Mind the Guardrails - They're in Place for a Reason

361 CAPITAL

For 10 years, alternatives managers have used the financial crisis as a rallying cry; the penultimate example of how far markets can fall, and how alternatives can cushion the blow.

As that moment fades in the rearview mirror, however, the lesson becomes easy to forget.

With equity indices producing an endless string of record highs, it's tantalizing to abandon alternatives and go full bore into stocks alone. We see evidence of this abandonment already, with investors pulling nearly $5 billion from alternative mutual funds in the summer months.

Against this backdrop, we urge caution. Alternatives still play a strategic role within portfolios as a diversifier and tool for generating a different source of returns and minimizing drawdowns. But the gravitational pull against the asset class has never been stronger.

The current market backdrop feeds into some of the most common behavioral biases that befell investors, inviting them to shed alternative investments from their portfolio. Advisors can help their clients stay the course if they make them aware of those biases and put them in context with the current climate. Consider some of the biases at work:

Anchoring:

When investors anchor, they tether their decisions to a single reference point, losing context of the bigger picture. For investors in today's market, what would that reference point be? Likely one of continuous record-breaking highs in equity markets. Since the beginning of the calendar year, the S&P, Dow and NASDAQ indices, collectively have broken previous records 55 times, as of 9/21/18. Those same indices have reached record highs 309 times since the presidential election.

In such buoyant markets, it's easy to lose sight of the bigger picture: Bear markets can and do happen. The longest equity bull market makes it easy to forget, but U.S. equities have still experienced three bear markets in the past 31 years. Alternatives have the potential to cushion those falls, helping portfolios recover faster so they can get back to compounding. Case in point, long/short equity strategies lost about 20 percent, on average, during the financial crisis, but nowhere near the losses of 50 percent or more experienced by many equity indices.

Recency Bias:

When investors exhibit recency bias, they let current market performance warp their assumptions about how markets will behave in the future. The oft-used

KEY TAKEAWAYS

- Alternatives play a strategic role within portfolios as a diversifier and tool for generating a different source of returns and minimizing drawdowns.
- Advisors can help their clients stay the course if they make them aware of common behavioral biases that befell investors and put them in context with the current climate.
- While behavioral impulses are hard to ignore, clients are better served when they put emotions aside and invest rationally with long-term asset allocations that include alternatives.

compliance statement that “past performance is no guarantee of future results” goes right out the window.

Recency bias today doesn’t just give investors a false sense of security about the trajectory of equities. It gives them a false sense of market tranquility. For perspective: The VIX has been below 13 in 50% of all days over the last two years, compared to less than 20% of days over a longer time frame. And for 16% of days in the last two years, the VIX was an unbelievably calm 10.4 or lower. Normally, only 2% of observations would exhibit such lows.

In such a calm environment, it’s easy to believe one doesn’t need alternatives to protect against volatile events.

Fear of Missing Out:

As stocks heat up, it’s tempting to get greedy. When investors see heady S&P 500 gains of 10.86% over the last decade and their own returns held back by a drag from their alternatives allocation, behavioral instincts may urge them to ditch the allocation in favor of owning more stocks.[1]

Investors should resist such temptations. While behavioral impulses are hard to ignore, clients are better served when they put emotions aside and invest rationally. Long-term asset allocations are guardrails for a portfolio. They keep our behavioral instincts in check and prevent us from acting to our detriment when the ride is too smooth … or too harrowing. Hold on to the alternatives allocation. The ride will get bumpy again.

For more:
Call 866.361.1720 or visit 361capital.com.

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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[1]Data from August 31, 2008 – August 31, 2018.

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