

# The Case for Liquid Alternatives, Especially Now

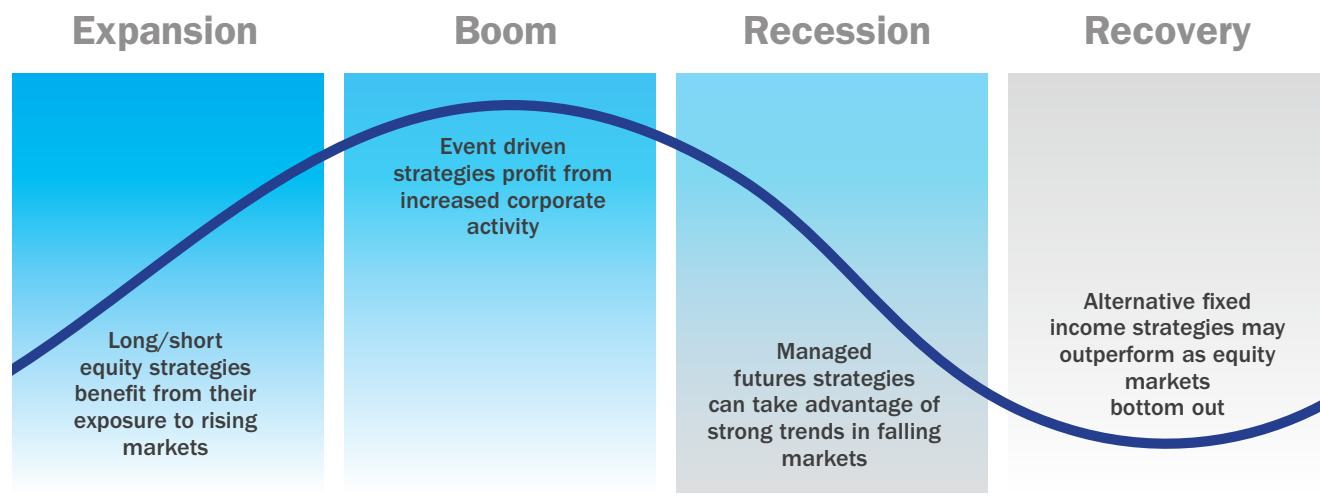


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While we have long advocated that alternatives should be a core allocation within any diversified investment portfolio, there are certain periods during an economic cycle in which it may be more advantageous to be hedged or have exposure to alternate sources of return than others. In this article, we will examine: 1) Why Envestnet | PMC believes that investors should own some liquid alternatives in their portfolios at all times, and 2) Why liquid alternatives make sense, especially in the current environment.

## Why Liquid Alternatives

Liquid alternatives can do many things that traditional mutual funds can't or don't. For example, liquid alternatives can take short positions in stocks, making them less vulnerable to or even able to profit from a declining stock market. They can also go negative in bond duration, enabling them to profit from a rising interest rate environment. Additionally, liquid alts can participate in many investment strategies that have virtually no correlation to traditional investments, such as arbitrage and futures trading which makes them excellent diversifiers.



The above descriptions are generalizations. There can be many other factors that can influence the relative performance of alternative investments.

The major attraction of liquid alternatives is enhancing diversification of traditional portfolios, as evidenced during the past two major recessions and market crises – the dot-com bubble burst (2000 – 2002) and the financial crisis (2007 – 2009). During the dot-com bubble burst, the S&P 500 Index fell 44% from peak to trough (3/24/2000 – 10/9/2002) while the HFRX Global Hedge Fund Index, a proxy for liquid alternatives, gained 17% during the same period. During the financial crisis, the S&P 500 Index plunged 55% from peak to trough (10/9/2007 – 3/9/2009) while the HFRX Global Hedge Fund Index declined 23% – 3,000 basis points of relative outperformance.<sup>1</sup> The drop during the financial crisis is mostly due to the severe disruptions of financial markets that prevented many types of liquid alternatives from fully executing on their investment strategies. Notably, the disruptions were so significant that short-selling on bank stocks was temporarily banned in the U.S. during the Fall of 2008, an extremely rare and controversial move, making it nearly impossible for long/short and market-neutral equity liquid alternatives to fully carry out their investment strategies during this period.

It is extremely difficult to time when a recession, bear market or economic crises is going to take place and it is important to be properly diversified. Since liquid alternatives can still provide benefits to a portfolio in rising markets, they are solid stand-alone investments. Over the trailing 20-year period ended on June 30, 2018, which spans multiple full market cycles, the HFRX Global Hedge Fund Index had an annualized return of 4.3% versus 6.5% for the S&P 500 Index but with an annualized standard deviation of 5.9% versus 14.8%, resulting in a similar Sharpe ratio (the measure of risk-adjusted return) of 0.42 versus 0.37.<sup>1</sup> Certainly, they are underutilized by the average retail investors and may aid in providing a smoother return experience without sacrificing risk adjusted performance.

