within these are:

Category	Example
Real Assets	Real Estate Core
	Real Estate Value Add
	Real Estate Opportunistic
	Infrastructure Core
	Infrastructure Multi-Asset
Hedge Funds	Equity Hedge Funds
	Event Driven
	Trend
	Macro
	Merger Arbitrage
	Relative Value
	Absolute Return
Private Equity	Leverage Buyout
	Venture Capital
Structured Products	Equity Linked structured products

Source: State Street Global Advisors. As at 31 Decemeber 2019.

Even under this definition, there is still a broad range of strategies that fall under the term "Alternatives". Further distinctions can be made between listed (such as hedge funds) and unlisted (such as private equity) strategies. Distinctions can also be made based on liquidity or price transparency.

Investor generally look at alternatives to provide the below characteristics:



Equity-Like Returns

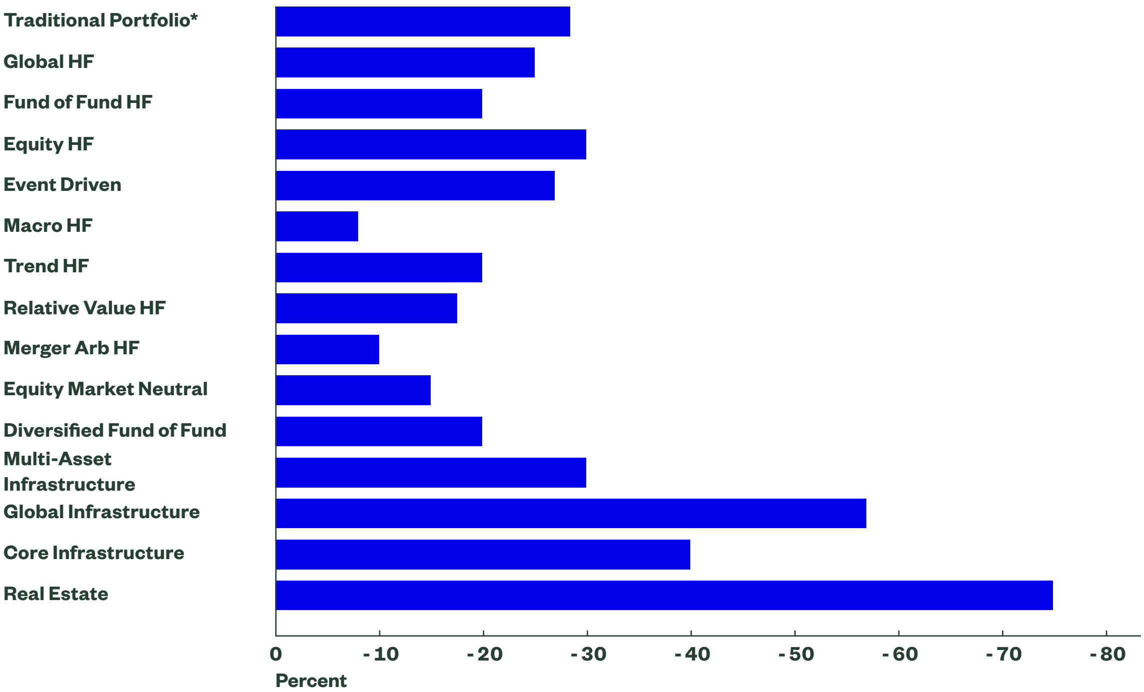
Investors' expectations are considerable. They want equity like returns, despite the other characteristics being more defensive. This means when forced to choose, investors will generally classify alternatives as a growth component of portfolios rather than defensive.

Diversification

Investors will often ask for "lower correlations to equities" is this what they really want? Investors want "lower correlation to equities when equities markets are down" but "equity like returns" in rising markets, This tells us that investors are seeking diversification properties to explicitly help manage drawdowns.

Some alternatives have been successful at this but not all. The Figure 7 below shows the maximum drawdown of a range of strategies (based on available index data) over the period from December 1999 to December 2018.

