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NEWPORT VIEW

Liquid Alternatives – Considerations for Portfolio Construction

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Gavin is a Director and Investment Adviser at Newport Private Wealth. Gavin is responsible for quantitative research, global asset allocation strategies, model portfolio construction and discretionary portfolio management. As well as being lead Investment Adviser to the Newport Core Fund, Gavin is the manager of Newport's global multi-asset model portfolios (both domestic and international) and the Newport Global Tactical SMA Model Portfolio that is accessible via the Praemium, Hub24 and Linear SMA platforms.

Gavin has 15 years of experience in the financial services industry having worked in Sydney, London, Kuala Lumpur, Singapore and now Melbourne. Gavin earned a Bachelor's degree in Economics/Banking & Finance and a Master's degree in Commerce/Financial Planning from the University of Western Sydney.

Introduction

The global financial crisis and the ensuing equity bear market has challenged investors' perceptions of vital portfolio management concepts such as diversification and correlation. Investors who had, up to that point, slept soundly in the knowledge that they had a sufficiently diversified portfolio, found that diversification wasn't enough and that supposed uncorrelated assets, such as equities and bonds, can indeed move in unison just at the moment when they needed to rely on diversification the most. Re-thinking the concept of 'risk' has defined the liquid alternatives 'movement'. The generation of capital growth and/or income is main objective of any investor, but there is now a much greater awareness of the importance of downside protection, capital preservation and genuine diversification. With historically low bond yields, elevated equity valuations and unpredictable bouts of volatility, liquid alternatives can assist in building more robust, truly diversified portfolios potentially better suited to withstand a range of different market environments.

Liquid alternatives play an important part in our multi-asset model portfolios as well as within the Newport Core Fund to which we are the Investment Advisers. This paper provides a brief framework around our liquid alternatives philosophy – what we mean by liquid alternatives, strategy selection, manager selection, performance characteristics and why/how to apply them in constructing portfolios.

What do we mean by Liquid Alternatives?

While there is no universal definition for liquid alternatives, they are hedge fund strategies that aim to generate positive absolute returns i.e. they do not operate relative to any particular index or market, and do so while providing investors with more favourable liquidity terms (such as daily, weekly or bi-monthly) than traditional hedge funds. In addition, liquid alternatives are generally structured within a more regulated environment meaning that investors may also expect all of the benefits associated with traditional mutual funds, such as a higher degree of governance, stronger safeguarding of assets, greater transparency, lower minimum investment levels as well as restrictions on leverage and asset concentration.

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Absolute return strategies aim to provide positive returns in all market conditions by seeking diverse sources of alpha and building portfolios that demonstrate reduced correlation to broader financial markets. To do this, absolute return strategies may employ certain investment techniques that traditional (relative return) strategies do not. Namely, utilising both long and short positions, trading derivatives, using some leverage, or by simply employing an extremely active and flexible long-only mandate.

What types of Liquid Alternative strategies do we use?

Absolute return strategies can be broadly grouped into 4 categories, with further sub-classifications therein:

1. **Macro**
2. **Equity Hedge**
3. **Event Driven**
4. **Relative Value**

We don't use Event Driven strategies/managers as they tend to get involved in illiquid transactions or trade ideas that may take lengthy periods of time to play out. Performance of the strategy group within the UCITS environment has also been less than impressive. The strategies that we do look at are those that trade liquid instruments, have a low correlation to traditional asset classes and asset allocation models, have a low correlation to each other and have displayed an ability to perform well within the UCITS environment. A description of each of the strategies we allocate to is provided below, courtesy of the Hedge Fund Research Institute (HFRI):

Macro - Systematic Diversified

Macro Systematic Diversified (more commonly known as CTA/Managed Futures) strategies have investment processes typically run as mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies which employ an investment process designed to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes. Strategies typically employ quantitative process which focus on statistically robust or technical patterns in the return series of the asset, and typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean reverting strategies. Although some strategies seek to employ counter trend models, strategies benefit most from an environment characterized by persistent, discernible trending behaviour.

