HYDE PARK
Wealth Management

Alternative Thinking Required

How Successful Investors Must Adopt Alternative Investments to Effectively Navigate Bull and Bear Markets

"Those who cannot remember the past are condemned to repeat it."

[George Santayana, Philosopher]

Abstract:

Following two debilitating bear markets during the first nine years of this century, investors should abandon Wall Street's self-serving theory that stocks, bonds and cash comprise an effective asset-allocation strategy. Conversely, such beliefs have led investors to pay for high-beta, low-alpha portfolios that closely track major indices. Requiring stocks to rise for portfolios to grow. And lacking the ability to provide returns independent of the ups and downs of those indices.

Academic studies and many of the nation's foremost capital managers postulate that investors seeking to effectively navigate both bull and bear markets should increase allocations to low-correlation, non-traditional, alternative asset classes.

This paper will explore how alternative investments have shown the ability to lower portfolio volatility and enhance long-term returns. Accordingly, they have become the asset classes of choice for many of the nation's foremost investors, including many of those managing endowments, foundations, family offices and large pension plans.

Investors failing to heed such advice may be doomed to repeat the same capital-degrading mistakes of the past. Advice that strikes us as being particularly cogent given present circumstances in capital markets.

Introduction

According to Gallup, only 55 percent of American adults owned stocks as of April 2019.[1] A much lower figure than the 62 percent holding stocks prior to the 2008 Credit Crisis. A figure that can, in part, be accounted for by the post-traumatic stress incurred by many investors following the conclusion of the 2008-2009 bear market.

Twice during the first decade of the twenty-first century did the stock market crash. Two bear markets. Spanning four of the century's first nine years. Each eradicating more than 50 percent of the S&P 500 index's market capitalization.

The first, a death-by-a-thousand-paper-cuts decline spanning 2000 to 2002. Followed six years later by the Credit Crisis, during which the S&P 500 lost 39 percent in 2008. 54 percent from October 2007 to March of 2009. The speed and ferocity of that decline continues to haunt many investors.

Investors responded to the 2008 tumult in understandably human ways. Fight or flight mechanisms kicked in. Sending many to cash out after having already taken massive losses.

Then, presented with one of the greatest buying opportunities in a lifetime, 52 percent of the nation sat on the sidelines until 2015. As fear imprisoned them in the past. Even as they despaired about the future.

Though stock and bond markets were laid to waste, market historians lose sight of the idea that investors were poorly prepared for such bouts of volatility. Of any magnitude.

Why?

Because for decades, Wall Street’s marketing machine had convinced Main Street investors that proper diversification was achieved by allocating capital to three primary asset classes: stocks, bonds and cash. Accordingly, investor portfolios typically consisted of a 75/20/5 percent allocation to stocks, bonds and cash. Depending on risk tolerance.

During both bear markets, some asset classes held up. Though few posted desirable returns. Desirable being a relative term.

Not All Investments Are Equal

2008's massive stock-market losses were made all-the-more problematic by the lack of investor preparedness. Investors were woefully diversified. Having been lulled into a false sense of security, they were over-allocated to risky asset classes. Particularly to higher volatility areas of the global marketplace. Tethered to numerous asset classes that, like Icarus, flew too close to the sun.

Why were investors -- from the uninitiated to the most sophisticated -- so unprepared?

First, traditional sources of diversification were mercilessly tested during a 17-month period in which there were few places to hide. Stocks, corporate bonds, emerging markets, commodities, real estate — all depreciated in tandem.

Begging the question: did traditional portfolio diversification fail investors?

Traditional diversification — the allocation of investment capital to stocks, bonds and cash, failed to decrease volatility and provide protection against the massive losses suffered by so many. More astute observers will question, however, the validity of focusing one's portfolio management efforts on only three asset classes. But an explanation can be found by considering the historical relationship between Wall Street and Main Street.

Following the passage of the Employee Retirement Income Securities Act (ERISA) in the 1970s, many Americans who had never invested began doing so. The percentage of individuals seeking to place their hard-won retirement capital into the markets grew quickly. And Wall Street was there to dispense advice and sell product. Most “stock brokers” made a living by providing investment ideas to clients and collecting a “commission” on transactions.

