What’s the Alternative? Part Two

An introduction to the wide range of real assets and financial strategies available in the world of Alternatives

In our 11 June 2018 report, What’s the Alternative? we pointed out that the returns that have been achieved in recent decades from the traditional assets (equities and bonds) have been exceptionally good but the prospective returns are likely less positive.

We also highlighted that the relationship between the returns on equities and gilts has become unstable. Between 2007 and 2013, the correlation of the two returns was always negative. So if the stock market was declining (as it was for much of that period), the gilt market was giving you a positive offsetting return. Since 2013 there have been many times when the correlation has been positive making the promised diversification no longer a sure thing.

This suggests to us that it is a good time to be looking at alternatives to these traditional asset classes for both return and diversification. In this report we explore some of the investments available.

‘Alternatives’ is a word that can mean many different things in the world of financial services. To us the universe it covers is a broad one but can be defined as anything that is not a clear-cut member of what we know as ‘traditional asset classes’, namely equities and bonds. Importantly, having invested in Alternatives for over 10 years, we believe that most alternatives can be grouped into two buckets: long-only, return-seeking alternatives, and alpha-seeking, long-short alternatives such as many hedge fund strategies. We are particularly interested in the former, which we break-down into the following sub-asset classes:

- Property
- Infrastructure
- Asset Finance
- Commodity
- Specialist lending

We describe the above universe as “real assets”. Real assets are predominantly physically asset-backed businesses and cash flow streams which we expect to provide a positive total return, above the rate of inflation, over the medium-to-long-term. The five of the above list fit into that characterisation.

Financial strategies round out the Alternative universe. Those consist of portfolios where active managers attempt to provide returns with characteristics that investors find attractive. This is where absolute return funds, which aim to make money in any market conditions, can be attractive for example, particularly as a diversifier.

Alternatives providing good returns

Each of the five broad real asset categories listed above has subsets that reflect the breadth and depth of the opportunity set.

A lot of these investments have for many years been constituents of pension funds, sovereign wealth funds and other large institutional investors. But today there are more and more vehicles being created that allow smaller institutions and individuals to access these opportunities.

For example, twenty years ago 95% of the investment trust market was focused on equity or private equity. Today only 62% is. A number of investment trusts focus on different parts of the property market, on infrastructure, commodities and direct lending. There are also other listed investment companies which provide exposure to ship ownership and music royalties. We see these types of assets as attractive for a number of reasons.
First, these tend to be investments that give exposure to different parts of the economic cycle. For example, some sectors of the property market have characteristics that are attractive in almost all phases of the economic cycle. These include long-lease and social housing. Other parts of the universe can be more cyclical in their nature such as specialist lending and other credit strategies. Traditionally transportation assets are good mid-cycle assets, benefitting from increased global demand. Infrastructure projects can also be good mid-cycle investments. Stronger demand helps revenue streams on toll roads, bridges and mobile phone masts for example. Late cycle assets traditionally include commodities. We will have commodity exposure via funds that invest in specialist areas such as mining or energy.

A lot of work has been done by financial services firms and academia on the long-term returns to be expected from investing in these types of assets. We believe that a return of around inflation plus 4% should be achievable. That return will come from a mixture of income and capital gains with the majority coming from income. In the world of historically low interest rates in which we continue to live, this return profile we believe to be attractive to a wide range of investors.

**Alternatives as diversifiers**

Some real assets are often described as providing an uncorrelated return stream. Such statements should be treated with caution. Virtually all the assets mentioned above do better in periods of economic growth and will struggle in periods of recession.

But it is the case that the return from the real assets universe does come from exposure to a different risk premium than equities or bonds. The cash flow from something like music royalties, for example, is not directly affected by movements in the stock market or in interest rates. So there are some diversification benefits from these assets. 'Differentially correlated' is perhaps a better way of describing them than 'uncorrelated'.

There are a number of financial strategies though that can provide some genuine diversification. For example, absolute return strategies are aimed at providing a positive return whatever the direction of the aggregate market. Well managed funds doing this in equities and bonds make a useful addition to a portfolio.

Volatility strategies can also be of use as diversifiers. Such strategies can include risk-parity funds where the idea is to take exposure to less volatile assets in a leveraged manner. This can sound counter-intuitive but it has worked historically well because when overall market volatility increases the fixed income component of such funds acts even more as an offset to equity market weakness than unlevered exposure to fixed income provides.

Of course, this does depend on fixed income itself being uncorrelated with equities. However, as we showed in our first report on this subject, in the UK the correlation between the gilt market and the equity market has become unstable in the last five years. In the US, however, the Treasury market has consistently been a good diversifier even in the last five years such strategies have broadly been successful.
Other hedge fund strategies can also provide some diversification from broad market moves. Many such vehicles have low correlations with the overall market and just as importantly, low correlations with one another.

This does rely on manager skill and successful managers can charge high fees. But our interest is in finding genuine portfolio diversification and if these strategies help us achieve that then our interests and those of the managers are aligned.

**Conclusion**

Most professional investors expect lower returns from traditional assets in the future than we have enjoyed since the early 1980’s. We particularly see a rising interest rate environment as an enormous challenge to the financial services industry.

We believe that investors will increasingly look at Alternative investments for a solution. They can provide sources of both return and diversification. A portfolio that has exposure to these types of assets and strategies today will likely benefit as more money flows into them in the years ahead.

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