Macro - Multi Strategy / Multi Asset

Macro Multi - Asset / Strategy managers employ components of both discretionary and systematic macro strategies, but neither exclusively. Strategies frequently contain proprietary trading influences, and in some cases contain distinct, identifiable sub-strategies, such as equity hedge or equity market neutral, or in some cases a number of sub-strategies are blended together without the capacity for portfolio level disaggregation. Strategies employ an investment process that is predicated on a systematic, quantitative evaluation of macroeconomic variables in which the portfolio positioning is predicated on convergence of differentials between markets, not necessarily highly correlated with each other, but currently diverging from their historical levels of correlation. Strategies focus on fundamental relationships across geographic areas of focus both inter and intra-asset classes, and typical holding periods are longer than trend following or discretionary strategies.

Equity Hedge - Market Neutral

Equity Market Neutral strategies employ sophisticated quantitative techniques of analysing price data to ascertain information about future price movement and relationships between securities, select securities for purchase and sale. These can include both Factor-based and Statistical Arbitrage/Trading strategies. Factor-based investment strategies include strategies in which the investment thesis is predicated on the systematic analysis of common relationships between securities. In many but not all cases, portfolios are constructed to be neutral to one or multiple variables, such as broader equity markets in dollar or beta terms, and leverage is frequently employed to enhance the return profile of the positions identified. Statistical Arbitrage/Trading strategies consist of strategies in which the investment thesis is predicated on exploiting pricing anomalies which may occur as a function of expected mean reversion inherent in security prices; high frequency techniques may be employed and trading strategies may also be employed on the basis of technical analysis or opportunistically to exploit new information the investment manager believes has not been fully, completely or accurately discounted into current security prices. Equity Market Neutral Strategies typically maintain characteristic net equity market exposure no greater than 10% long or short.

Equity Hedge - Long / Short

Equity Long/Short strategies maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short.

Relative Value - Multi Strategy

Multi Strategy Relative Value managers employ an investment thesis is predicated on realization of a spread between related yield instruments in which one or multiple components of the spread contains a fixed income, derivative, equity, real estate, MLP or combination of these or other instruments. Strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. In many cases these strategies may exist as distinct strategies across which a vehicle which allocates directly, or may exist as related strategies over which a single individual or decision-making process manages. Multi-strategy is not intended to provide broadest-based mass market investors appeal, but are most frequently distinguished from others arbitrage strategies in that they expect to maintain >30% of portfolio exposure in 2 or more strategies meaningfully distinct from each other that are expected to respond to diverse market influences.

Performance Characteristics

Liquid alternatives cover a broad range of strategies with diverse risk & return characteristics that are often suited to certain market environments more than others. For example, long/short equity can be more focused on capturing growth potential while hedging market exposure through short selling; commodity strategies might be looked at to mitigate inflation risk; while others, such as managed futures, simply exploit upward and downward trends in futures markets and are largely uncorrelated with macroeconomic factors and individual assets classes.

In limiting ourselves to only the most liquid of absolute return strategies (previously defined) we have created our own index that represents our liquid alternatives universe. The NCF Liquid Alternatives Index[i] is an internally constructed index made up of equal allocations to the HFRI Equity Market Neutral, HFRI Multi-Strategy Macro, HFRI Systematic Macro (managed futures/CTA) & HFRI Relative Value indexes. The diversity in the liquid alternatives universe means that they can be combined to build a diversified and robust portfolio that can provide an alternative source of risk premium (return over risk-free) that is not subject to the fluctuations and volatility associated with equity market risk premium. Chart 1 (at the back of this paper) shows that the NCF Liquid Alternatives Index has historically provided a healthy risk premium without the volatility and drawdowns associated with a traditional asset class like global equities.