Today, Wall Street's bread is buttered through the accumulation of assets under management (AUM), from which the brokerage firms collect a fee under the auspice of providing forward-looking investment advice. The more AUM, the more the firms get paid. And Wall Street is nothing if not a hyper-efficient marketing machine. Accordingly, Wall Street has developed a variety of investment products over the years that enabled brokers, advisors and salesmen to spend time gathering new assets as opposed to managing those they had.

To keep the process simple and effective, Wall Street's minions focused on three primary asset classes in pursuit of diversification: stocks, bonds and cash.

Leading into the tech bubble, the belief that investors need only diversify between three primary asset classes had become commonplace. When the market fell apart in 2000, investors were scared. But the 2000 bear market was different than 2008. Because that downturn featured equity and fixed-income allocations that held up.

> **"By the time any view becomes a majority view, it is no longer the best view; somebody will already have advanced beyond the point which the majority have reached."** – Friedrich Hayek

The end of the tech-bubble witnessed a collapse in large cap growth and international stocks. With other asset classes posting gains and/or smaller losses. Leaving investors weary, but not shell-shocked. So, investors quickly returned to the markets after equities bottomed in 2002.

Why the focus on stocks, bonds and cash?

In the 1970s, an investor could aptly diversify with 100 stocks from the New York Stock Exchange. Since then, however, the financial system has become more complicated. Correlations between stocks have risen appreciatively. Sometimes to the point of near-perfect correlation. Even stocks and bonds have increased in their propensity to mirror each other.

When U.S. stocks fall, foreign developed and emerging market stocks often drop in sympathy. And during periods of hyper volatility, corporate bonds may lose value. Leaving average investors with few places to hide. Punishing investors for what they formerly equated to portfolio diversification. Actually, for assuming any risk at all.

Nor did Wall Street do much to ease the pain.

The Lords of Wall Street recognized that the tide was coming in. But they were making too much money to muster the effort required to educate Main Street investors. So, when the Credit Crisis occurred, investors -- especially those on Main Street America -- were wholly unprepared.

The lesson gleaned from the 2008 tumult? Investors long-term diversification efforts require more than the traditional allocations between stocks, bonds and cash.

Among the few asset classes left standing in 2008 were certain fixed-income and alternative-investment classes:(2)

Managed Futures…	17%
10-year Treasuries…	14%
Mortgage-Backed Securities…	8%
Short-Duration Bonds…	6%
Gold…	5%
Global-Macro Hedge Funds…	4.70%
Short-Term Muni Bonds…	4%
Cash…	1.50%

Interestingly, private equity trounced public equity in 2008, losing 23.97 percent compared to the S&P 500's 38-percent collapse.(3)

Moreover, the nation's smartest capital allocators – those running top-tier hedge funds, college and university endowments – long ago recognized that allocations to asset classes that could move independently of stocks and bonds could help returns by lowering portfolio risk, and rendering them less correlated to stocks and bonds.

Asset Allocations for U.S. College and University Endowments and Affiliated Foundations, Fiscal Year 2018

	Domestic Equities %	Fixed Income %	Non-U.S. Equities %	Alternative Strategies (Total) %	Short-term Securities/ Cash and Other %
All Public Institutions	**19**	**10**	**22**	**46**	**3**
Public Colleges, Universities, & Systems	*14*	*9*	*22*	*52*	*3*
Institution-Related Foundations	*23*	*12*	*22*	*39*	*4*
Combined Endowment/Foundation	*23*	*12*	*19*	*43*	*3*
All Private Colleges and Universities	**15**	**7**	**19**	**56**	**3**

Source: 2018 NACUBO-Commonfund Study of Endowments® [3]

The Benefits of Low-Correlation Diversification

Among the major aims of asset allocation ranks the creation of portfolios with components that don't all behave In exactly the same way. With such a blend of lower-correlated investments capable of offering protection against all asset classes and portfolio components crashing at once.

