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LIQUID ALTS: RISING TO THE OCCASION

How Liquid Alternatives, Aided by Higher Cash Rates, Could Help Position Portfolios to Achieve 5% Real Returns

John Thorndike

Executive summary

- In the years following the Global Financial Crisis, liquid alternative investment strategies ('liquid alts' or 'alts') have failed to match their pre-crisis performance.
- Post-crisis returns have been dragged down by negative real (i.e. after inflation) cash yields, but this drag has likely been eliminated thanks to recent interest rate hikes by the Federal Reserve.
- Buoyed by short-term rates above expected rates of inflation, liquid alts now look poised to deliver attractive real returns and outperform developed equity markets in the coming years.
- Investors who redeem from alts today are exhibiting the classic investor behaviour of selling out as the opportunity set improves.
- Considering the risks and perceived opportunities of GMO's alternatives strategies, we believe the alts in our asset allocation portfolios have the potential to deliver 5% real returns.
- The improved prospects for alts and the attractive prices of emerging market value stocks indicate that our portfolios may be well positioned to outperform traditional balanced portfolios.
- While the 5% real return target sought by many institutional investors will likely remain a challenging bogey for diversified portfolios in the coming years, we are increasingly optimistic about our portfolios' prospects for delivering 5% real.

Liquid alts since the Global Financial Crisis

Liquid alternative investment strategies ('liquid alts' or 'alts') have disappointed many investors who bought into these strategies in the aftermath of the Global Financial Crisis (GFC). The term 'liquid alts' covers a broad spectrum of investment programs (e.g. equity hedge, event-driven, global macro, multi-strategy and relative value categories) that can colloquially be described as hedge fund strategies in mutual fund form. While no two liquid alts funds look exactly alike, the strategies generally exhibit low sensitivity to traditional asset class movements, take both long and short positions in securities, and turn over their portfolios relatively frequently. Unlike hedge funds that may employ lockups, restrict redemption activity, and provide only limited transparency into portfolio positions, liquid alts provide daily liquidity to investors and position-level transparency through public filings. In other words, liquid alts had much to offer in the post-GFC environment.

Not only did liquid alts have some attractive characteristics, they had also performed well through the GFC (the Wilshire Liquid Al-

The quote

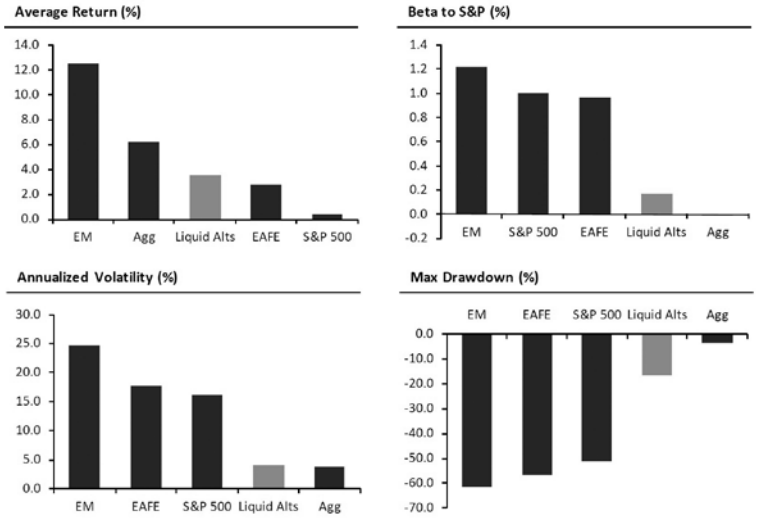
Liquid alts provide daily liquidity to investors and position-level transparency through public filings.

ternative Index is used in this paper as a proxy for the category's performance). In the 10 years ended 2009, liquid alts outperformed developed equity market indices, exhibited about as much volatility as bonds, and limited losses during equity market drawdowns. From 2000 to 2009:

- Liquid alts delivered average annual returns of +3.5%, outpacing the +2.8% average return of the MSCI EAFE Index and the +0.4% average annual return of the S&P 500.
- The 4.1% annualised standard deviation of monthly returns for liquid alts modestly exceeded the 3.8% volatility of the Bloomberg Barclays U.S. Aggregate Bond Index.
- Liquid alts experienced a 16.4% drawdown compared to losses of greater than 50% for broad equity market indices.