Correlation

A vitally important aspect when looking at the performance characteristics of individual strategies and managers, as well as the performance characteristics of the overall liquid alternatives portfolio, is that of correlation. The reason for this is that the primary purpose of asset allocation and diversification is to lower portfolio risk and the effectiveness of diversification relies on portfolio assets having a low correlation to each other.

Table 1 (at the back of this paper) contains 5-year (monthly return) correlation figures for a selection of portfolios and indexes. Looking at the table you can see that the traditional 60/40 portfolio[ii] had a near perfect correlation with the S&P 500 Index (+0.94) meaning that the traditional equity/bond portfolio directionally moved almost in unison with equities. Our liquid alternatives portfolio, on the other hand, exhibited a low correlation with both the S&P 500 Index (+0.40) and the 60/40 portfolio (+0.46) meaning that the portfolio's returns are less likely to move in the same direction as the S&P 500 Index and that it would have been a good diversifier if added to the 60/40 portfolio.

Another important performance characteristic to look at is that of correlation to market risk as measured by the VIX Index. Looking at Table 1 you can see that both the S&P 500 Index and the traditional 60/40 portfolio had a significantly negative correlation to the VIX Index (-0.71 and -0.72 respectively) meaning that they had a high tendency to move in the opposite direction to, or be 'short', volatility i.e. they fall when volatility rises. Our liquid alternatives portfolio, on the other hand, exhibited a much lower negative correlation (-0.29) to volatility meaning that the portfolio had much less of a tendency to fall when risk (volatility) rose and an ability to profit from falling/volatile markets. The ability for some parts of a diversified portfolio to be long volatility (rise when markets fall) is important in the preservation capital and in possibly limiting a portfolio's potential for drawdown.

Manager Selection / Portfolio Construction

Quantitative screens are used to filter the liquid alternatives universe down using factors like:

(i) Fund structure
(ii) Strategy
(iii) Size
(iv) Base currency
(v) Performance – returns and statistics
(vi) Correlation data
(vii) Liquidity – of the traded instruments and the fund itself (daily/weekly)
(viii) Independent research ratings where available

Qualitative manager research might then look at attributes such as:

(ix) Proven manager experience
  - Returns generated, and risk deployed, in a consistent manner
  - Performance during periods of market stress, both short term and long term

(x) A well-defined and repeatable investment process

(xi) Depth of research and ability to convert research themes into profitable trades

(xii) Trading efficiency, often achievable through economies of scale

(xiii) A robust risk management framework

(xiv) Proper alignment with investor incentives

(xv) Ability to clearly communicate strategies, objectives and risks to investors

(xvi) Strong regulatory and compliance processes

In constructing our liquid alternatives portfolio, we look to diversify across multiple liquid alternative strategies by utilising 8-15 managers. All managers must have displayed consistent and leading performance in their peer group and exhibit a low correlation to other managers in the portfolio. The aim of our liquid alternatives portfolio is to outperform the NCF Liquid Alternatives Index thereby adding alpha through manager selection.

How do we apply Liquid Alternatives?

While investment portfolios have traditionally been built around traditional asset classes like equities and bonds, there is a growing movement, particularly within institutional sovereign wealth and endowment funds, towards meaningful allocations to alternative investments. The types of liquid alternatives we use offer diverse sources of alpha, reduce volatility and directional market risk, offer protection in falling markets and are a simple but flexible approach to enhancing diversification.

As a result, liquid alternative strategies can enhance the risk-adjusted returns of a balanced portfolio by reducing volatility and potential drawdown during periods of market stress. Chart 2 (scatter diagram[iii]) on the following page reinforces this point by showing how the introduction of a 30%, 20% or 10% liquid alternatives allocation to a traditional 60/40 ‘balanced’ portfolio can, in each instance, help to increase returns and reduce volatility.