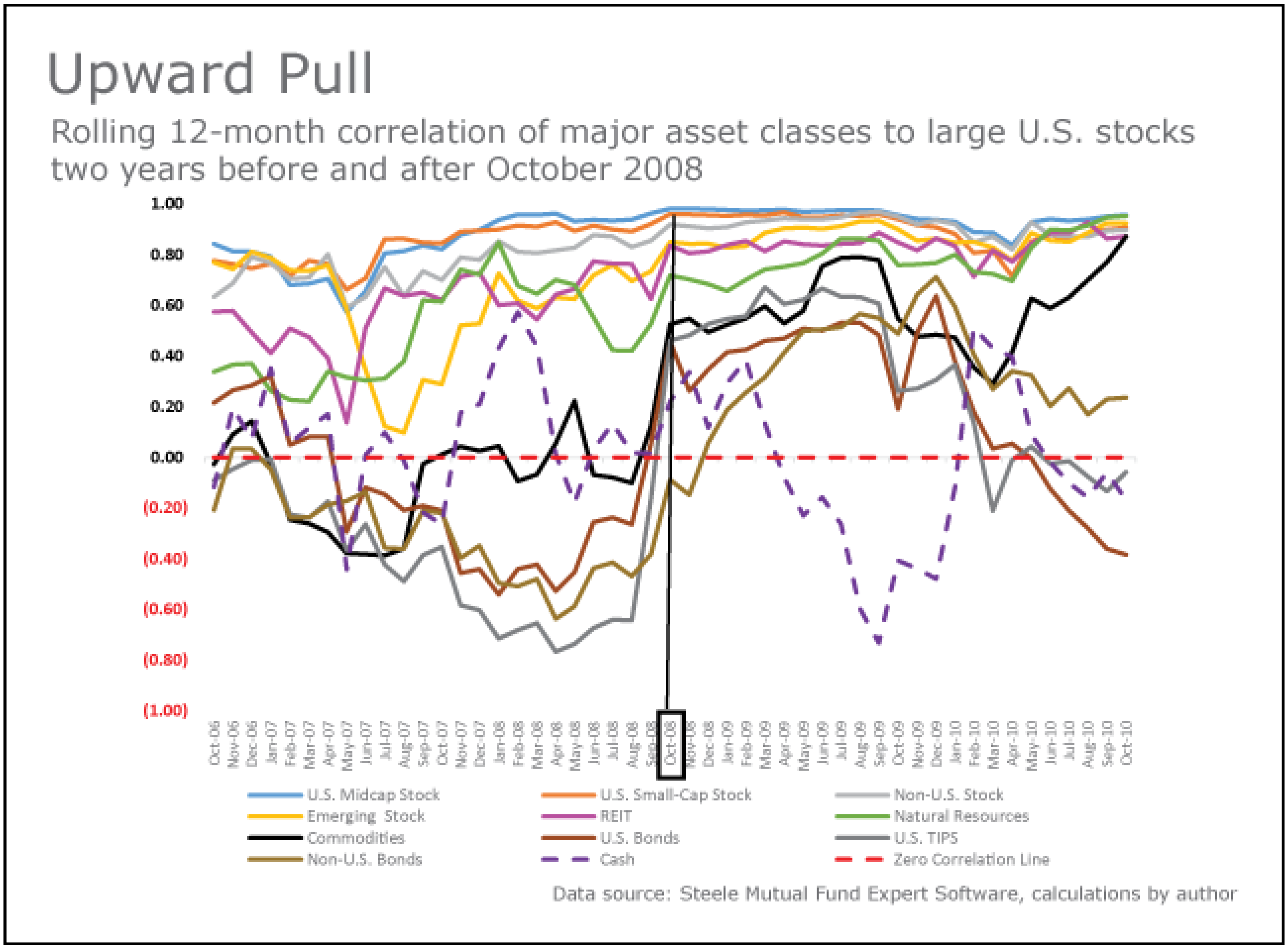
A commonly heard sentiment in 2008 was, "All correlations have gone to 1; there's no place to hide." In other words, when the correlation between two asset classes equals one, they will move in perfect lockstep. Conversely, a correlation of -1 indicates that two investments can behave very differently — when one moves up, the other moves down.

Finally, a correlation of zero or close to zero indicates that the behavior between two portfolio components is random. Which is usually the goal when constructing well-diversified, volatility mitigating portfolios. That is, to have at least some investments within a portfolio that have no well-defined correlation to each other, capable of moving independently of each other.

The problem plaguing most investors in 2008? Too much weighting to asset classes that were highly correlated. Accordingly, there were very few portfolio components moving independently of large-cap stocks as stocks were free-falling. Leaving entire portfolios to precipitously decline as volatility increased throughout the year. And as the chart on the following page reveals, correlations between the 12 major asset classes (ex-alternative investments) rose markedly as the year advanced.

