EFFICIENT PORTFOLIO ALLOCATION IN A TIME OF SLOWING GROWTH

Marketing material for professional / institutional / accredited investors

Following a decade of sustained global growth and further rate hikes on the horizon, forward looking yields across both equities and fixed income now appear challenging. We have seen investors increasingly seeking alternatives that can allow them to diversify their portfolio away from traditional equities or duration risk. In this paper we discuss some of the topical liquid alternatives that are available to investors, and how each can play a role as constituents of a balanced portfolio.

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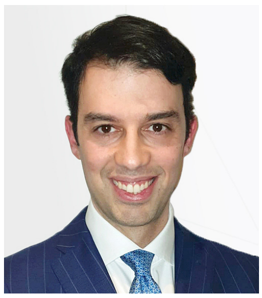

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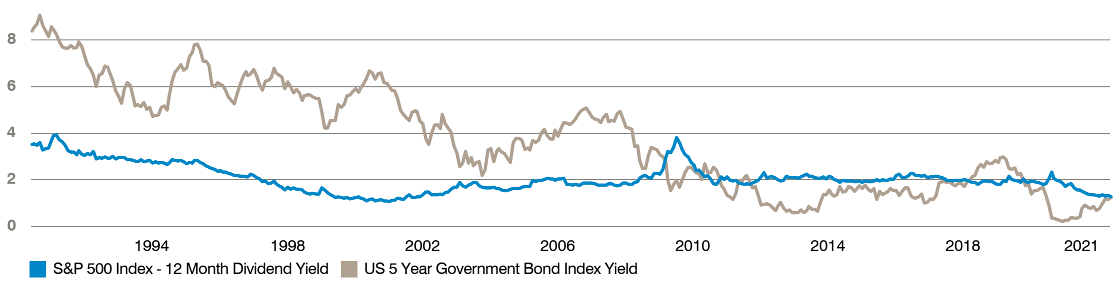
A challenging time for traditional investors

Traditionally investors have been advised to hold a balanced portfolio that is well diversified across cash, equities and fixed income. Over the past decade such portfolios have performed well, boosted by a period of strong global growth and a supportive regime of low rates across key developed markets.

However, the forward looking picture now seems more challenging, and compared to history both bonds and equities appear fully priced. In Figure 1 we show US equity and bond yields over the last 30 years. We can see that yields from both equities and bonds are now at all-time lows.

Alternative metrics such as price to earnings or CAPE ratios also tell a similar story. Equities are arguably priced for continued strong growth and no rise in the discount rate, while markets are concerned about those exact same things – the risk of moderating growth and further rate hikes. Those risks can also occur simultaneously should we enter an extended period of stagflation. While our primary focus is on liquid markets, we also see similar issues across less liquid asset classes such as infrastructure and real estate which are trading at – or near – all time highs.

Figure 1 - US equity and bond yields over the last 30 years



Source: GAM, Thomson Reuters. 31 Jan 1990 to 31 Dec 2021. For illustrative purposes only. Indices cannot be purchased directly. Past performance is not a reliable indicator of future results.

A closer look at the equity market

It is also important to consider equities' longer-term history. In Figure 2 we show rolling ten-year returns of the US equity market. There are several points where ten-year returns have been flat or even negative for extended periods of time. Most recently this includes the Global Financial Crisis and its aftermath, but there were similar periods of weak equity growth during the oil crisis in the 1970s and following the Second World War.

So equities do not always go up, even when measured over decade long periods, and equity risk – or global growth risk – is the main risk in almost every investor portfolio, in our view.

To be clear, we are not predicting a decline in equities, but it is one of the possible paths of markets and has happened before. So if you are an investor looking to maximise the probability of achieving your desired portfolio outcome, then we believe having all your eggs in the equity basket is risky.

Finally, not only are equities expensive relative to history, but equity market valuations seem to have decoupled from actual forward earnings expectations, as shown in Figure 3. To put it another way, arguably equities are pricing for significant earnings growth from here, and for discount rates – and central bank policy – to remain highly supportive.

What can investors do?

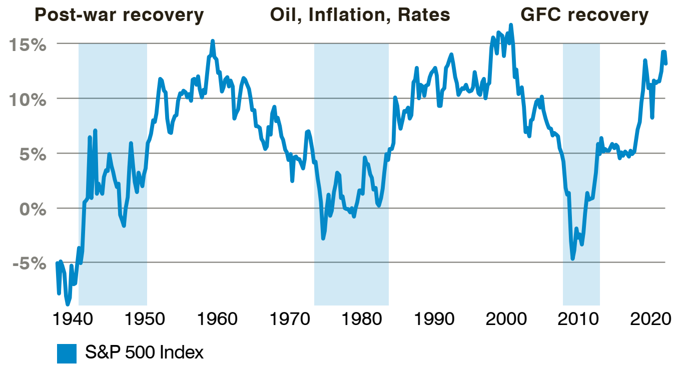
Against this backdrop, many of our investors are looking for ways to diversify their portfolio risk by adding liquid alternative strategies. However, liquid alternatives are not a homogenous group and can have very different characteristics and pay-off expectations.

