RESS CAPITAL

THE CASE FOR ALTERNATIVE ASSETS IN THE CURRENT MARKET ENVIRONMENT

ABOUT THE AUTHOR

Gustaf Hagerud is the Managing Director of Ress Capital. He has worked in the financial industry since close to 40 years. Gustaf spent most of his time on global asset allocation and strategic portfolio construction. For seven years he served as the deputy CEO of the public pension fund AP3, responsible for all investments, including global equities, global bonds, hedge funds, private equity, real estate, forestry, infrastructure, and insurance-linked securities. Prior to that, he spent ten years working with global asset allocation at the pension funds Alecta and AP1. He began his career in the banking sector, as a trader at Nordea and Swedbank. Gustaf holds a PhD in Finance from Stockholm School of Economics. His research focuses on volatility forecasting, and he has co-authored a textbook on the Swedish financial markets.

EXECUTIVE SUMMARY

- **In this market insight, Gustaf Hagerud, gives his views based on his experience from senior roles within asset allocation and portfolio construction.**
- **Institutional investors have increased their allocation to alternatives assets since the 1990's.**
- **Several market events in the last ten years have intensified the discussion on what type of alternatives that best fit investment portfolios.**
- **This Market Insight outlines which risk exposures within alternatives are well suited in different macro-economic scenarios, and what should work in the current market environment.**

BACKGROUND

Alternative investments have become a common term for assets that are not listed equities or liquid fixed income instruments. Table 1 below shows a list of common *alternatives*, some which can be accessed directly, for example private equity and private debt, whereas some of the other alternatives are created using sophisticated trading strategies, which is true for hedge funds, trend following strategies and alternative risk premia.

TABLE 1: A COLLECTION OF ALTERNATIVE ASSETS OR ALTERNATIVE INVESTMENTS STRATEGIES

Real Estate	Infrastructure
Private Equity	Private Debt
Trend Following Strategies	CTA Hedge Funds
Commodities	Macro Hedge Funds
Land and Forestry	Alternative Risk Premia (ARP)
Life Insurance Policies	Catastrophe Bonds (Cat Bonds)

Investor interest in alternatives has increased sharply in the last 25 years. There are many interconnected reasons for this development. We would like to highlight three of them. Firstly, several large corrections in global equity markets have motivated investors to better protect their portfolios against short- and medium-term losses. Investors have come to realize that global diversification in liquid markets does not safeguard their portfolio returns in periods of high downside volatility. Alternatives have accordingly been used to reduce the equity exposure in investment portfolios. Secondly, investors have to a large extent adopted investment strategies based on modern portfolio theory (MPT), introduced by Harry Markowitz in his essay from 1952. Central to recent MPT advancements is the acknowledgement that capital market returns are driven by a number of common risk factors. Dominant among these factors is the business cycle risk. Therefore, an allocation to alternative assets with low exposure to the business cycle risk will benefit the risk characteristics of an investment portfolio greatly. Thirdly, the range of accessible alternatives with sufficiently long track records has increased steadily during the last decades. This is particularly true for alternative risk premia and trend following strategies, but also for illiquid alternatives such as private debt, land and forestry. This development has greatly simplified portfolio diversification.

THE ROLE OF ALTERNATIVES IN ASSET ALLOCATION

The primary reason to allocate to alternative assets should be to increase the *risk-adjusted return* of the portfolio. Here we will use the term risk-adjusted return in a broader sense, letting high risk-adjusted return imply that a successful alternatives allocation should meet one or more of these criteria:

1. Over time increase the return of the portfolio without increasing the volatility.
2. Increase the portfolio's resilience against large falls in global equity markets.
3. Reduce the portfolio's exposure to unexpected changes in the global business cycle.
4. Make the portfolio resilient to major changes in global inflation, which will make the portfolio less sensitive to changes in monetary policy by central banks.

Evaluating the alternatives in Table 1 against these four criteria, shows that some of the assets are more fit for purpose than others. Particularly, traditional real estate with high leverage will most likely be exposed to both the global business cycle and unexpected monetary tightening by central banks. Furthermore, equity hedge funds with high correlation to global stock markets, will not benefit the portfolio when there is a large decrease in global equity markets. However, within each category of alternatives in Table 1, there are strategies and managers that certainly will increase the risk-adjusted return of investors' portfolios.