True portfolio diversification, that which provides investors the opportunity to survive bear markets, should include low-correlation, alternative asset classes. As should any portfolio that aspires to more than simply track the ups and downs of market indexes.

Today, our team frequently asks groups of investors, "What are you doing differently today than you were in the fall of 2007?" To which most investors sheepishly admit to few if any changes. More than ten years later, they once again find themselves over-allocated to stocks, bonds and cash.



What constitutes an "alternative investment"? One that resides beyond the risk-and-return parameters of traditional stocks, bonds and cash. The benefits of which boil down to two core ideas:

1) Alternative investment managers generally seek a net positive annual return. They don't track a benchmark index like the S&P 500 or the Barclay's Aggregate Bond Market. They don't exclaim victory when they beat the S&P 500 index by 1.3 percent even as the index lost 39 percent. They simply seek to deliver a positive return. Year in and year out. Doesn't always happen. But that's the goal.

2) Alternative investments can provide portfolio diversification while often reducing portfolio risk. Some are specifically designed to mitigate risk. While others do so by working alongside asset classes to which they have little-to-no correlation. Enabling them to move independently of each other in any market environment.

The primary alternative investment types used by most seasoned, savvy capital managers include:

Hedge Funds
Managed Futures
Private Equity
Specialty Debt/Credit
Non-Traded Real Estate
Commodities

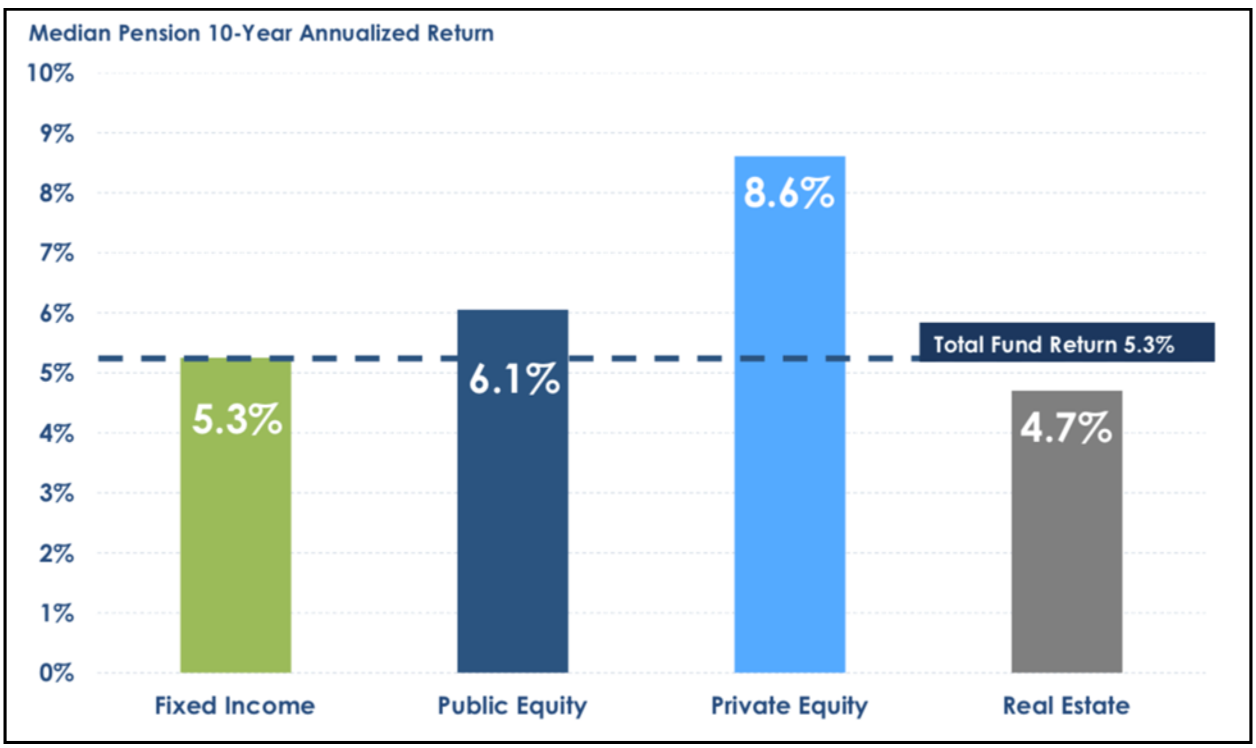
The average investor may utilize ETFs, mutual funds or individual stocks. Regardless, he'll require the stock market to move higher if his capital is to grow in value. Occasionally, markets do not cooperate.