A framework that we often use during discussions with investors is to characterise different alternatives according to two key features:

1. **Diversification** – Does the investment capture, or offer an exposure to, a source of return other than global growth?
2. **Convexity** – Can this investment deliver positive returns in sharp market dislocations or during a sustained bear market?

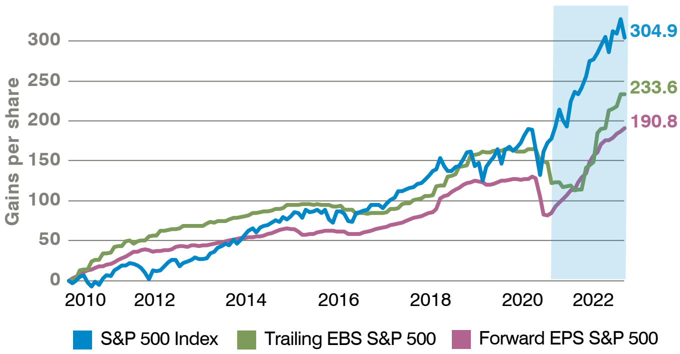
The second of these is particularly valuable, in our view, as it implies that an investment can offer a positive return at the same time as other constituents of an investment portfolio are suffering.

Figure 2 - Ten year rolling returns for US equity markets



Source: Bloomberg. For illustrative purposes only. Indices cannot be purchased directly. Past performance is not a reliable indicator of future results.

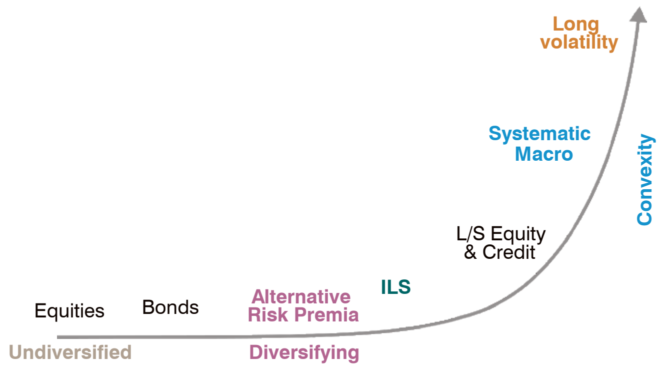
Figure 3 - Gains from S&P growth outperforming earnings



Source: Bloomberg. Rebased to 31 Dec 2009. For illustrative purposes only. Indices cannot be purchased directly. Past performance is not a reliable indicator of future results.

Figure 4 on the following page shows several topical liquid alternatives plotted according to these characteristics. This representation can be helpful to understand how they relate to each other and the expectations that investors should have for each.

Figure 4 - Diversification versus convexity for several topical diversifiers



Source: GAM. For illustrative purposes only. The mentioned financial instruments are provided for illustrative purposes only and shall not be considered a recommendation to buy or sell securities or investment advice.

On the far-left side of the chart are investments in long-only equities, which is likely the typical starting point for an investor. As expected, long-only equity investments are designed to capture – rather than diversify from – global growth and are therefore expected to suffer when equity markets decline.

The first step for an investor seeking additional diversification is usually to step into **duration** investments – such as portfolios of long-only bonds. These can be a valuable diversifier, although recent negative equity bond correlations are not necessarily expected to continue, especially during a period of rising inflation. In addition, as we have already discussed, this is an asset class that is costly and potentially at risk of capital loss in the event interest rate hikes.

We then come to strategies which can take both long and short positions, which includes multi-asset, hedge funds and other liquid alternatives. One of the styles that has received particular interest in recent years is **Alternative Risk Premia (ARP)** which can provide an efficient mechanism to gain exposure to alternative factors that are not driven primarily by global growth or interest rates. Typically, ARP should be considered as a diversifier rather than a hedge.

Another increasingly popular diversifier is **Insurance Linked Securities (ILS)** which include catastrophe bonds. By design these instruments offer an investment that is fully independent from growth and have historically offered a strong return. In the period from 1 January 2002 to 31 January 2021, the Swiss Re Global Cat Bond Performance Index Total Return, for example, delivered an annualised return of 6.7% for investors. However, as a result of their independence from growth, ILS also offer zero convexity and cannot be relied upon to offer positive returns during periods when traditional investments are underperforming.

Next are hedge fund style market neutral strategies such as **market neutral equities and credit**. These typically have positive expected returns but are generally designed to offer little or no convexity. In addition, they can carry crisis risk. If markets suddenly decline it is possible for the underlying correlations to break down. Furthermore, as leveraged strategies, they can also be comparatively costly.