Conclusion

However investors decide to use liquid alternatives, the ultimate aim for investors should be to increase the diversification of a traditional portfolio away from simply moving allocations between equities and bonds. Careful evaluation of the different risk, return and correlation characteristics of liquid alternatives in order to determine how they may best fit within a portfolio can result in a more robust portfolio that is better able to withstand a variety of market conditions and, most importantly, assist in reducing the extent of potential drawdown.

Chart 1

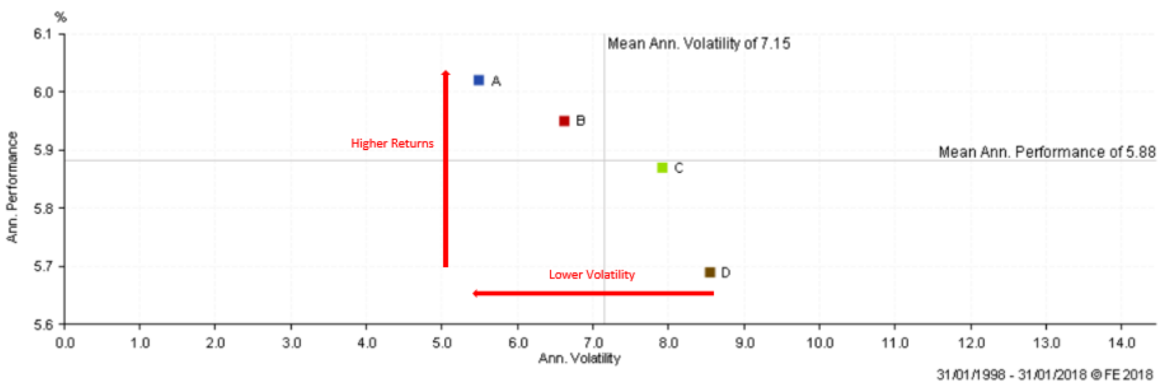
Table 1

	CBOE SPX Volatility VIX in US	NCF Liquid Alternatives Portfolio GTR	S&P 500 GTR in US	SAA 60% Equity / 40% Bonds GTR
CBOE SPX Volatility VIX in US		-0.29	-0.71	-0.72
NCF Liquid Alternatives Portfolio GTR	-0.29		0.40	0.46
S&P 500 GTR in US	-0.71	0.40		0.94
SAA 60% Equity / 40% Bonds GTR	-0.72	0.46	0.94	

Positive Correlation | Low Correlation | Negative Correlation

Period: 31/07/2011 to 31/01/2018

Chart 2



Key	Name	Annualised Performance	Annualised Volatility
A	SAA 40% Equity / 30% Bonds / 30% LA GTR	6.02	5.49
B	SAA 45% Equity / 35% Bonds / 20% LA GTR	5.95	6.62
C	SAA 50% Equity / 40% Bonds / 10% LA GTR	5.87	7.92
D	SAA 60% Equity / 40% Bonds GTR	5.69	8.55

Data Source = Financial Express (Holdings) Limited and Newport Private Wealth.

[i] The Newport Liquid Alternatives Index is an internally constructed index made up of equal allocations to the HFRI Equity Market Neutral, HFRI Multi-Strategy Macro, HFRI Systematic Macro (managed futures/CTA) & HFRI Relative Value indexes. Data Source = Financial Express Holdings Limited and Newport Private Wealth calculations. The index is USD based and assumes a monthly re-balance back to equal weights

[ii] Source: Financial Express (Holdings) Limited and Newport Private Wealth. For bonds, the Barclays Global Aggregated Bond Index has been used. For equities, the MSCI World Index has been used and for liquid alternatives, the NCF Liquid Alternatives Index has been used.
[iii] Source: Financial Express (Holdings) Limited and Newport Private Wealth. For bonds, the Barclays Global Aggregated Bond Index has been used. For equities, the MSCI World Index has been used and for liquid alternatives, the NCF Liquid Alternatives Index has been used.