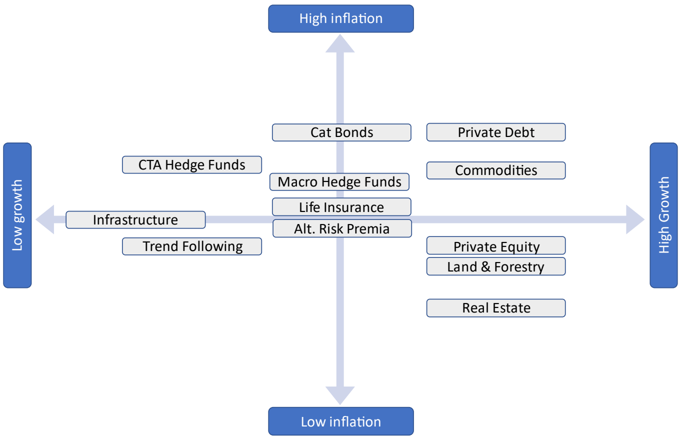
A necessary condition for an alternative asset to increase the risk-adjusted return of the portfolio over the long term, is that the asset is exposed to an underlying risk factor that is not directly available through investments in liquid financial markets. Two clear examples are life insurance policies and catastrophe bonds (cat bonds). For, life insurance policies the dominant return driver is *longevity* risk, while cat bonds investors are compensated for taking risk on *natural disasters* like hurricanes or earthquakes. Both these risk factors are unique, and are not accessible in bond and stock markets.

ALTERNATIVES AND THE BUSINESS CYCLE

One strong argument for allocating to alternatives, as noted above, is to make the portfolio return less dependent on macro-economic conditions. Ideally, the investor would be able to make allocations to alternative assets independent of the current growth and inflation outlook. Unfortunately, most alternative assets will have some connection to the business cycle and monetary policy. Some alternatives will have a direct dependence, which make them less powerful in increasing the risk-adjusted return of a portfolio. Other alternative assets or strategies are only indirectly dependent on the macro-economic environment. This could for instance be alternatives whose return is linked on the level of interest rates both in absolute and relative terms. These assets will be less interesting to allocate to when monetary policy is synchronised and expansionary, and more in demand when interest rates are unusually high. Finally, some alternatives are fundamentally unrelated to macro-economic conditions. In this respect investments in life insurance policies stand out.

In Figure 1, different alternatives are classified according to their dependence on the strength of the business cycle and their exposure to the inflation rate relative to central bank targets. The position of different asset classes indicates under which regimes they are expected to perform well, and thus deliver high risk-adjusted return. To give an example, private equity will most often perform best when global growth is above the long-term trend, and when inflation is medium to low.

FIGURE 1: SWEET SPOTS FOR ECONOMIC GROWTH AND INFLATION FOR DIFFERENT ALTERNATIVES



ALTERNATIVES LIKELY TO PERFORM WELL IN LATE 2023 AND 2024

The global economy is currently growing below trend, and inflationary pressure is clearly above average. The slow growth in developed countries is to a large extent the result of the aggressive tightening of the monetary policy, instated by central banks to harness current inflation and inflation expectations. However, the consensus view on how economic growth and inflation will develop in the coming 12 to 24 months is relatively positive, in that most financial market participants expect central banks to succeed and bring inflation under control. This is indicated by flat yield curves. Policy rates are expected to be lowered in 2024, accelerating global growth in late 2024 and 2025.

Ress Capital agrees with the consensus view that central banks will be successful in their inflation control, and that increases in interest rates will soon be over. When it comes to the timing of monetary loosening, we are more uncertain. Central bank policy usually works with a response lag of up to 18 months. There will therefore be a long period of uncertainty during which central banks as well as market participants will not be able to determine if monetary policy has been a success or not. It is prudent to be cautious about the development of economic growth and inflation in 2024. Consequently, a more defensive strategy should be preferred when allocating to alternatives.

In our view, now is a good time to allocate to alternatives with low correlation to the business cycle. Moreover, investors should not be aggressive in taking on exposure to alternatives that is negatively impacted by rising interest rates and bond yields. If the investor wishes to take a more aggressive position on the outlook for a normalization of growth, this is better implemented in liquid markets, where the allocation can be easily adapted to new economic data.

Table 2 lists alternatives that have the potential to increase the risk-adjusted return of investment portfolios over the medium to long term. These alternatives will most likely reduce portfolio risk in the short term since their performance is not dependent on the success of the current monetary policy implemented by most major central banks.

