Weekly Digest

Week ending **26 November 2017**

Alternative facts

The universe of so called 'liquid alternative' strategies has grown significantly in recent years, supported by strong investor demand. Within the UK market alone, the IA (Investment Association) Targeted Return sector that these funds fall into now represents over 150 funds and £100bn of assets under management, compared to fewer than 40 funds and £10bn AUM in 2008. This growth likely reflects a desire from many investors to diversify the return drivers in portfolios as well as a shift away from traditional hedge fund strategies, driven by regulation, security, transparency and cost factors. Portfolio managers have recognised the opportunity afforded by new strategies and have introduced allocations to several strategies across most portfolios over the last 18 months.

A key benefit from such investments is the diversifying qualities they can provide to portfolios, driven by returns having a lack of 'beta' or correlation to traditional asset classes, such as equities or bonds. Investment risk is not additive so long as holdings are less than perfectly correlated; the lower the level of correlation amongst investments, the greater the theoretical diversification benefits. Therefore adding particular alternative investments with highly differentiated return drivers allows for the creation of more efficient portfolios.

It's not always obvious but many alternative funds do have some persistent or time varying levels of market exposure. This introduces a risk that such strategies could become correlated to other holdings at just the wrong time, vastly reducing the potential diversification benefits. For example, long/short equity strategies are well represented amongst alternative funds. While they would all have a number of long and short positions at all times, many will have a level of net market exposure that is positive at times if not persistently, perhaps reflecting the manager's short term view on market direction. They could still reasonably present their strategy as having a low beta to these asset classes, because the exposure is low on average, but the correlation of returns may be unduly high at times. An investor holding such a strategy alongside long only equity holdings may be disappointed if the manager has a long bias during a period of falling markets!

A related point to consider is fee efficiency. Buyers of liquid alternative funds may be willing to accept a higher fee level in anticipation of medium to high returns with low volatility. However, given the low volatility environment across markets for the last few years, many managers could have delivered on this objective whilst carrying a degree of market risk, but yet may come unstuck when volatility rises or when risk assets decline. The point is that if returns are being driven partially by exposure to traditional asset classes, which investors could access at much lower costs through passive strategies, then the higher fee level is harder to justify. Returning to the long/short equity example, if two strategies achieve the same returns but one doesn't carry any market exposure and achieves the results through selection skill, or 'alpha', while another has persistently long net exposure to markets, then the former is arguably much more valuable.

Recent industry developments have led to an even greater distinction between 'beta' and 'alpha'. The menu of effective beta's available now extends well beyond traditional asset classes to include specific isolated risk premia, such as style factors. These are additional premia observed for taking on particular risk over and above what you would expect from the market as a whole and the idiosyncratic risk inherent within each individual security or asset class. They are generally factors that have been rigorously researched and proven to generate excess returns over time. Within equities, for example, factors include value (stocks which are relatively cheap), quality (stocks with high or reliable return streams), low volatility, size (small-cap stocks tend to outperform large cap-stocks) and momentum (stocks with strong and improving price or earnings characteristics). While these represent some of the most widely used alternative risk premia, others include more niche premia such as merger arbitrage premia. Asset managers and investment banks have designed systematic strategies that provide access to these premia in an efficient and low cost manner, in much the same way as smart beta equity strategies have allowed investors to access style tilted equity exposure without needing to hire an active manager. These developments effectively raise the bar for defining manager 'alpha' whilst also driving down the cost of accessing uncorrelated alternative return drivers. Given those beta's can now be accessed at a relatively low cost, investors should ensure they don't overpay for beta masquerading as alpha.

These sorts of considerations are clearly overlooked by some investors, representing a missed opportunity to create greater risk and cost efficiencies within portfolios. The only way to guard against them is to conduct thorough due diligence on managers and scrutinize historical returns and exposures. Portfolio manager's approach to strategy selection among liquid alternatives has been focused and highly selective driven by these considerations as well as a number of others. They have created a low cost blend of five liquid alternative strategies that each has distinct return drivers with little to no sensitivity to returns of traditional asset classes. Making full use of this richer universe of liquid alternatives funds helps managers to smooth the journey for investors in solutions while increasing the chances of delivering on the return objectives.

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The **Marketplace**

- Brent crude finished the week @ 63.77, up +1.8% after a strong week
- Gold had an overall flat week closing at 1291.6, down -0.5%
- Bitcoin up more than 800% in 2017

Market **Focus**

US

- The S&P 500 was up 0.9% closing at 2602.4, another record breaking high
- The Dow Jones index ended the week at 23558, up 0.9%
- Another record breaker as the Nasdaq finished up 1.5% at 6409.3
- Trump's Senate tax bill, dubbed 'the tax cut bill' is due to be voted upon this week after the Senate Finance Committee agreed the text last Monday
- Treasury yields between long and short maturities at the narrowest levels in a decade.

UK

- Philip Hammond ear-marked £3bn for the contingency of a no-deal Brexit in last week's budget
- OBR sees growth at 1.4% vs 1.6% forecast in March. The Resolution Foundation calculated wages would not return to pre-crash levels until 2025
- A meeting has been scheduled for the 4th of December between Jean-Claude Juncker and Theresa May. Seen as a potentially pivotal negotiation, the expectation is of an improved financial settlement offer from the UK government.
- The FTSE closed at 7427, up 0.4% on the week
- The CBI factory index rose from -2 to +17 in October. The biggest surge in factory orders in nearly 30 years. Bucking the trend, auto sales have fallen for seven straight months, down 4.6% on the same period (April to November) in 2016.