There have been 13 bear markets -- defined as declines of 20-percent or more lasting at least a month with no immediate recovery -- in the postwar era. According to First Trust, the average bear spans 15 months and entails a cumulative decline of 38 percent.

Throughout each of these periods, portfolios holdings stock and bonds portfolios fared poorly. In the long run? Stocks recover. But that doesn't deride from the mental angst incurred during market downturns. Moreover, cognitive psychology and decision theory have taught us that investors dislike losing money more than they find joy in making it. The principle of “loss aversion” refers to people's tendency to prefer avoiding losses more than acquiring equivalent gains. In other words, the average investors would much rather to not lose 100 dollars than she would make 100 dollars.

Investors also understand that every 30 percent decline requires a 43 percent gain just to regain one's par value. Meaning, If a correction occurs within close proximity to the beginning of retirement? The wrong portfolio allocation can adversely impact an investor’s life.

John Maynard Keynes said, "In the long run, we're all dead." But in the near term, it is incumbent upon investors to allocate retirement capital in such a way that permits them to live within the means for which they’ve planned.



Source: American Investment Council

Accordingly, if one could utilize asset classes and investments that enhance the probability for success throughout market cycles of five to seven years, what's the excuse for not doing so?

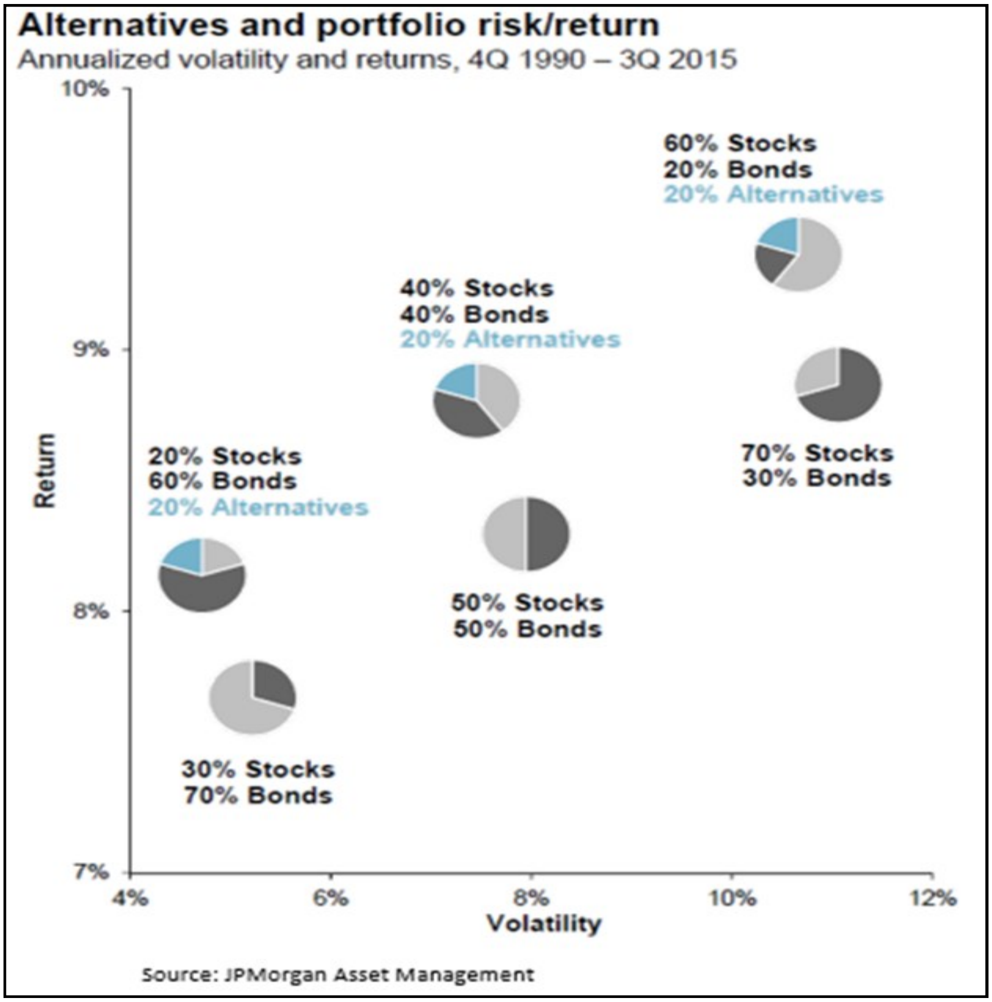
Consider private equity, which has been the top-performing asset class over the last 10 years. Outperforming U.S. and foreign equities. Bonds. The Nasdaq. Small Caps. By a wide margin.