Table 2: Alternatives Likely to Increase the Risk-Adjusted Return in the Current Macro-Economic Environment

Alternative Risk Premia	Life Insurance Policies
CTA Hedge Funds	Trend Following Strategies
Cat Bonds	

NUMERICAL EXAMPLE ON THE ALLOCATION TO ALTERNATIVES

In this section, we will present a numerical example, in which a traditional 60/40 equity/bond portfolio will be compared to a portfolio with a large allocation to the five alternatives listed in Table 2. The expected returns and volatilities used in the two examples are shown in Table 3.

Table 3: Expected Returns in US-dollar and Volatilities used in the Example

Asset class or strategy	Expected return in USD	Expected volatility
Global Equities	8.0%	15.0%
Global Government and Investment Grade Bonds	5.0%	8.0%
CTA Hedge Funds	9.0%	15.0%
Trend Following Strategies	7.0%	12.0%
Cat Bonds	6.5%	4.5%
Alternative Risk Factors	8.0%	6.5%
Life Insurance	7.0%	4.0%

In Figure 3, the two example portfolios are shown. For Portfolio A, 60% of the portfolio is allocated to developed market equities, and 40% is allocated to a global government and investment grade bond index, both in US-dollars. Given reasonable return expectations for the two indexes and historical volatilities and correlations, the expected medium-term return is 6.8% p.a., as indicated below in Figure 3.

In Portfolio B, an allocation of 25% have been made to five alternative assets, with 5% in each alternative. The allocation to the two liquid asset classes is set so that the expected return for the portfolio is the same as in the traditional 60/40 portfolio, i.e., 6.8%. Historical data as well as fundamental forward-looking economic relationships have been used to estimate the correlations between the alternatives.

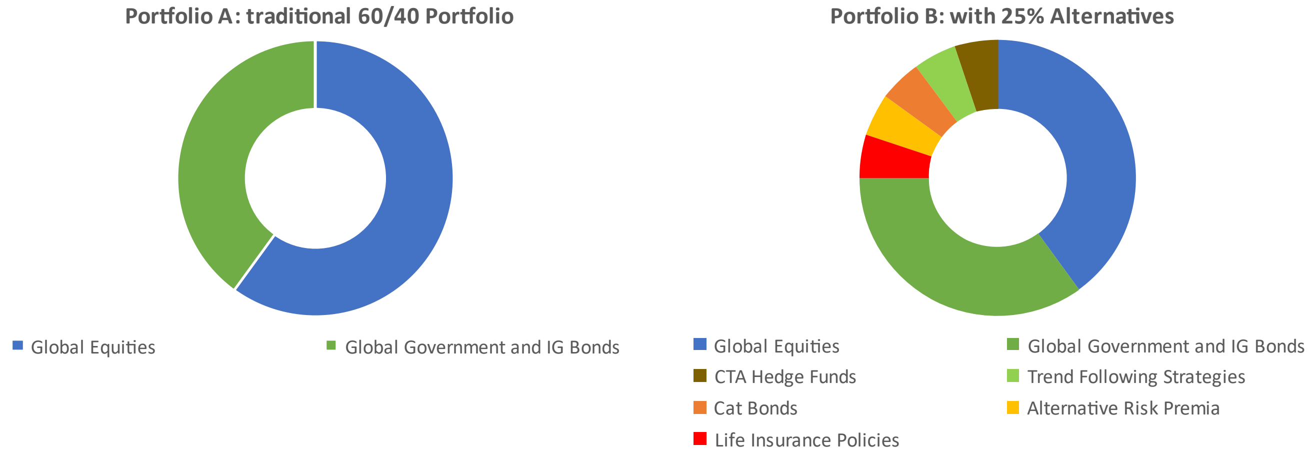
The resulting expected volatility of Portfolio A is 11.5%, compared to 8.5% for Portfolio B, demonstrating that Portfolio B is more robust and less likely to suffer large falls in value in the event of a major equity market correction. Moreover, the *Raw Sharpe Ratio* (see definition at the end of this document) is 33% higher for portfolio B, indicating the positive outcome of being more diversified.

The allocation to global bonds has been reduced in Portfolio B, from 40% to 35%. This allocation change is smaller compared to the reduction in global equities, going from 60% to 40%. Therefore, also Portfolio B will be negatively affected by a sudden increase in global bond yields. However, since a traditional 60/40 portfolio has most of its risk linked the business cycle, it is far more important to reduce the equity allocation.

The fact that the allocation to global equities is lowered from 60% to 40% in Portfolio B, makes the allocation to alternatives powerful in reducing the exposure to the global business cycle. Depending on the prevailing stance on monetary policy, either loose or tight, the global equity portfolio will be more or less dependent on changes in monetary policy.