Europe

- The Eurostoxx 50 rose 0.3%, closing at 3591.7
- Merkel's party set to revive alliance with the Social Democrats to avoid another election despite her saying she's open to another vote. Coalition talks with the Free Democrats and Greens collapsed.
- ECB minutes showed that a large majority support further extensions of QE tapering
- The Dax closed the week at 13044, up 0.5%
- PMI for the euro-area economy rose to 57.5 in November from 56 in October, a 6.5 year high. Employment rose at the fastest rate in 17 years.

Asia

- The Nikkei was up .7% % at 22495.9
- The Hang Seng was up just over 2% at 29686
- MSCI Asia Pacific Index climbed above its 2007 peak closing at 568.5475 last Friday
- In signs that growth in China may stall over the next two quarters, the yield on the China Development Bank rose 5% last Thursday and the Shanghai market fell 2.3% on its worst day of trading this year.

Andrew Hardy (CFA) & James Jones

Source: Bloomberg. Returns in US dollars unless otherwise stated.

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Weekly Digest

Week ending **26 November 2017**

Asset Class/Region	Currency	Currency returns			
		Week ending 24 Nov. 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	0.9%	1.2%	17.7%	19.7%
United Kingdom	GBP	0.5%	-0.7%	7.5%	12.5%
Continental Europe	EUR	0.9%	-1.9%	12.1%	19.7%
Japan	JPY	1.0%	0.8%	19.6%	24.5%
Asia Pacific (ex Japan)	USD	1.7%	3.3%	36.5%	36.2%
Australia	AUD	0.4%	1.9%	10.0%	13.9%
Global	USD	1.3%	1.3%	19.7%	22.5%
Emerging markets equities					
Emerging Europe	USD	2.2%	2.1%	16.9%	27.8%
Emerging Asia	USD	1.6%	3.6%	43.8%	43.8%
Emerging Latin America	USD	1.6%	0.5%	22.7%	25.5%
BRICs	USD	2.1%	4.4%	42.9%	43.4%
MENA countries	USD	-0.5%	-2.1%	-3.4%	2.1%
South Africa	USD	1.1%	6.6%	22.5%	29.6%
India	USD	1.2%	0.3%	34.8%	40.1%
Global emerging markets	USD	1.6%	3.2%	36.5%	38.5%
Bonds					
US Treasuries	USD	0.1%	0.3%	2.6%	2.5%
US Treasuries (inflation protected)	USD	0.1%	0.6%	2.6%	2.7%
US Corporate (investment grade)	USD	0.4%	0.2%	5.8%	6.6%
US High Yield	USD	0.4%	-0.4%	7.0%	9.3%
UK Gilts	GBP	0.8%	1.2%	1.3%	3.7%
UK Corporate (investment grade)	GBP	0.6%	0.5%	3.7%	6.4%
Euro Government Bonds	EUR	0.2%	0.2%	0.9%	1.9%
Euro Corporate (investment grade)	EUR	0.0%	-0.2%	2.7%	3.3%
Euro High Yield	EUR	0.3%	-0.3%	6.9%	9.1%
Japanese Government	JPY	0.0%	0.3%	0.1%	-0.2%
Australian Government	AUD	0.4%	1.1%	4.4%	4.4%
Global Government Bonds	USD	0.8%	1.5%	6.9%	6.4%
Global Bonds	USD	0.8%	1.3%	7.3%	7.2%
Global Convertible Bonds	USD	1.0%	0.8%	10.9%	11.8%
Emerging Market Bonds	USD	0.3%	-0.8%	7.7%	9.1%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 24 Nov. 2017	Month to date	YTD 2017	12 months
Property					
US Property Securities	USD	0.3%	3.2%	4.9%	10.5%
Australian Property Securities	AUD	0.9%	3.5%	0.3%	7.0%
Asia Property Securities	USD	1.7%	2.1%	26.0%	23.2%
Global Property Securities	USD	0.9%	2.6%	14.5%	18.5%
Currencies					
Euro	USD	1.2%	2.4%	13.4%	13.0%
UK Pound Sterling	USD	0.9%	0.4%	7.9%	7.1%
Japanese Yen	USD	0.5%	1.9%	4.9%	1.6%
Australian Dollar	USD	0.6%	-0.6%	5.8%	2.8%
South African Rand	USD	0.8%	1.9%	-1.4%	2.0%
Swiss Franc	USD	0.9%	1.7%	4.0%	3.8%
Chinese Yuan	USD	0.6%	0.6%	5.5%	5.1%
Commodities & Alternatives					
Commodities	USD	0.6%	2.3%	3.1%	6.7%
Agricultural Commodities	USD	-0.1%	0.2%	-3.4%	-4.4%
Oil	USD	1.8%	4.1%	12.4%	30.3%
Gold	USD	-0.5%	1.4%	11.8%	8.8%
Hedge funds	USD	0.5%	0.0%	5.2%	6.3%

Source: Bloomberg. Past performance is not indicative of future returns

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