Not surprisingly, capital gravitated toward liquid alts funds. According to the *Financial Times*, industry assets doubled from 2011 to 2014. Perhaps also not surprisingly, increased assets under management for liquid alts funds corresponded with lower returns. So far this decade, liquid alts funds have averaged returns of +1.5% annually, which is 2.0% lower than their average in the prior 10 years and 0.1% below the rate of inflation over this period (as of 12/31/2018). As returns from liquid alts have disappointed investors, sales have plunged, and investors have questioned the role of these strategies in their portfolios. At first glance, it appears that liquid alts have suffered from the all-too-common effect of increasing strategy assets leading to decreasing strategy returns.

Figure 1. Liquid alternatives, circa 2010



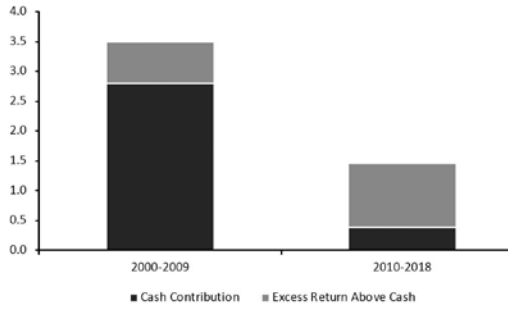
Sources: S&P, MSCI, Wilshire, GMO. 12/31/99 – 12/31/09
The Wilshire Liquid Alternative IndexSM measures the collective performance of the five Wilshire Liquid Alternative strategies that make up the Wilshire Liquid Alternative Universe. Returns are gross of fees.

The Fed's effect

Yet placing the blame for liquid alts' reduced performance on rising assets under management doesn't stand up to scrutiny. If increasing assets under management in liquid alts strategies were to blame for decreasing performance, we would expect the effect to show up in the strategies' excess returns relative to a passive benchmark. Cash, a short duration risk-free asset, is the most relevant benchmark for liquid alts because many of the underlying activities use cash as collateral and, more fundamentally, the underlying activities tend to have low duration. For example, in event-driven strategies, the time horizon for an event such as a merger closure is typically measured in months or quarters, not years.

Rather than experiencing degradation in excess returns since 2010, liquid alts have seen just the opposite. Figure 2 shows that from 2000 through 2009, alts returned an average +3.5% per year (net of fees). However, cash delivered an average return of +2.8%, so returns in excess of cash and fees during that period were only +0.7%. By contrast, while alts returns since 2010 have averaged just +1.5%, cash has only generated +0.4%, implying a +1.1% net-of-fee excess return over cash. Relative to cash, liquid alts have performed better since 2010 than over the prior decade.

Figure 2. Alts earn cash returns plus a spread



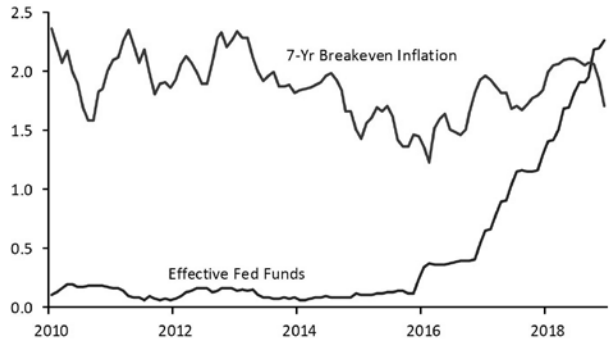
Source: Wilshire. As of 12/31/18

If too much money flowing into liquid alts strategies doesn't explain their decline in performance, what does? Lower returns on cash. Since 2010, cash yields have averaged 2.4% less than their 2000-09 levels, more than accounting for the 2.0% drop in liquid alts performance. Unhappy liquid alts investors need look no further than the Eccles Building – home of the Federal Reserve – to find the source of their disappointment. Investors should recognise, however, that as the Fed has moved away from a zero interest rate policy to a target rate roughly equal to the rate of inflation, the real return prospects for cash, and by extension for liquid alts, look much improved relative to recent years.

