INVESTMENT

Capital Versus Risk Allocation:

What Most Investors Get Wrong In Alternatives

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There is one aspect of investing that most retail and institutional investors often get wrong and that is diversification.

We see it all the time. While it starts in a place of diligent thought and effort, it is important to recognize that diver-

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sification expresses an old approach to investing that may not actually shield investors as intended. Even though portfolios are typically built on the basis of diversifying capital across assets, this does not necessarily diversify risk.

Most commonly, investors believe that diversifying across traditional fixed income, equities, and non-traditional assets is a smart thing to do. While going beyond geographic diversification makes sense, investors should now realize that non-traditional alternatives are an important consideration when trying to protect a portfolio and prosper over the long term.

Healthy Mix

Even with a healthy mix of traditional alternative assets, balanced asset allocation does not necessarily mean that a portfolio's risk is diversified.

Despite being revered as a great differentiator when it comes to diversifying risk in tough times, many traditional alternatives have a high correlation to the market. Not only are the most common alternative investment areas like real estate, private equity, and infrastructure strongly linked to the market, but others that have typically been the first stop outside of the traditional alternatives such as high yield, hedge funds, and equity multi-strategy have a high correlation as well.

In fact, of all the alternatives only currency, commodity, agriculture, and CTA/managed futures alternatives have a low-to-negative correlation to the market. While many investors have heard of these asset classes, investing in them may seem opaque and complicated. However, there are a number of institutional offerings available for each of these areas, with more and more choices becoming available to retail investors and advisors.

Though it is true that these investments are still somewhat underdeveloped in certain markets like Canada, they are invaluable to any institutional or retail portfolio given that they provide an atypical return stream which helps to diversify risk. Arguably, the most important alternatives of all are the ones with a slightly negative correlation to equities, which are understood to commonly be available within the managed futures space.

Return Streams

At this point, you might be thinking why you would even consider adding an asset that is negatively correlated to the stock market when equities are rallying. Aside from protecting your portfolio from a drawdown, how are they able to provide returns in the interim? The answer lies in risk taking strategies which can be broken down simply into two types of return streams – convergent and divergent.

Convergent return streams *(Figure 1)* are the most common, producing returns that are characterized by many small gains with an occasional devastating loss, as markets grind higher slowly for long periods of time with the risk of a sharp correction. This type of return stream is a 'human' feel good strategy as it gives investors constant gratification, often through yield or dividends, follows logical sense, and is based in fundamentals. Whether classified as an alternative or not, the returns experienced under this stream will look a lot like that of an equity market and will encompass both active and passive investment strategies. The reality is, most alternatives fall into this category and therefore do little to help your portfolio in difficult times.

In contrast, divergent return streams

(Figure 2) are less common yet are very valuable as they produce returns differently and at different times when compared to most investments. They are characterized by many small losses followed by an occasional large gain, often at times of crisis or correction. Unfortunately, they are not 'feel good' strategies. In fact, to most, they feel like taking many small paper cuts while waiting patiently for potential gains. These strategies go against the human need for constant gratification and are not typically influenced by fundamentals in order to produce an atypical return stream. They are most often based on a repeatable process that is systematic and unbiased, ultimately producing returns that are generally derived from trend following. The most common strategies under this umbrella are managed futures/CTA investments.

As one can see, a clear solution to creating a better portfolio is adding divergent alternative return streams that have a negative or near-zero equity correlation, but still produce positive returns over time. There is no sense in adding more convergent streams or equity risk to an already well-diversified portfolio as you will always land on the same problems when the markets correct. In order to reduce portfolio risk while potentially increasing opportunity or reward, the return stream should differ from what you may already have while still being accretive.

Check your portfolio to see how tied you are to the equity market. All you have to do is run a correlation between your portfolio's returns and the stock market, followed by a look at the correlation of the components that make up your portfolio. Do you have any that are of low correlation to the equity market? Perhaps you hold a commodity fund, agricultural play, or currency strategy.

Clear Advantages

However, for most retail and institutional investors, this area is often overlooked despite the clear advantages. Adding a CTA/managed futures strategy to a diverse portfolio of traditional and alternative assets can lead to obvious improvements, with better risk-adjusted returns, a higher Sharpe ratio, and lower volatility and drawdowns. To access these types of strategies, all investors need to do is their homework and find fund managers who offer a full suite of investment products that include fairly priced, transparent, performance-driven CTA/managed futures investments. The good news is that these strategies are now available to both institutional and retail investors through not only private hedge fund structures, but mutual funds and low cost ETFs as well.

It is only with these types of additions that one can truly diversify risk and take advantage of the unknown while still being positioned to achieve gains if the seemingly unflappable equity market keeps rallying – or just as likely – fails and reverses. **BPM**

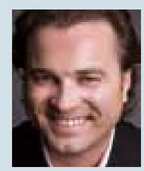

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Figure 1

CONVERGENT

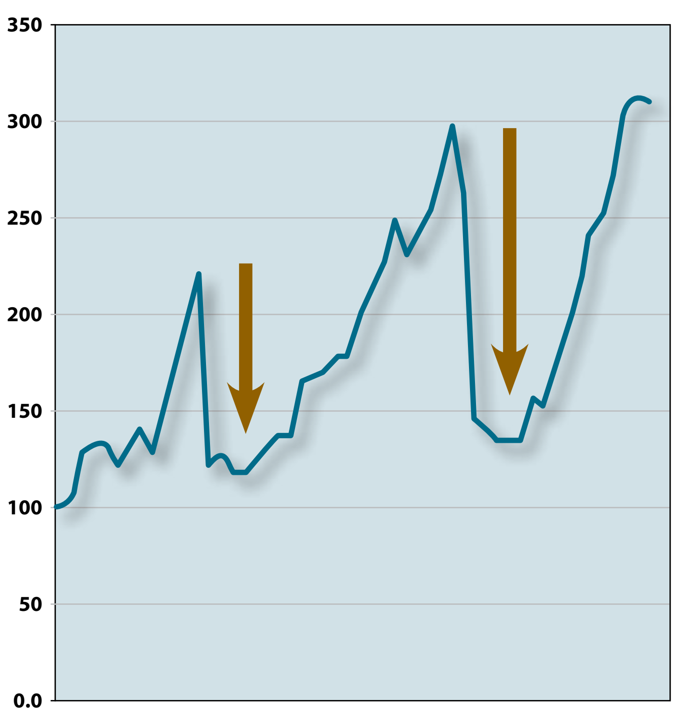

Figure 2

DIVERGENT