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LIPMAN BURGON & PARTNERS

# Wealth Strategy
# Alternatives – A tool for the times

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# Adapting to changes in the market is central to successful long term portfolio management. Two powerful long-term market trends have now reached a point where allocators of capital must respond:

1. Global interest rates have bottomed close to zero
2. Alternative assets ('alternatives') have been democratised

Traditional Strategic Asset Allocation (SAA) was based around the key principle that bonds provide reliable income, capital preservation and are negatively correlated with equities. This relationship no longer holds. The negative correlation of bonds to equities is weakened by the effective zero lower bound of interest rates (or just below zero in some countries), and the correlation could become strongly positive if inflation increases significantly. Further, after a 30+ year bull run in bonds as interest rates have fallen, the yield on 10-year US government bonds – the global risk-free rate – is less than 1%. Income is negligible, and less than inflation.

The SAA approach is limited in its ability to address these changes. We have, therefore, recently adapted our portfolio construction process to incorporate a Total Portfolio Approach (TPA).

An important feature of TPA is to analyse investments on their individual return, risk and diversification characteristics, rather than grouping them into asset classes. In the case of alternatives, this decoupling is significant because of the broad array of investments that exist.

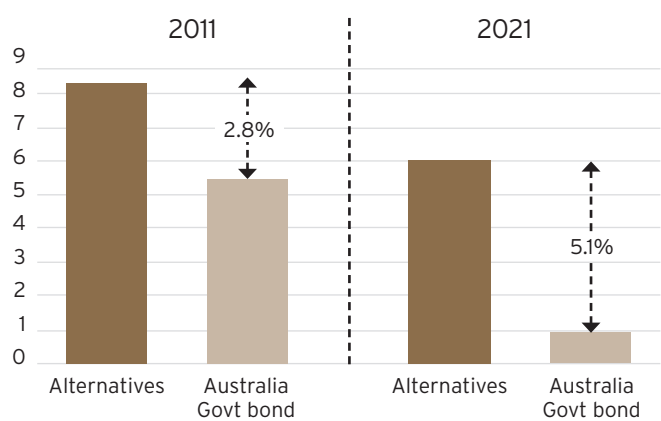
***Alternative investments are varied and have unique characteristics that can enhance portfolios.***

Alternatives, in their broadest sense, include investments and investment strategies that differ in substance and/or application from the standard purchase of public equities, government bonds, corporate bonds and cash. They range from higher risk and higher return investments such as private equity, through to lower risk and lower return assets such as property or private debt. Some are more liquid (gold, hedge funds) than others (private debt and equity, unlisted property and infrastructure). Notably, many have a relatively low correlation to equities and can increase portfolio diversification as a result.

Analysing the portfolio inclusion impact of each alternative investment ensures the recognition of the unique characteristics of these varied assets and the benefits they deliver to portfolios. This enables exposure to a broader universe of investment opportunities to enhance portfolios.

Ultimately, alternatives are an increasingly attractive portfolio tool at a time when low interest rates have reduced the returns offered by so many investments.

**Chart 1: Expected returns – Alternatives more relatively attractive***




Source: JP Morgan, Factset, Lipman Burgon & Partners

* Alternatives' expected returns from JP Morgan Long Term Capital Markets Assumptions 2011 and 2021. Australia Gov Bond is the 10-year yield that prevailed at the time.

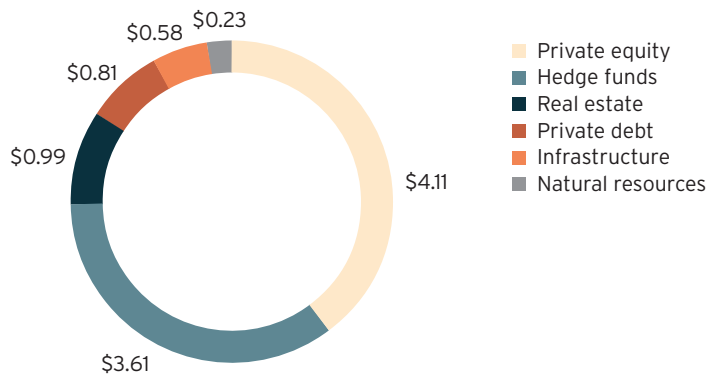
## THE DEMOCRATISATION OF ALTERNATIVES

Previously considered to be illiquid, risky, complex and opaque, alternatives had been perceived as unattractive to investors with limited knowledge. However, better reporting, stricter regulation, increased distribution and technological innovation, have improved the accessibility and transparency of alternative investments. For example, the number of available alternative investments on one of the major administration platforms has increased by 40% in the past five years.