Fewer fisherman in a much bigger pond? Makes sense.

Yet performance itself is not the top priority. Better performance achieved because of a reduction in long-term portfolio volatility is the primary objective. That is what can help investors sleep better at night. Many alternative investments can improve long-term portfolio management endeavors simply by providing a lack of correlation to traditional asset classes. Helping to lower volatility, or standard deviation, within the portfolio as a whole.

Much like a general manager assembling the roster of a sports franchise. The best GMs usually opt for the players that most improve the team, as opposed to those with the most upside potential (and all the attendant downside risk).

Studies like the one below by JPMorgan Asset Management reveal that the addition of alternative investments to portfolios can and often does improve performance while lowering volatility. That alone merits consideration in any investment endeavor. While explaining why the largest, savviest and most successfully managed pools of capital in the world often allocate a large percentage of capital to alternative asset classes like private equity, managed futures, hedge funds and real estate.



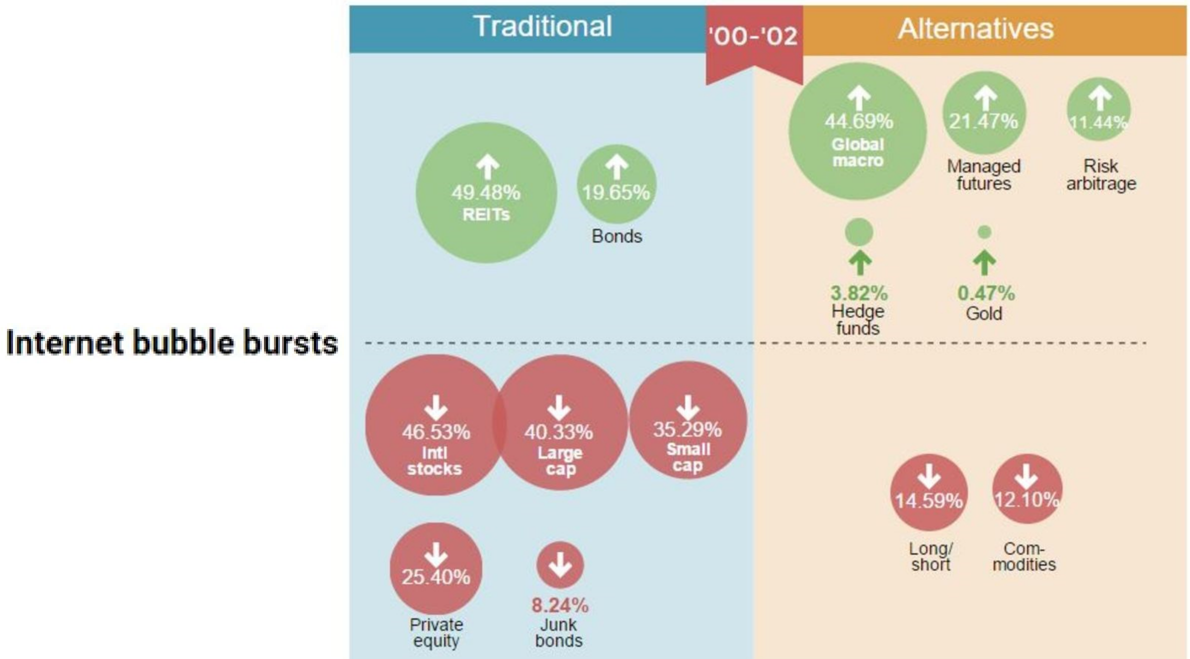
Of course, most investors think that such opportunities lay beyond their reach. Believing that alternative investments are available only to institutions and wealthy individuals. Which was once true. But today, the alternative investments industry has increasingly democratized. Our firm, for instance, has developed relationships with a variety of alternative investment opportunities available to all investors. Realizing, as we do, that all clients can benefit by diversifying into these asset classes. Not merely the wealthiest.

