Alternatives Demystified: A Simple Framework for Preparing for a Bear Market

361 CAPITAL

Ten years after the financial crisis—followed by a record-long bull market—investment advice is at a critical turning point: from participation to preservation.

Advisors served clients well coming out of the last downturn by preaching patience and discipline with equities. Now they are tasked with protecting those gains. That client conversation is much more complex.

KEY TAKEAWAYS

- Allocations to both true diversifiers and risk reducers can help investors hedge against an equity market downturn.
- True diversifiers include alternative strategies with little correlation to equities.
- Investors also need alternative strategies that reduce portfolio risk, but don't overly sacrifice returns.

Alternatives can play a valuable role in hedging equity market risk but with so many different strategies—many of which are unfamiliar to clients—advisors need a framework for explaining the various strategies and their role. We suggest dividing the asset class into two broad categories: alternatives that offer true diversification, and those that reduce risk but don't sacrifice return potential.

The true diversifier camp includes alternatives with little correlation to equities. Their value should not be understated. Most asset classes are highly correlated to stocks, and this has big implications during an equity market downturn. For perspective: an equally weighted portfolio of two assets with like volatilities and a correlation of 0.7 would still exhibit 92% of the volatility of either asset in isolation. True diversifiers offer much lower correlations.

We include three types of more popular alternative strategies within this camp. Here's a brief description of each type, and their correlation to equities (S&P 500) over the last 10 years:

- **Managed Futures:** This strategy invests long and short across multiple asset classes, using quantitative signals to identify when an asset class is poised to rise or fall. The strategy's ability to track different assets and take advantage of both rising and falling markets has led to a substantially different return profile from most other asset classes, and a correlation of -0.10 with equities.
- **Market Neutral:** These funds include a long portfolio of stocks or other assets expected to outperform and a short portfolio of securities expected to underperform. Near identical long and short exposure makes the returns less related to the overall stock market. As a group, market neutral funds have 0.34 correlation to equities.
- **Multicurrency:** As the name suggests, this strategy invests in different currencies to capitalize on their relative strength. Traditionally, return streams are different from equity and fixed income markets. Over the last 10 years, the strategy has had a correlation of 0.48 to equities.

Finding true diversifiers is only half the battle. Separately, investors need alternatives that reduce portfolio risk, but don't overly sacrifice returns. We call this camp the "risk reducer" category. In short, these strategies hold up during equity market downturns, but typically outperform more traditional downside risk mitigators over longer time horizons. These alternatives can play an important role in limiting large portfolio drawdowns that may adversely affect investor psychology and behavior. In this camp, we suggest three basic strategies:

- **Long/Short Equity:** A long/short equity strategy takes long positions in stocks that have superior return characteristics, while shorting stocks with a poor outlook. Historically, the category's annual returns are not that different from a long-only equity fund, but historically its standard deviation is much lower and its maximum drawdown has been less than that of the S&P 500 Index.*

- **Long/Short Credit:** Such strategies are a diversifier but seek diversification from fixed income investments. Managers use long and short positions, with a mix of global credit securities, to help mitigate volatility and earn returns that are less interest rate dependent.

- **Non-Traditional Bond:** These funds have few constraints on maturity, sector, credit quality or geography. The flexibility gives the portfolio manager more ability to adapt to changing interest rate environments.

Allocations to both categories, true diversifiers and risk reducers, can help investors hedge against an equity market downturn. After a long bull market run, advisors and their clients have been reminded in 2018 that it would be wise to prepare their portfolios for unexpected bouts of volatility and uncertainty in the future.

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About 361 Capital

361 Capital is a leading boutique asset manager focused on alternative and behavioral-based equity solutions that seek to deliver meaningful alpha, manage risk and offer diversification potential to investor portfolios. Founded in 2001, we offer a suite of investment products including Long/Short Equity, Managed Futures, Macro, as well as Small, Mid and Large Cap Equity.

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*Based on comparison of the S&P 500 Index and the Morningstar Long/Short Equity Category from 1/1/1994 to 9/30/2018.

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