As a result, investment in the alternatives universe has grown. Global alternative assets under management have grown from US$3.5 trillion in 2008 to US$10.3 trillion today. They are predicted to exceed $14 trillion by 2031.[1]

***Improved accessibility and transparency has led to huge growth in alternatives.***

**Chart 2: Global alternatives industry assets under management (US$ trillion)**




Source: Prequin, Alternatives in 2020. Natural Resources excludes private equity and infrastructure funds with a focus on natural resources. AUM as of 30 June 2019 in US$

Australian portfolios have historically tended to include a lower proportion of alternatives than portfolios overseas. This is likely to have been driven by historically higher prevailing interest rates in Australia, as well as the outperformance of the Australian equity market due to 29 consecutive years of economic growth. This helped large cap Australian banks and resources companies perform so well during the 1990s and 2000s and feature prominently within domestic portfolios. Today, these drivers are no longer present.

***Three key roles:***

1. ***Increase diversification***
2. ***Generate income***
3. ***Maximise returns***

## THE VARIED ROLES THAT ALTERNATIVES PLAY

Alternative assets often have low correlations with equity markets and can play useful and varied roles in portfolios. Three important roles we consider when constructing portfolios are reducing overall portfolio risk through diversification, generating income, and maximising returns. It is unusual for a single investment to perform all three functions; however, in combination, different alternatives can traverse these roles within a portfolio. It is therefore important to identify the different roles that these investments play in meeting portfolio objectives.

| | DIVERSIFICATION FROM EQUITIES | INCOME | GROWTH |
|---|---|---|---|
| Hedge funds | ✓ | | |
| Absolute return bonds | ✓ | ✓ | |
| Gold | ✓ | | |
| Private debt | ✓ | ✓ | |
| Unlisted property | ✓ | ✓ | |
| Unlisted infrastructure | ✓ | ✓ | |
| Private equity | | | ✓ |

Source: Lipman Burgon & Partners

1 Alternatives in 2020, Prequin. https://docs.preqin.com/reports/Preqin-Alternatives-in-2020-Report.pdf

Diversification is the most important and common role that alternatives play in portfolios, particularly if they are partly being used to replace government bond exposures. Equity beta is the most dominant risk factor in diversified portfolios, so adding diversification to a portfolio often means simply targeting exposure to risks that are not correlated to equities.

***Diversification from equities is the best way to enhance the risk/return of diversified portfolios.***

The diversification that an alternative investment will provide to a portfolio can be analysed in two ways. The historic Equity Beta measures the volatility of an investment as it relates to the volatility of the broader equity market – the key risk that needs to be diversified. It is also instructive to identify the key risk factors that drive the returns of the alternative investment to help conceptualise the likely future behaviour and its performance in different scenarios. It is also helpful to understand where returns are coming from so that a conclusion can be reached about how sustainable those returns are.

The table below highlights that equity is not a dominant risk factor in alternatives.

| | EQUITY BETA* | RISK FACTORS |
|---|---|---|
| Hedge funds | 0.2 | Active management, volatility, equity, leverage |
| Absolute return bonds | 0 | Active management, volatility, interest rate, credit |
| Gold | -0.3 | Commodity, currency |
| Private debt | 0.3 | Active management, liquidity, credit |
| Unlisted property | 0.5 | Property, active management, liquidity, interest rate |
| Unlisted infrastructure | 0.5 | Interest rate, inflation, active management, liquidity |
| Private equity | 1 | Active management, liquidity, leverage, equity |

* Projected equity beta estimates Source: Lipman Burgon & Partners

***Alternatives are more dependent on individual manager skill and as such require more in-depth manager due diligence.***

The most dominant risk factor across the alternatives universe is the choice of the investment manager ("active management"). Performance dispersion between managers can be high. Consequently, in-depth manager due diligence in alternatives is critical because performance is more dependent on the skill of the individual manager than any other factor. This is different from most other asset classes, where the primary performance factor is the asset class' beta and active management differences are secondary.

Lipman Burgon & Partners spends considerable time understanding funds management teams through face-to-face meetings, examining their track record, and studying individual managers' backgrounds and method of generating returns. The aim is to identify precisely how returns are generated so that we can assess how sustainable that performance is. Six criteria are used in evaluating managers:

1) Investment strategy and process
2) People and culture
3) Business alignment
4) Performance
5) Fees and terms
6) Risk management

While past returns are no guarantee of the future, they can tell a valuable story. The performance generated by a strategy in different market and economic environments can help conceptualise the risk factors that are driving the performance.

## MANAGING RISK AND MAXIMISING PORTFOLIO OUTCOMES

We believe that investors can maximise outcomes by using a tailored mix of alternatives to meet their portfolio objectives. Alternative investments can play a role in portfolios that is hard to replicate through other assets.

***A broader set of investment options helps to manage risk and maximise portfolio returns.***

With government bonds no longer investable and an improved access to alternative assets, incorporating TPA into our portfolio construction has helped increase exposure to a broader set of investment opportunities. In combination, we are using alternatives to provide the diversification and income that bonds no longer provide, which helps to maximise portfolio returns and, most importantly, to manage risk.

In subsequent articles, we will further explain how we manage the risks associated with investing in alternatives, as well as discuss which alternative assets can be best used to bring diversification to portfolios, generate income and maximise returns.



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