In the current environment, when most market participants expect monetary policy to be loosened in the medium term, it is our view that a tighter monetary policy by central banks is a major risk to equity markets. Therefore, a larger allocation to alternatives and a smaller allocation to global equities is recommended. However, it is important to choose alternative assets that have an expected return target in line with global equities. In this example, as can be seen in Table 3, global equities have an expected return of 8% p.a.

Figure 3: Portfolio Characteristics for the Two Example Portfolios



Expected Return:	6.8%
Expected Voaltility:	11.5%
Expected Raw Sharpe:	0.6

Other Characteristics

- Highly exposed to changes in global growth
- Sensitive to monatary policy changes
- Sensitive to increases in bond yields

Expected Return:	6.8%
Expected Voaltility:	8.5%
Expected Raw Sharpe:	0.8

Other Characteristics

- Lower exposure to changes in global growth
- Less sensitive tomonetary policy changes
- Less sensitive to increases in bond yields

CONCLUSION

The strong increase in bond yields since January 2022, has made it possible to get a reasonable return from a 60/40 portfolio of equities and bonds. Unfortunately, the risk exposure to tighter monetary policy and lower economic growth in such a portfolio remains high. A superior portfolio with better characteristics can be achieved by allocating to alternatives. In this Market Insight, we have presented alternative assets and strategies that over the long term can increase the risk-adjusted return of an investment portfolio. Furthermore, we have indicated five alternatives that gives the investor an allocation which is less exposed to unexpected changes in global growth and inflation.

From the example presented in this Market Insight, we show that a significant increase in the risk-adjusted return can be created by reducing the allocation to global equities and instead increasing the allocation to diversifying alternatives. The alternative assets and strategies will expose the investment portfolio to risk factors that are unrelated to general equity risks, since the risk of these alternatives are not dependent on global macro-economic events. Our view is that the macro-economic risk will continue to be elevated in 2024. Thus, more diversification to alternatives is warranted.

SOME TERMS USED IN THIS MARKET INSIGHT

Alternative Risk Premia (ARP)
Alternative risk premia strategies extract value from liquid financial markets by using quantitative methods to systematically isolate and harvest excess returns from risk factors that are not directly observable in financial data. These alternative risk factors primarily exist in equity markets, but they can also be found in currency and fixed income markets. Investors can get exposure to ARP either through hedge funds or products delivered by investment banks.

Catastrophe Bonds (Cat Bonds)
Catastrophe bonds are debt instrument issued by insurance and reinsurance companies, where the return is dependent on the occurrence of different natural disasters like earthquakes and hurricanes. If a natural disaster does not occur during the term of the bond, a relatively high return will be given to the investor, whereas if a natural disaster happens the investor could lose some or all the capital invested. Cat bonds have short maturity dates of between three to five years. The main advantage with the asset class is that the risk exposure is completely uncorrelated to returns in other parts of the financial market.

CTA Hedge Funds
CTA stands for commodity trading advisor. In CTA hedge funds, derivates are used to build diversified portfolios strategies over a global investment universe. Often the portfolios contain several systematic trading strategies, based on statistical analysis. In some cases, discretionary strategies are also included. CTA hedge funds usually has some of the risk allocated to trend following strategies. However, CTA tends to use more advanced quantitative methods, and the risk allocation is more sophisticated.

Life Insurance Policies
The secondary market for life insurance policies, often termed *Life Settlements*, is a US market, where professional investors buy large portfolios of life insurance policies from individual policy holders. Individual households sell their policies when they no longer need the life insurance coverage. Policies traded in the market have a large financial value, that fund managers enable the households to capitalize on. Like cat bonds the risk in this asset class, longevity, is fundamentally different to other risks in financial markets.

Sharpe Ratio and Raw Sharpe Ratio
The *Sharpe Ratio* measures the performance of an investment, or an investment portfolio, compared to a risk-free asset, after adjusting for its risk. It is defined as the difference between the return of the investment and the risk-free return, divided by the standard deviation of the investment returns. It represents the additional amount of return that an investor receives per unit of increase in risk. It was named after William F. Sharpe, who developed it in 1966. The *Raw Sharpe Ratio* is a simplified measure that only considers the investment return rather than the excess return.

Trend Following Strategies
Trend following is an investment strategy based on statistical analysis, rather than on fundamental analysis. The strategies take advantage of long, medium, or short-term trends in various global financial markets. Often the strategies are constructed so that it is the relative rather than the absolute strength of different financial assets that motivates the size of positions. The strategies are often implemented and supplied by investment banks.

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