## Why Liquid Alternatives – Especially Now

While no one knows for sure how long the current economic expansion will last and how high the stock market can go, there is little argument that we are currently in the late cycle of economic expansion. The unemployment rate is at or near its historical low, the Fed is raising short-term rates and tightening and M&A (merger & acquisition) is booming, to name a few – all hallmarks of a late-cycle period. This late-cycle market environment is very constructive for liquid alternatives and there are a number of ways in which they can benefit:



### Rising Short-Term Interest Rates

This is almost universally positive for most liquid alternatives. As a result of using derivatives, many liquid alternative strategies need to keep ample cash-equivalent to meet additional collateral requirements or simply maintain appropriate levels of economic leverage. With the Fed far from finished with raising rates and short-term interest rates rising, the returns on these cash-equivalents can be an added tailwind as compared to virtually nothing just several months ago.

### Intermediate- and Long-Term Interest Rates Trending Up

While these interest rates can be volatile, the major trend is up. Many liquid alternatives such as alternative fixed-income have the ability to go negative in bond duration and benefit from rising interest rates.

### Higher Dispersion of Stock Performance

During late cycle of an economic expansion, stock performance becomes more divergent as some companies can handle economic headwinds such as rising interest rates and rising inflation better than others. For long-short and market-neutral equity liquid alternatives, there may be more opportunities for them to buy the winners while shorting the losers.

### Abundant M&A Deals

During the late cycle of economic expansion, companies rely more and more on M&A to keep growing rather than focusing primarily on organic growth as with the early cycle of economic expansion. As a result, there is likely to continue to be ample M&A deals for event-driven liquid alternatives such as merger arbitrage to choose from and potentially profit from these deals.

<sup>1</sup>Source: Bloomberg

## Conclusion

It is important to examine these strategies through a lens of diversification and capital preservation. Consequently, it should come as no surprise that strategies that aim to reduce downside capture will exhibit lower beta and may meaningfully underperform during market rallies. However, in order to protect capital, some tracking error in positive equity markets should be balanced out when markets reverse course.

History reinforces the importance of allocating assets to liquid alternatives at all times, but now seems like a particularly good time to invest. The additional return potential of equity markets seems limited due to the late stage of the market cycle and interest rates are on the rise, leaving many fixed-income portfolios exposed. Liquid alternative strategies may be the perfect solution, as their broadened toolkit with the ability to short and utilize leverage opportunistically could aid in protecting on the downside.

## Author Bios

### Tim Clift

Chief Investment Strategist

Mr. Clift serves as Chief Investment Strategist at Envestnet | PMC and is responsible for research and consulting services for the organization. He leads a team of analysts who are responsible for the selection and monitoring of investment managers and a team of consultants who support institutional and advisory clients. Mr. Clift serves on PMC's Investment Committee and is instrumental in setting investment policy for the Company. Prior to joining Envestnet | PMC, Mr. Clift was the Chief Investment Officer and Chairman of the Investment Committee at FundQuest. He joined FundQuest in 1994 and maintained overall responsibility for the firm's investment management programs for separately managed accounts, mutual funds, alternative investments, exchange-traded funds, and annuities. As Chairman of the Investment Committee, he led a team of analysts and portfolio managers that produced the firm's research and recommendations.

Mr. Clift possesses over 24 years of industry and investment management experience. He received an MBA in Finance from Boston University and a BA in Economics from Allegheny College.

### Cynthia Crandall, CAIA

Senior Investment Analyst, VP

Ms. Crandall is a Senior Investment Analyst on Envestnet | PMC's Research team. Ms. Crandall is responsible for the due diligence of liquid alternative strategies on the fund's platform. The Research team works together to conduct manager searches and provide updated reviews and materials for consulting, portfolio management, and external clients.

Prior to joining the firm in 2013, Ms. Crandall led a team of hedge fund analysts for Cambridge Associates, where she spent the prior seven years conducting performance and manager reviews on the consulting company's robust roster of hedge fund managers.

Ms. Crandall holds a BS degree in Business Administration with a dual concentration in Finance and Organizational Behavior from Boston University. She has earned the Chartered Alternative Investment Analyst designation.

### Frank Wei, CFA, CAIA

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Mr. Wei is a Senior Investment Analyst on Envestnet | PMC's Research team. Prior to joining PMC, Mr. Wei served as a portfolio manager and analyst at FundQuest and was responsible for the oversight of separately managed accounts, as well as the management of client assets. Before joining FundQuest in 2001, he held positions at Salomon Smith Barney and ABN AMRO Securities as a Research Analyst and Equity Analyst, respectively.

Mr. Wei has over 20 years of industry and investment management experience. He holds a BA in Economics from East China Normal University and an MBA from the Leonard N. Stern School of Business at New York University. He has earned the designations of Chartered Financial Analyst and Chartered Alternative Investment Analyst.



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