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OBSERVATIONS

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Embracing the alternative lifestyle

Alternative investments, such as hedge funds and private equity, have historically been the domain of institutional investors such as superannuation, university endowment, and sovereign wealth funds. In recent times, however, they have become more popular with private investors due to the value they can add to the overall risk/return efficiency of a portfolio.

In this article, we look at the key benefits of investing in alternatives or hedge funds, and discuss how they can be incorporated into a diversified investment portfolio.

The potential to limit downside risk

One of the key benefits of investing in alternatives or hedge funds is that they exhibit a low correlation to traditional asset classes such as equities, bonds and property.

Correlation refers to the way in which assets move together from a directional perspective. A low correlation means that hedge funds have the ability to earn a positive return irrespective of whether equities or bonds are performing well—although it should be stressed there is no guarantee this can happen. Furthermore, the low correlation between hedge funds and traditional asset classes means that, when combined, the downside risk of an overall portfolio can be reduced during volatile market environments. As shown in the following table, global macro strategies, in particular display this low correlation trait.

Figure 1: Correlation of global macro hedge funds

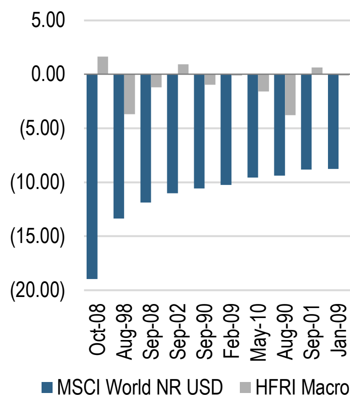
	60% MSCI WORLD/40% CITI WGBI	CITIGROUP WGBI (BOND BENCHMARK)	MSCI WORLD (EQUITY BENCHMARK)	US 3-MONTH BANK BILL
HFRI macro	0.32	0.31	0.27	0.08
HFRI systematic	0.03	0.28	(0.03)	0.17

Source: MercerInsight. Data from December 2008 to December 2015.

The low correlation is in evidence during normal market conditions, but it is particularly obvious during periods of heightened volatility. In 2008, during the height of the Global Financial Crisis (**GFC**), domestic equities and domestic property fell 38.4% and 54.0% respectively. Conversely, however, the HFRI Fund Weighted Composite index gained 1.98% in Australian dollar terms (-19.03% in US dollar terms).

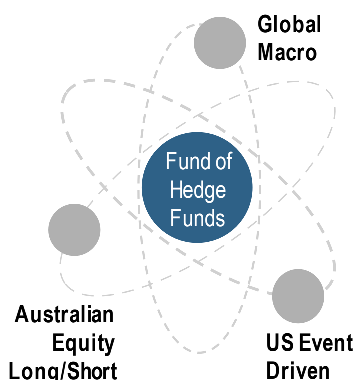
Additionally, while the GFC was an extreme environment, the ability for hedge funds to limit downside risk is also obvious in months where equity markets have produced large negative monthly returns. Figure 2 over the page shows how global macro hedge funds have performed in the ten worst months for global equity markets over the last 25 years.

Figure 2: Outperformance of global macro funds



Source: Bloomberg, Crestone Wealth Management. Data from 1990 to 2016.

Figure 3: Core satellite approach to hedge fund investing



Source: Crestone Wealth Management

Additional sources of return

An additional benefit of hedge funds is that they source return differently to traditional asset classes. These return sources can take many forms—but essentially, it means they do not need to rely on positive performance from traditional asset classes in order to make money. This is particularly important when traditional asset classes appear fully valued such as at present. Two examples of hedge funds that source return from outside traditional asset classes are provided below:

Event-driven strategies

These strategies attempt to capitalise on major corporate events such as takeovers, bankruptcies or special cash distributions (share buy-back of special dividends). To better understand how this works in practice, a sub-strategy is 'merger arbitrage' which seeks to profit from announced mergers, typically by buying the stock of a target firm and short-selling the stock of the acquiring company. The directionality of the overall market is irrelevant to the profitability of this trade with only the relative performance being of importance.

Global macro strategies

These strategies seek return from a broad range of asset classes including international equities, bonds, currencies, and commodity markets. They can also make both directional or relative value trades. The breadth of this opportunity set allows returns to be captured in markets and ways that are often very different to traditional asset classes.

To better understand how these strategies work in practice, a typical trade for a 'macro' hedge fund might be to buy Australian 10-year government bonds and, at the same time, sell US 10-year government bonds. This is a relative value trade whereby the manager seeks to make money if Australian interest rates go down more than US rates, or if Australian interest rates go up by less than US rates. The overall direction of interest rates is unimportant with the relative movement between Australian and US interest rates being the important factor.

