MACQUARIE

Investment Strategy Update #96

Alternatives – why the time is now

- Listed markets have endured a very difficult 1Q22 with global bonds and equities falling anywhere between 5-8%. Allocations to alternative assets has helped cushion the blow, but for most portfolios even this has been insufficient given returns from traditional assets.

- The global economy is transitioning into the mature phase of the cycle (*see Investment Strategy Update #95: Asset Allocation through the business cycle)* which is characterised by weaker and more volatile returns from traditional assets. Allocating to alternatives should help improve the risk-reward outlook for a diversified portfolio given higher expected returns alongside a low correlation with bonds and equities.

- In 2020 we raised our strategic allocation to alternatives assets to ~15%, reflecting the potential for lower returns from traditional assets given a maturing cycle and elevated valuations. For those who are prepared to give up some near-term liquidity, alternatives will play an increasingly important role in portfolios in coming years.

- Alternatives are not completely immune to market volatility and investors must be prepared to take a medium to long term view on realising value particularly as the backdrop for alternatives faces increasing headwinds on several fronts:

    - Exit activity has cooled as businesses and dealmakers look to delay M&As and IPOs in the face of ongoing uncertainty and high volatility.

    - Valuation compression is flowing through to private markets, threatening years of expanding revenue multiples on private valuations.

    - Dispersion of fund performance continues to grow, raising the stakes for manager selection.

- On the other hand, certain alternative strategies thrive on rising / high volatility. **Hedge funds** benefit from an improved environment for shorting and stock selection, **macro strategies** can pull more levers to position for the current backdrop (and have been the best performing strategy YTD) while **multi-strategy funds** provide solid diversification. These are our preferred strategies for the current market which should help preserve capital with a *lower* correlation to markets.

Alternatives are well placed for the current market

Traditional asset classes are facing a challenging environment as markets grapple with geopolitical tensions, elevated inflation and monetary policy tightening. As such, investors are also facing the prospect of lower returns in public markets. Similarly, while one of the biggest benefits of private markets is reduced volatility in valuations relative to public markets, the private landscape is also changing as investors become more cautious off the back of rising capital costs and weakening confidence. While 2021 was a great year for private market returns (with most recent fund vintages delivering an outperformance of 7-15% versus public markets), moving forward, private market returns are expected to normalise back towards long term averages, with an expected outperformance of ~1-2% over public markets.

Nevertheless, certain alternative strategies thrive on rising / high volatility and against this backdrop, we expect select strategies to deliver superior risk adjusted returns over the medium to long-term relative to other asset classes while also providing diversification benefits and downside risk protection.

Alternatives have low long-term correlation with other asset classes

Public and private market correlations, quarterly returns (2008-2021)

	Public markets		Private markets			Hedge funds		
	Global Bonds	Global Equities	Direct Lending	Venture Capital	Private Equity	Macro	Equity L/S	Relative Value
Global Bonds	1.0							
Global Equities	0.3	1.0						
Direct Lending	0.0	0.7	1.0					
Venture Capital	0.0	0.6	0.5	1.0				
Private Equity	0.2	0.9	0.8	0.8	1.0			
Macro	0.3	0.4	0.2	0.4	0.3	1.0		
Equity L/S	0.2	1.0	0.7	0.7	0.9	0.5	1.0	
Relative Value	0.2	0.9	0.9	0.5	0.8	0.4	0.9	1.0

Source: MSCI, Bloomberg Barclays, Cambridge Associates, NCREIF, Cliffwater, HFRI, JPMAM, March 2022

Role of Alternatives within a portfolio

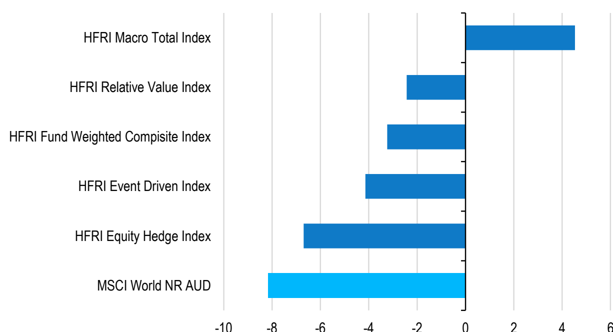
We see Alternatives delivering the following benefits for portfolios:

- **Strong alpha generating opportunities:** With the VIX (measure of market volatility) unlikely to settle back to its pre-pandemic levels of ~15 in the coming 12 months, Alternative managers should benefit from high stock and factor dispersions as it gives rise to opportunities for them to generate alpha through differentiated trading strategies.

- **Downside protection:** While inflation is viewed as a headwind for market performance, it can also present trading opportunities for hedge fund managers. By diversifying portfolio returns away from interest rate, equity market and credit spread risks (which typically dominate multi-asset class portfolios), investors can reduce their volatility exposure and smooth the path of overall portfolio returns.

