

Should Liquid Alternatives Be Part of the Core Allocation?

Posted 04.22.15 From Michael Winchell, Larkin Point

Many advisors may view alternative investments as diversifiers in portfolios: satellite investments added to a portfolio of stocks and bonds in an attempt to “hedge,” or counterbalance a specific risk the advisor believes is not completely addressed by the stock/bond core. For example, real assets, such as gold and real estate, are alternatives that may be added to portfolios for inflation protection because advisors may expect real assets to rise in value with any overall increase in wages and prices.

However, we believe that quite a few advisors are now investigating whether alternative investments, particularly those we refer to as *alternative strategies*, should occupy a place at the portfolio core.

A Focus on Alternative Strategies

Because stocks and bonds generally have been the building blocks of the current core U.S. securities portfolio managed over the past fifty years, we define stocks and bonds (and funds holding only long positions in the same) as *traditional* assets. By extension then, many advisors, including us, define an alternative investment in simple terms: 1) not a traditional long-only equity investment, 2) not a traditional long-only bond investment. At Larkin Point, however, we define and separate alternative investments into two categories: 1) *nontraditional assets*, and 2) *alternative strategies*.

We are most interested, however, by the growth of alternative strategies—which typically deploy traditional assets in unconventional ways—and it is our opinion that such strategies will increasingly become part of the core allocation.

Because equities have generated most of the volatility in traditional portfolios over the past thirty years and have been for many advisors the core growth assets, it is our opinion that advisors tend to seek non-equity assets, including alternative assets, that exhibit low correlation to stocks in an attempt to reduce a portfolio’s overall volatility. Bonds have generally been the assets of choice to fill this role, and have often demonstrated both low volatility and low correlation to equities. With fixed income today offering relatively low yields, many advisors now seek other assets to balance equity risk. As a result, it is our opinion that advisors often start their search for alternative investments among nontraditional asset classes that demonstrate low correlation to equities. We think nontraditional assets often offer the desired low correlation, but present other hurdles to effective use. It is our opinion that advisors can find greater depth using *alternative strategies* and should view the goal as a search for low volatility, not just low correlation.

Evolution in Portfolio Construction

We view alternative strategies as part of an ongoing evolution in portfolio construction: an attempt to push beyond simple diversification in which investors’ funds are divided among multiple assets or asset classes. We believe managers’ use of leverage, derivatives and hedging

techniques opens wide a broad range of portfolio outcomes. It is our opinion that the adoption of alternative strategies will far outpace the use of nontraditional assets in portfolio construction in the coming decade.

Today, many asset managers are constructing alternative portfolios (strategies) they believe will be less volatile than the un-hedged, long-only bundles of assets that dominate most portfolios. Some of these strategies will show low correlation to equities, others will not. It is our opinion those strategies with a high correlation to equities should not be ignored as they may deliver reasonable growth with less volatility and lower drawdowns than a basket of stocks.

Consequently, it is our opinion that wealth managers and advisors will embrace these solutions as part of a new framework for asset allocation that depends less on two buckets of long-only risk, and more on various return re-shaping techniques.

We believe client portfolios should be constructed with the goal of securing both growth and protection to reduce the client's longevity risk. We define longevity risk as the risk of the portfolio collapsing in total value while the client still has on-going liabilities. We thus define portfolio balance not in terms of stocks versus bonds, but as a search for the right combination of growth and protection. In our view, portfolio risk is not merely portfolio volatility. Portfolio risk is a drawdown that creates fear the client will outlive their means and that could cause clients to liquidate growth assets to preserve capital at exactly the time they should be buying growth assets.

Reduce Drawdown Risk

We view hedging within the portfolio as an attempt to reduce drawdown risk without too great of a reduction in returns. We see hedging as an extension of portfolio diversification. In our view, given the needs of the typical mass affluent client, we think reducing downside portfolio variance and targeting *steady* growth are essential to reducing longevity risk.

It is also our opinion that some assets used for protection, namely sovereign and high-grade debt, recently have become more expensive relative to the cost of direct hedges such as purchasing put options on growth assets, and that other assets often used for protection, such as high-yield debt and emerging market debt, are best classified as growth assets. Specifically, we believe advisors should not rely on the latter forms of debt for portfolio protection, and should choose high yield debt or emerging market debt based upon the prospects for total return growth.

We believe specifically targeting protection in the portfolio, via hedging with put options, not only aims for protection but also works towards setting the stage for potential portfolio growth. We believe the potential for harvesting gains from put options can produce cash for rebalancing during market downdrafts—instances we believe offer the best buying opportunities. We describe this technique as generating 'cash and confidence in a crisis'.

Finally, we believe advisors must be prepared to answer five questions when selecting alternative strategies for their clients. Advisors are being inundated with varying approaches to managing client assets. We believe if advisors can answer the following questions when evaluating liquid alternatives, they may have a strong framework by which to choose among the many choices now being presented to advisors and their clients.

What is the primary market in which the strategy sources returns?

How liquid are the underlying assets employed by the asset manager?

Does the asset manager articulate a targeted participation with the primary source of market beta?

Does the strategy target growth, protection, or both?

Does the strategy rely on derivatives, levered ETFs or exchange-traded notes?

We believe an advisor's clients want, and need, portfolios that last beyond their own liabilities and life expectancy. It is our opinion that advisors will choose alternative investments because they believe such allocations will improve the clients' outcome, including reducing behavioral risk. We also believe neither client nor advisor wants to be surprised by the outcome or performance of an alternative strategy.

To summarize, we expect alternative strategies to increasingly constitute the *core* of many individual and institutional investment portfolios as advisors seek low volatility replacements to holding long-only equities and long-only fixed income. In our view, many advisors who previously devised their own mix of assets in the pursuit of low portfolio volatility (and therefore sought assets with low cross-correlation) may search instead for managers who are building portfolios by mixing assets, hedges, market-timing decisions and various amounts of leverage.

The article above is an extract from our guide to alternative investments and is available on our website: [Why Liquid Alts Now?](#)

DISCLOSURE

Larkin Point Investment Advisors LLC ("Larkin Point") is an investment advisor registered with the U.S Securities and Exchange Commission. Registration with the U.S Securities and Exchange Commission does not constitute an endorsement of the firm by the Commission, nor does it indicate that Larkin Point has attained a particular level of skill or ability. Larkin Point is not a registered broker-dealer in the United States. Larkin Point is not registered under the laws of any foreign jurisdiction and this report shall not be deemed a solicitation of any investors or clients in contravention of any such foreign laws and regulations.

The statements and material appearing in this report have been prepared, except as otherwise noted, by Larkin Point, contain confidential or privileged information, and should not be read, copied or otherwise used by any other persons.

This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein does not constitute a personal recommendation or take into account the particular investment objectives, investment strategies, financial situation and needs of any specific recipient. It is based on numerous assumptions. Different assumptions could result in materially different results. We recommend that you obtain financial and/or tax advice as to the implications (including tax) of investing in the manner described or in any of the products mentioned herein.