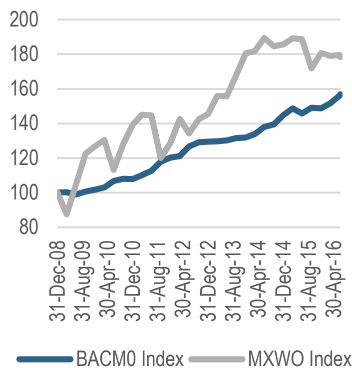
Incorporating hedge funds in your portfolio

Event driven and global macro strategies are two of the major hedge fund strategies available to investors—but there are many more such as equity long/short, distressed debt, quantitative arbitrage and convertible arbitrage. In addition, there is the option to invest in strategies that are geographic-centric such as Australian long/short, or European distressed debt. In light of the expertise and time needed to manage such strategies, as well as capital restrictions, it can be extremely difficult for a private investor to build a portfolio of hedge funds by themselves.

We believe the best way to include hedge funds in your portfolio is via a 'core-satellite' approach. It is advisable that the core, or bulk, of your exposure is managed by a team of experienced professionals who are solely dedicated to understanding hedge funds and constructing hedge fund portfolios. This type of vehicle is called a fund of hedge funds (**HFOF**) and provides diversified access to a range of managers across geographies within a single fund.

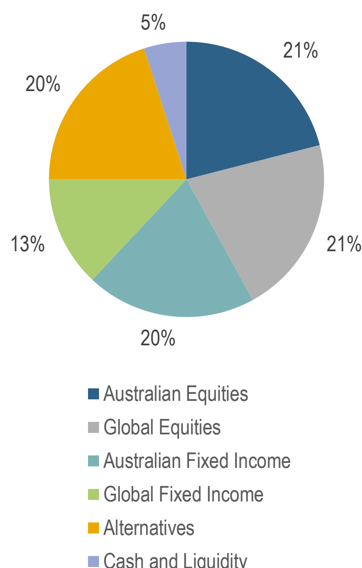
The satellite component enables you to complement the core of the hedge fund portfolio with specific strategies that are either opportunistic in nature, niche or that simply offer an increased exposure to a strategy which best suits the investor's risk/return profile. An example of this may be to add an Australian equity market neutral fund (a non-directional type of equity long/short fund) to the portfolio in conjunction with a global HFOF—see Figure 3.

Figure 4: Global equities and bonds have rallied in unison since the GFC



Source: Bloomberg, Crestone Wealth Management. Base date is December 2008.

Figure 5: Our strategic asset allocation for a balanced portfolio



Source: Crestone Wealth Management. Data as at 30 June 2016.

Understanding the risks

While there are many benefits associated with investing in alternatives, it is important to remember that, like any investment, there are also risks involved. In addition to the possibility of capital loss due to adverse market behaviour, alternatives are also subject to less liquidity than investing in public markets, and usually less regulation. Also, when an investment strategy relies on a specific person's skillset, there can be key person risk involved.

Liquidity, in particular, is something that investors need to consider as investments are usually redeemable only on a monthly or quarterly basis, and in times of severe market distress, such as during the GFC, redemptions can be frozen to protect existing positions. Investors need to understand and be comfortable with this lower liquidity profile before investing in alternatives.

An appropriate allocation

We believe that an allocation to a lowly correlated asset class is now more important than ever to gain portfolio diversification. This is due to the higher correlation that now exists between equities, bonds and listed property. Historically, these asset classes have moved relatively independent of each other. However, this is no longer the case as almost all asset classes have rallied in unison as a result of central bank policies such as quantitative easing—see Figure 4.

An investor's allocation should be significant enough to generate both return across the market cycle, and to dampen overall portfolio downside if volatility increases. It also needs to reflect your comfort level with hedge fund strategies and your individual risk profile.

Our current strategic asset allocation recommends that an investor with a 'balanced' risk profile should have around 20% of their portfolio in alternative assets. However, this allocation also includes additional alternative investments such as private equity. As such, an allocation of between 10–15% to hedge funds would seem appropriate for an investor with a 'balanced' risk profile.

While this allocation to alternatives might seem high if you have had limited previous exposure to hedge funds, it is important to note that it is low relative to many global institutional investors, and is consistent with Australia's Future Fund asset allocation. As at March 2016, the Future Fund had 12.7% allocated to hedge funds and 9.8% allocated to private equity.

Conclusion

We believe that alternative investments such as hedge funds have an important role to play in your portfolio as both return drivers and volatility dampeners. The role they play has become even more important given the multi-asset class boom that has resulted from polices such as quantitative easing. As with your broader portfolio, it is best to access this investment via a diversified portfolio of underlying strategies and geographic exposure.

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