- **Less correlated / uncorrelated returns:** Alternative strategies have historically had low correlation with other asset classes (equities, fixed income, commodities) and as such provide an opportunity for diversifying portfolio return streams.

Hedge funds have the potential to deliver uncorrelated returns during public market downturns



Source: HFRI, MWM Research, April 2022

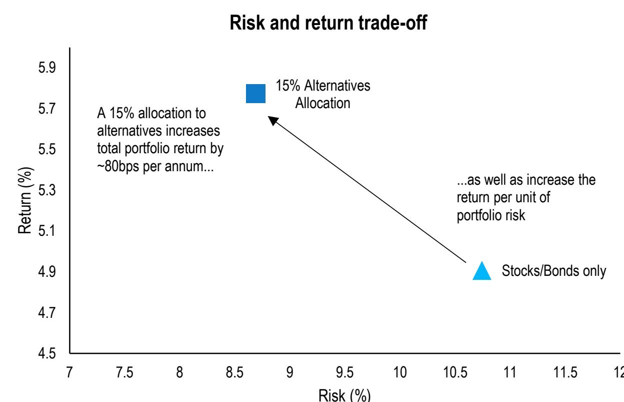
Alternatives to hedge against downside risks

Alternatives can be used to optimise the expected level of return at a given level of risk or to maintain expected returns while reducing risk exposure and hence smooth the overall path of portfolio returns because of low correlations to traditional assets and a higher expected return.

The predominant driver of returns in a 60:40 portfolio is typically equity market beta, interest rate and credit risk. Another way of increasing expected returns without taking on additional beta is to consider Alternative strategies which focus on generating returns from idiosyncratic or "stock-specific" risk. **This includes long/short equity funds as well as hedge funds strategies such as diversified macro strategies and multi-strategy funds.**

Hedge funds have historically been able to provide return and diversification benefits during periods of crises and market downturns as many strategies hedge out beta risks (market risk, sector risk). For example, the HFRI Fund Weighted Composite Index outperformed equity markets by ~10% during the first quarter of 2020. This plays an important role within a portfolio construction context, as by participating less in the initial drawdown, this means investors and their portfolios do not have to work as hard to recoup losses and return to where they were before the drawdown.

Including Alternative strategies improves risk and return profiles of portfolios

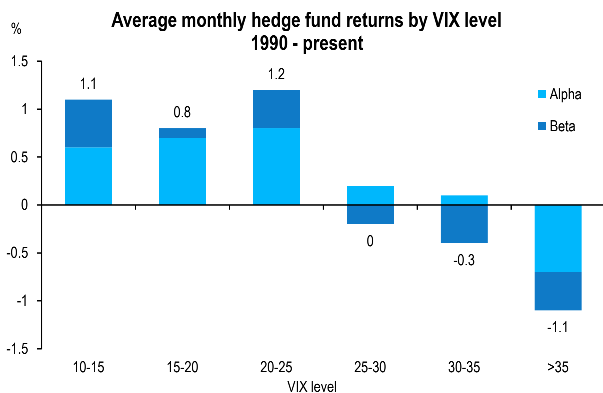


Source: Factset, NFA, MWM Research, July 2021

Lower expected equity/bond returns raise the return appeal of Alternatives

Higher valuations embedded in bond and equity markets are pulling down their expected total returns over the long-term forecast horizon. Further, the ability of bonds to cushion overall portfolio returns from volatility and drawdowns in risk assets is also reduced given the absolute low level of yields. As many hedge fund strategies seek to generate returns that are independent from / uncorrelated to the performance of public equity and fixed income markets, they have the potential to deliver attractive risk-adjusted returns relative to other asset classes. In particular, hedge funds have shown to be able to deliver attractive risk-adjusted returns during periods of moderate to elevated volatility.

Elevated volatility has historically provided alpha generation opportunities for hedge fund strategies

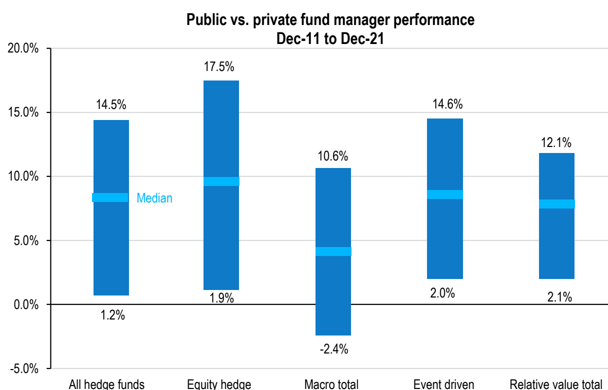


Source: HFRI, JPMAM, MWM Research, March 2022

However, it is important to note that Alternative strategies are not homogeneous and come with a range of unique risks, some which are also increasing:

1. Performance dispersion between alternative and traditional asset managers has historically been very wide, for example, over the last ten years the difference between the top and bottom quartile hedge fund managers was almost 14%. This means manager selection is crucial to ensure the impact to portfolios is beneficial on a risk-adjusted basis.
2. Impending rate hikes, ongoing geopolitical conflict and escalating supply chain disruptions have dampened exit activity as dealmakers hit pause on M&As and IPOs in 1Q22. Valuation compression, particularly in tech companies which dominate a large portion of private markets, are also hurting both deal and exit activity.