Do alternative investments represent a magic elixir? The remedy for all investment woes? Of course not. Like any investment, alternatives must also be scrutinized. They can be risky. Involve loss.

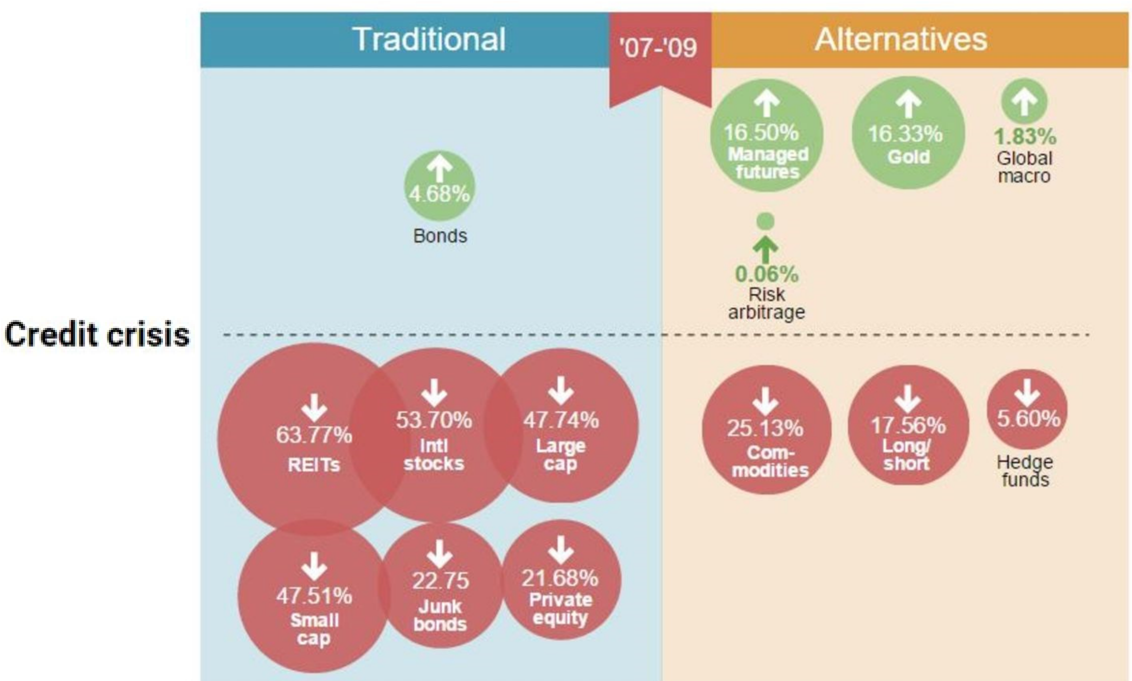
That said, the prospective risks of not incorporating such investments into portfolios have been emphatically established on two occasions over the previous 17 years.

Charles Prideaux, global head of product and solutions at Schroders, states that alternatives have "moved into the mainstream" because investors value their ability to add diversification and incremental returns at a time when publicly traded assets are not expected to deliver returns as high as those achieved historically.

"Alternatives can provide three to four percentage points of additional annual returns over public equities even through the fees are higher but investors have to be comfortable with longer lock-up periods, different transparency standards and to ensure that their alternative allocations are compatible with their overall risk and return profile," Prideaux explains.

