Taking an alternative approach

Rocq Capital's Adam Cox explains the benefits of complementing traditional equity and bond investments with 'alternatives'

As bond markets approach what many perceive to be the end of a 30-year bull market and equity markets hit highs at the same time, the question on many investors' lips is how they can protect capital if markets were to see a simultaneous fall in the value of both equities and bonds.

For some investors this means attempting to time a move to cash correctly (at the risk of missing a continued move up in asset prices or suffering the initial rapid fall if timed incorrectly); for others this means moving to equity markets not at highs, for example emerging markets, in the hope that they will continue to move upwards. Some will attempt to ride out the storm and remain invested throughout. At Rocq Capital, we prefer to take an 'alternative' approach to this problem.

The term 'alternatives' can be seen as an all-encompassing definition of any asset class or strategy other than traditional holdings in bonds or equities. This includes investments in commodities, property, private equity, hedge funds, structured products, timber, vintage wine, patents or cars, to name just a few. The challenge an investor faces within an alternatives allocation is how to allocate to their chosen selection with the same diligence and rigour they would when investing in traditional asset classes.

Alternatives are often opaque not only in strategy but also in valuation. How does one assign a value to a vintage Bordeaux, or an old master?

Traditional assets can be valued by discounting the cash flows that an investor will receive in the future to a present value; alternative asset classes often have no such cash flows other than resale value in an unpredictable market, often influenced unduly by one or two 'experts' in the field. We invest in alternative strategies using financial products held within structures that aim to provide preservation of capital and steady risk adjusted returns over time; however much we might like to think we are oenophiles we remain acutely aware of our limitations in these more idiosyncratic fields.

The ultimate goal of an investor in alternatives is the same, regardless of approach: to diversify risk away from traditional exposures to equities and bonds. A consequence of this diversification is often a lower level of portfolio volatility over a market cycle and thus a more predictable outcome to the investor.

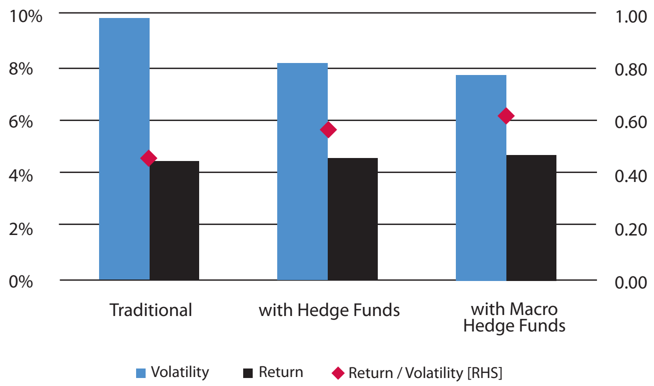
The advent of UCITS III regulation in 2001 allowed greater access to alternative investment strategies through vehicles typically domiciled in Luxembourg or Dublin. The regulation provides comfort to investors through limits on liquidity, leverage and portfolio diversification whilst still offering enough freedom for managers to run some of the more esoteric strategies that were previously only available to the ultra wealthy or large institutions and at fee levels more aligned with those in traditional assets.

Hedge funds alone have grown from $322 billion in 2001 to over $3 trillion at the end of 2016 with investors attracted to the perceived high return, low volatility performance. The sheer number of funds to choose from makes it imperative to choose carefully and understand the risks associated with each investment. What might appear at the outset to be a differentiated approach can have significant and correlated risk associated with it. However the right process, when found, can add enormous value to a portfolio, protecting overall wealth during times of market stress.

In the chart below we compare a traditional portfolio, allocated 60% to global equities and 40% to global bonds, with the same portfolio but with a 30% allocation to hedge funds or a 30% allocation to macro-hedge funds since inception of the hedge fund indices. We see that the addition of hedge funds achieves a marginally greater return but with considerably lower volatility.

We include macro hedge funds in addition to the broad index because they represent exposures with the least sensitivity to traditional assets. The broad hedge fund index includes funds with significant exposure to traditional markets, negating the benefit of such funds and emphasising the need for careful selection.

At Rocq Capital we see alternatives as a complement to allocations in traditional equity and bond exposures. By adding a third asset with a low correlation to other holdings in a portfolio, we aim to reduce portfolio volatility without substantially inhibiting long-term capital growth. At a time when both equity and bond markets are at or near all-time highs, a potential reduction in market sensitivity through an allocation to alternatives appears a prudent move.



Source: Rocq Capital/Bloomberg