Figure 7
Maximum Drawdowns From a Range of Alternative Strategies
1999–2018



Source: State Street Global Advisors, Hedge Fund Research HFRX, Bloomberg.
Index returns reflect capital gains and losses and income. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Past performance is not an indicator of future performance.
*35% MSCI Australia/35% MSCI World/30% FTSE Australia GBI in AUD.
MSCI, Barclays, State Street Global Advisors. Returns do not represent those of an index but were achieved by mathematically combining the actual performance data of 35% MSCI Australia/35% MSCI World/30% FTSE Australia GBI. The performance assumes no transaction and rebalancing costs, so actual results will differ. Index returns reflect capital gains and losses, income, and the reinvestment of dividends. Past performance is not a reliable indicator of future performance.

Portfolio	Underlying Index
Traditional Portfolio	
Global HF	Hedge Fund Research HFRX Global Hedge Fund Index
Fund of Fund HF	Hedge Fund Research HFRI Fund of Funds Composite Index
Equity HF	Hedge Fund Research HFRX Equity Hedge Index
Event Driven	Hedge Fund Research HFRI Event-Driven Total Index
Macro HF	Hedge Fund Research HFRI Macro Total Index
Trend HF	SG Trend Index

Portfolio	Underlying Index
Relative Value HF	Hedge Fund Research HFRI Relative Value Total Index
Merger Arb HF	Hedge Fund Research HFRX ED Merger Arbitrage Index
Equity Market Neutral	Hedge Fund Research HFRX EH Equity Market Neutral Index
Diversified Fund of Fund	Hedge Fund Research HFRI FOF Diversified Index
Multi-Asset Infrastructure	Morningstar Gbl Multi-Asset Infra GR USD
Global Infrastructure	S&P Global Infrastructure Index
Core Infrastructure	FTSE GLOBAL CORE Infrastructure INDEX TR USD
Real Estate	S&P/ASX 200 A-REIT Index

The traditional portfolio with its static asset allocation, had a maximum drawdown of almost 30%. Some alternative strategies have been able to cushion the drawdown, in particular Macro Hedges and Merger Arbitrage Hedge Funds. Both (represented by index data) posted drawdowns of less than 10%. *It should be noted that index data for alternatives will not be representative of the performance of any individual managers.*

Transparency

Identifying the right manager and understanding what they are doing is critical. In the past, most alternative managers operated in a black box. Investors are increasingly seeking more transparency to understand:

- How strategy generates returns?
- How it will perform under different market environments
- How it will correlate with other assets in the portfolio

Liquidity

Some investors are willing to accept a degree of illiquidity which opens a wider range of options. However most investors require daily liquidity, which narrows the alternative universe in an effort to avoid:

- the risk of getting locked into a strategy if the fund is gated
- the risk that the strategy suffers a liquidity squeeze under adverse market conditions