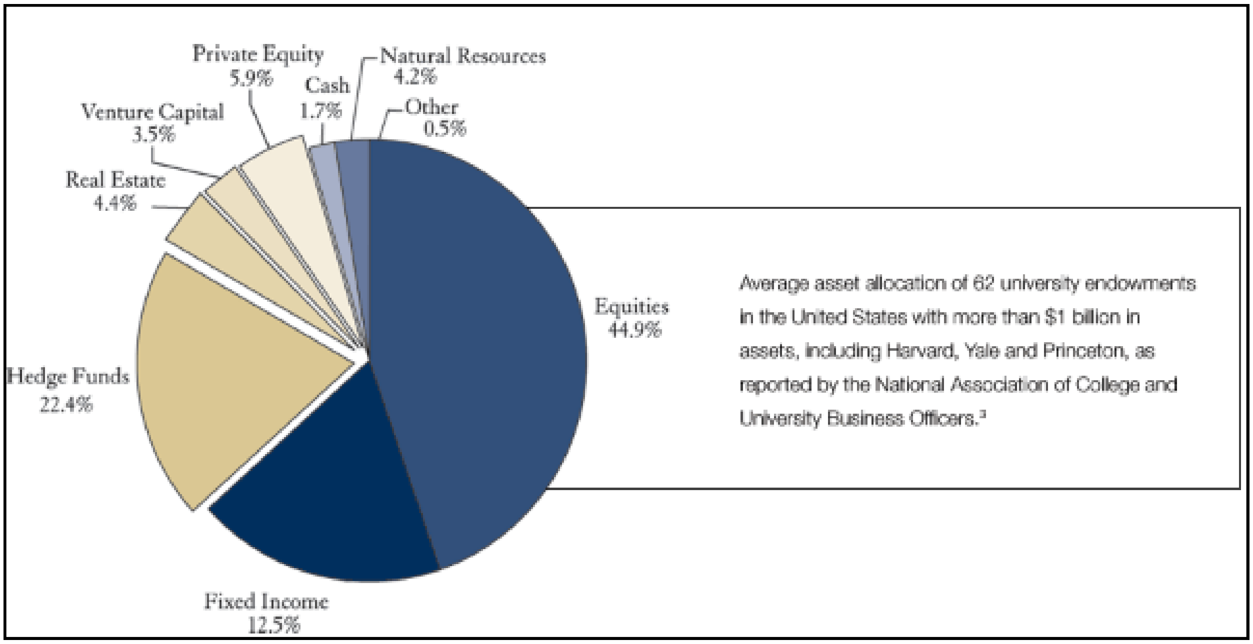


Source: RCM Alternatives



Source: RCM Alternatives

Alternative investments not only hedge against market risk, but can also outperform their traditional counterparts, as shown in the following graphs by RCM Alternatives. These illustrate how alternative investments fared during the Internet bubble burst and the Credit Crisis, respectively. Alternative investments are not immune to volatility, their lower correlation to traditional investment markets can help protect one's portfolio.



Conclusion

To move from traditional investment methods -- long-only stocks, bonds and cash -- to a more modernized, nuanced approach, alternative thinking is required. Investors must expand the toolbox by which they construct portfolios. Broadening from stocks and bonds to stocks, bonds, commodities, private equity, hedge funds and real estate and other real assets -- depending upon individual objectives.

Thus far, investors have been limited because Wall Street -- in its never-ending effort to gather additional assets without adding incremental effort -- has largely focused on stocks, bonds and cash. Even as executives at the big banks and brokerages allocate their capital into private equity, hedge funds, real estate and managed futures.

Today, the opportunity set available to all investors has evolved.

We live in a world of 7.7 billion people. Each of them engaging in financial transactions of one sort or another. The sheer magnitude of today's interconnected global financial system means that we can no longer invest like we used to. We must develop more sophisticated approaches for dealing with and investing within a more complex world.

Hedge fund manager Ray Dalio has counseled, "I think the first thing you should have is a strategic asset allocation mix that assumes that you don't know what the future is going to hold."

Dalio's statement conveys the idea that no asset class rises in perpetuity. Moreover, asset classes that are correlated will rise and fall, in unison. Leaving pragmatic investors, of all backgrounds and levels of affluence, to consider opportunities beyond stocks, bonds and cash. To climb outside of the little box in which Wall Street has long kept them.

Market returns have been excellent for over a decade. Which means the only thing we can count on is mean reversion. At some point, stocks will drop. Perhaps precipitously. It's not a matter of if, but when.

Investors can better weather the inevitable storms if they're willing to think and act differently. We believe they've worked too hard not to.

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1. http://news.gallup.com/poll/211052/stock-ownership-down-among-older-higher-income.aspx
2. https://www.portfoliovisualizer.com/historical-asset-class-returns
3. http://www.cambridgeassociates.com/wp-content/uploads/2015/05/Public-USPE-Benchmark-2014-Q4.pdf
4. https://www.cambridgeassociates.com/press-release/private-equity-and-venture-capital-outperformed-public-markets-in-2015-but-returned-less-than-previous-two-years/
5. https://www.ft.com/content/b535da30-448a-34bb-95f7-37ad56338213

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