Significant return dispersion exist between top and bottom hedge fund managers



Source: HFRI, JPMAM, March 2022

Our preferred Alternative strategies

Hedge funds are our preferred allocation within Alternatives due to the potential for strong alpha generation, low correlation to traditional asset classes and a focus on downside protection to deliver risk-adjusted returns. In particular, we like the following hedge fund strategies:

- **Equity long/short strategies:** These strategies aim to create alpha via a manager's skill at stock picking and involve buying (or going long) stocks that the manager expects to appreciate in value and sell (or go short) positions that are anticipated to decrease in value. Both long and short positions within a portfolio are expected to deliver outperformance, while minimising exposure to the overall equity market.

- **Macro strategies:** These strategies apply an opportunistic approach that aims to generate returns from market swings caused by geopolitical and/or macroeconomic events. Macro strategies seek to maximise returns during periods of higher market volatility and lower liquidity. They often have a lower-beta equity exposure and an idiosyncratic return profile. A shift in policy regime (such as the environment investors are in now) creates market opportunities for macro managers with a tactical and nimble approach.

- **Multi-strategy funds:** The aim of a multi-strategy funds is to combine multiple uncorrelated strategies together (e.g. equity market neutral, equity and credit arbitrage, event driven and relative value strategies to name a few) in order to deliver returns during any market environment. Managers accomplish this by identifying which strategy should be overweight or underweight against the current market backdrop in order to achieve risk-adjusted returns. Whereas single strategy funds are limited in their scope of investment opportunities and may not always consistently perform across all environments, the benefit of multi-strategy funds is in their flexibility to capitalise on the best strategy for a given market and thereby shifting risk to more than one strategy and reduce the risk of the overall fund.

Macquarie WM Investment Strategy Team

The report was finalised on 26 April 2022.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

The analyst(s) responsible for the preparation of this research receives compensation based on overall revenues of Macquarie Group Limited (ABN 94 122 169 279 AFSL 318062) ("MGL") and its related entities (the "Macquarie Group", "MGL", "We" or "Us"). No part of the compensation of the analyst(s) was, is or will be directly or indirectly related to the inclusion of specific recommendations or views in this research.

This research has been issued and is distributed in Australia by Macquarie Equities Limited (ABN 41 002 574 923 AFSL 237504) ("MEL" or "We"), a Participant of the ASX. MEL is not an authorised deposit-taking institution for the purposes of the Banking Act 1959 (Cth), and MEL's obligations do not represent deposits or other liabilities of Macquarie Bank Limited (ABN 46 008 583 542). Macquarie Bank Limited does not guarantee or otherwise provide assurance in respect of the obligations of MEL.

This research contains general advice and does not take account of your objectives, financial situation or needs. Before acting on this general advice, you should consider if it is appropriate for you. We recommend you obtain financial, legal and taxation advice before making any financial investment decision. Past performance is not a reliable indicator of future performance. You should consider all factors and risks before making a decision. Please refer to MEL's Financial Services Guide (FSG) for more information at **https://www.macquarie.com.au/advisers/financial-services-guide.html**.

This research has been prepared for the use of the clients of the Macquarie Group and must not be copied, either in whole or in part, or distributed to any other person. If you are not the intended recipient, you must not use or disclose this research in any way. If you received it in error, please tell us immediately by return e-mail and delete the document. We do not guarantee the integrity of any links, e-mails or attached files and are not responsible for any changes made to them by any other person. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any transaction. This research is based on information obtained from sources believed to be reliable, but We do not make any representation or warranty that it is accurate, complete or up to date. We accept no obligation to correct or update the information or opinions in it. Opinions expressed are subject to change without notice. We accept no liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research. The Macquarie Group produces a variety of research products, recommendations contained in one type of research product may differ from recommendations contained in other types of research.

The Macquarie Group has established and implemented a conflicts policy at group level, which may be revised and updated from time to time, pursuant to regulatory requirements, which sets out how we must seek to identify and manage all material conflicts of interest. The Macquarie Group, its officers and employees may have conflicting roles in the financial products referred to in this research and, as such, may affect transactions which are not consistent with the recommendations (if any) in this research. The Macquarie Group may receive fees, brokerage or commissions for acting in those capacities and the reader should assume that this is the case. The Macquarie Group's employees or officers may provide oral or written opinions to its clients which are contrary to the opinions expressed in this research. Investors should obtain and consider the Product Disclosure Statement ("PDS") or offer document of the financial product before making any financial investment decision. You can obtain the relevant PDS or offer document by contacting the issuer of the product, or as identified below:

Important disclosure information regarding the subject companies covered in this report is available at **macquarie.com/disclosures**.

© 2022 Macquarie Group. All rights reserved