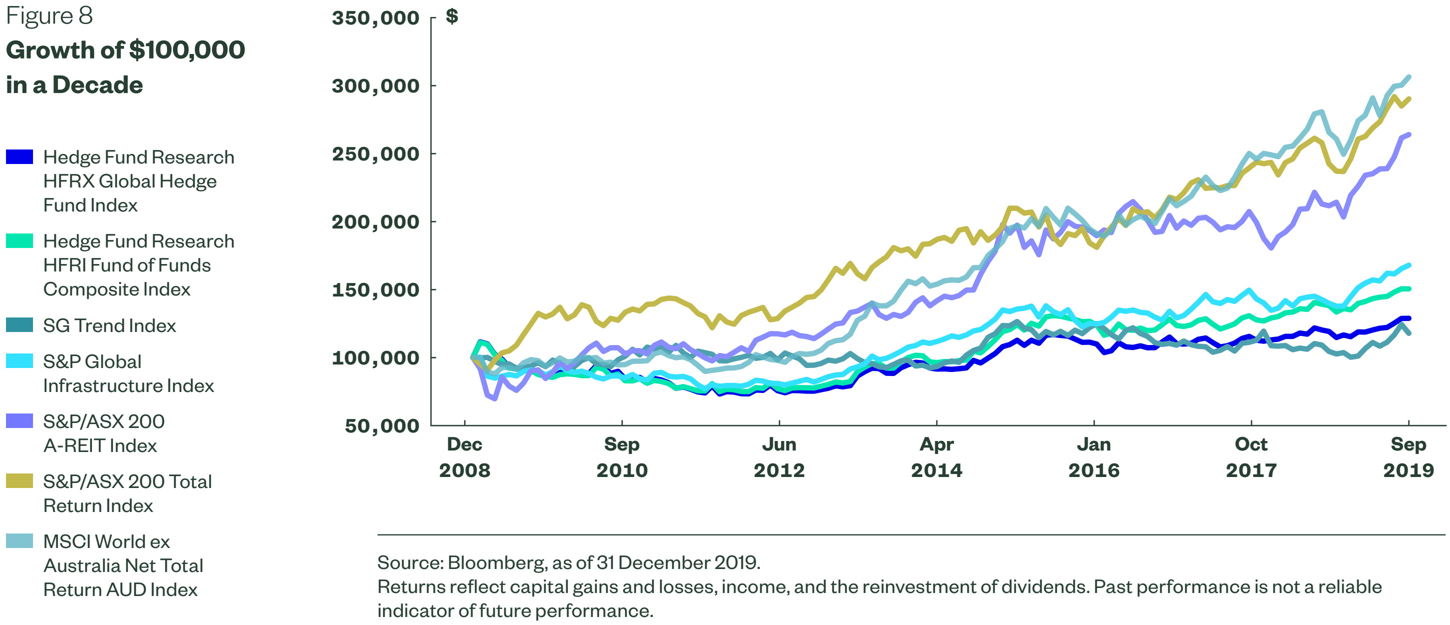
Reasonable Fees

Finally, investors are increasingly looking for “reasonable” fees. They may be willing to pay a manager for their skill, but the industry is under increasing fee pressure and alternative asset managers are not exempt.

Performance

The list of requirements from investors is long making it challenging for firms providing alternative investments. As shown in the Figure below, the focus on helping to manage drawdowns has meant they have struggled to keep pace with the equity market rally post the GFC.

Figure 8
Growth of $100,000 in a Decade



Source: Bloomberg, as of 31 December 2019.
Returns reflect capital gains and losses, income, and the reinvestment of dividends. Past performance is not a reliable indicator of future performance.

Meeting Investor's Needs

Meeting all the requirements investors may lay out is challenging particularly at this point in the market cycle. One category that is trying to broadly meet investors needs is absolute return funds. In the Morningstar database there are 65 Australian domiciled funds listed as "Multi-Asset Flexible". The typical objective across these funds is (Australian) CPI + 5% p.a. That generally equates to what investors are expecting equity markets to deliver over the next 10 years.

However, even across these absolute return funds, there are a range of managers with different approaches to achieving the same goals. Investors should form their own beliefs on the ability of these strategies to deliver. One aspect that makes that task easier for investors is that most of these Multi Asset Flexible Funds are simpler to understand and more transparent. They tend to be long only, invest in liquid markets and provide daily pricing.

They also have a clear focus on downside risk management, aiming to cushion drawdowns. The volatility of these types of funds is typically two thirds of equity markets. Investors should ensure that there is a balance between aiming to meet the return objective and the risk the strategy takes.

Finally, there are fees. Fees across this segment of the alternative universe tend to be more reasonable.

Things investors should consider when assessing any alternative:

- Will the strategy deliver on the objective?
- Is it true to label and following the approach the manager has outlined?
- Is it providing exposure to up markets and reduced exposure to down markets?
- Is it providing diversification to the existing asset classes?
- If liquidity is important does it provide daily pricing?
- Are the fees reasonable? And are there any hidden fees?

Endnotes

1 Source: EY 2018 Global Alternative Fund Survey.

2 Alternative Investments — CAIA Level 1 Third Edition, Donald R Chambers, Mark J P Anson, Keith H Black, Hossein Kazemi.