So which strategies actually have convexity, and can potentially assist a portfolio when risk assets sell off? One strategy we believe can is **systematic macro**, of which trend following is a well-known style. While trend following has a positive expected return during sustained bear markets, it is also crucial to emphasise that it typically will not offer turning point protection during sudden market sell-offs as this strategy takes time to adjust to changes in market regime.

Finally, at the far end of the convexity axis is **long volatility protection**. This can be implemented in several different ways, such as through positions in the VIX or via options structures. During abrupt turning points, this is the type of strategy that would offer protection. However, being long volatility is a form of insurance and typically has negative expected return over the long run. This can limit its attractiveness for an investor and is more appropriately used as a tactical hedge.

We would now like to discuss alternative risk premia and systematic macro in greater detail.

Alternative Risk Premia

ARP has gained traction among investors in recent years, although at GAM we have been investing in it for many years. In our view, ARP can be a valuable **diversifier** and can be thought of as a liquid unconstrained multi-asset portfolio that is not driven purely by long equities and long bonds.

We believe ARP provides a less costly way to access what used to be considered alpha but is perhaps better described as "alternative factors". The underlying assumption is that for any systematic risk in the market there is a corresponding premium to take this risk on. ARP seek to monetise slowly evolving macro or behavioural patterns, or factors, such as value, carry, momentum and low risk with a typical timeframe ranging from several months to several years. These patterns transcend asset classes and have been observed to various degrees in equities, fixed income, currencies and commodities. Broadly speaking, they can be considered as micro-premia (single name equity) and macro-premia (equity indices, FX, bonds and commodities), each having their own specifics. Importantly, both micro and macro factors are often weakly correlated with pure equities or bond returns due to their unconstrained long-short nature (although they can also be implemented in a long-only form – equity value or growth indices being the best known examples – in which case correlations with the market remain quite high, diversification benefits remain low, and adding those to a portfolio becomes a macro position).

Given their long timeframes, harvesting such premia systematically is not always straightforward as it requires longer holding periods and consequently entails longer and potentially deeper drawdowns for individual factors. On the other hand, longer timeframes naturally can offer more flexibility with entry and exit points. Therefore, an effective ARP implementation will generally combine exposures to a number of different factors rather than being overly reliant on a single source of premia (e.g. value), and hence will aim to diversify returns away from global growth and interest rates. In this case, given the low correlations of factors with each other, a well designed combination of factors would hold its value even if a few of them are experiencing protracted drawdowns, in our view. That said, we should stress once again that typically ARP portfolios are not designed as a hedge or to offer convexity. With their focus on diversification, they could dampen volatility during a risk sell-off, but normally will not offer turning point protection. Despite this, alternative risk premia strategies can be an important component of a balanced portfolio in our view.

Systematic Macro

As we have seen, one example of a diversifier with a very different long term payoff profile for investors is systematic macro. Systematic macro is typically an umbrella term describing a number of different styles, of which trend following is the best known, but can also include other styles such as value or carry investing. Like ARP, systematic macro can also be thought of as a liquid unconstrained multi-asset investment, differing in the fact it typically works with shorter time frames – ranging from several days to several months – which make it more reactive to sudden market moves.

Systematic macro portfolios typically invest across a broad range of highly liquid markets, thereby accessing returns that are not driven primarily by global growth or interest rates, for example capturing trends in commodity markets or foreign exchange.

In contrast to some of the other styles that we have discussed, systematic macro portfolios are typically highly dynamic with the ability to adjust positions rapidly in response to market developments. This provides convexity by design as portfolios can react to, and benefit from, a sustained fall in market prices as well as, to limited extent, a sharp market dislocation.

Most traditional investment strategies are in fact exposed to potential major losses during equity market crises. Therefore, for almost any investor, finding true diversification likely means finding an investment strategy that can deliver positive performance during such turbulent periods. For this reason, we believe a systematic macro strategy is a strong candidate for diversifying and protecting a traditional portfolio, with the capability of delivering crisis alpha, i.e. to generate gains by exploiting the persistence of trends that occur across different markets during times of crisis.

In conclusion: diversification can add value; and not all diversifiers are alike

Given current market concerns about the future trajectory of equities and fixed income markets, our clients are actively considering diversifying beyond these markets. We believe this framework of diversification versus convexity to compare different liquid diversifiers is valuable.

Importantly, no single diversifier is a panacea. Different diversifiers vary in terms of the advantages and disadvantages they offer and it is important to understand the specific conditions under which a given diversifier can add value and to have appropriate expectations. **We believe that a basket approach to diversifiers is sensible and will generally include, for example, both alternatives focused on diversification, such as alternative risk premia, and those that can offer convexity, such as systematic macro.**

All of the diversifiers that we have discussed, in our view, can play a helpful role in building a robust portfolio, especially today when growth may be challenged, and the discount rate is at risk of rising. **However, it is critical to have appropriate expectations for the very different profiles of the diversifiers you select.**

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