Real return prospects for alts

To build a real return forecast for liquid alts, we need to estimate the real return potential for cash and then estimate the potential for alts to deliver excess returns above that risk-free rate. Figure 3 shows that the Fed has hiked rates by 2.25% since December 2015, when it moved off its longstanding 0-0.25% target range. Figure 4 also shows that inflation expectations have been relatively stable over this period. As a result, current cash rates are modestly above the market's expectation for inflation over the next seven years. That's a significant improvement compared to the 1.8% spread between cash rates and the average rate of expected inflation that persisted from 2010-15. The Fed's move away from zero nominal rates means that cash returns have transitioned from a headwind for alts to a tailwind. Our forecast methodology for cash is informed by market pricing over the next two years and an assumed terminal real cash rate seven years from now. Across the different mean reversion scenarios that we consider (see sidebar), we forecast real cash returns of 0.2% to 0.6%.

Figure 3. Effective federal funds rate vs. market inflation expectations



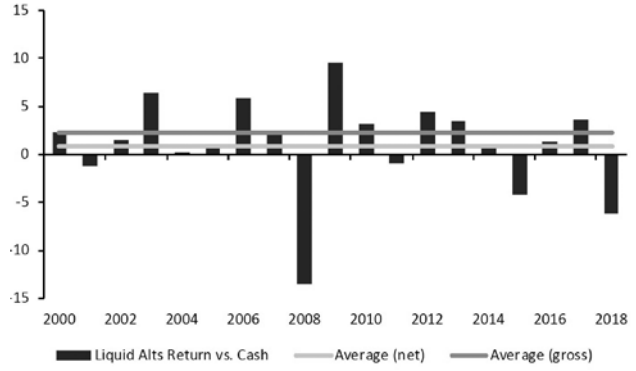
Source: FRED. As of 12/31/18

What does this mean for alts? If we look back on the full history, we can see in Figure 4 that the category has delivered 0.9% of incremental return above cash net of fees, which we estimate equates to about 2.25% before fees and other expenses. It's worth noting that the excess returns plotted in Figure 4 have a correlation with equity markets of 0.8. Further, liquid alts lost to cash in 2001, 2008, 2011, 2015, and 2018 – all years in which the MSCI All Country World Index declined. To our minds, this correlation is a favorable feature of the liquid alts track record: it provides a hint that liquid alts are incurring some amount of equity-like risk – what we on GMO's asset allocation team refer to as depression risk – and therefore deserve to earn a return premium above cash. For the purpose of looking at the prospects for alts broadly, we will assume that they continue to earn cash plus 2.25%, which when added to our forecasts for cash, equates to a targeted real return of about 2.5%-3%.

Alts vs. equities

Alts look attractive relative to developed equity markets. Table 1 shows our forecasts for U.S. and non-U.S. developed equities under the assumptions of *full, partial, and no mean reversion.*

Figure 4. Annual returns vs. cash for liquid alts



Source: Wilshire, GMO. As of 12/31/18

Full, partial, and no mean reversion

Full mean reversion assumes stock markets need to re-rate to deliver a 5.5-6% equilibrium real return. *Partial mean reversion* assumes stock markets need to re-rate to deliver a 4.5-5% equilibrium real return. *No mean reversion* assumes stock market valuations stay where they are today. In the *full* and *partial* scenarios, we assume that profitability falls such that corporate returns on capital equal the cost of equity capital whereas in the *no mean reversion* scenario we assume that corporate profitability trends toward its average of the last 10 years. (In managing asset allocation portfolios for clients, we put sufficiently high probabilities on the *full* and *partial* mean reversion scenarios with the ultimate aim to build portfolios that will outperform a passive portfolio in either case; we consider the *no mean reversion* scenario as a risk to our mean reversion-based process.)

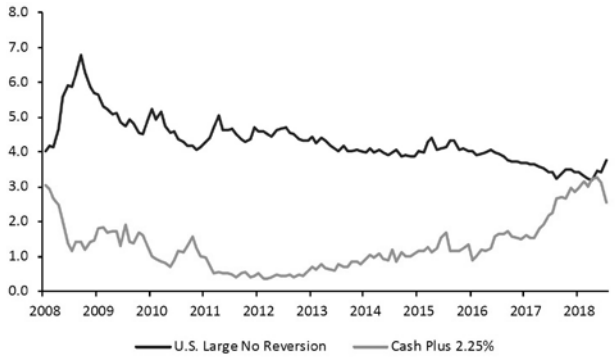
Only the value half of non-U.S. developed markets look priced to outperform alts across this range of scenarios. Large cap U.S. stocks look priced to significantly underperform alts whether we get full (-2.5%) or partial (-0.3%) mean reversion. Only if U.S. equity valuations remain constant do their expected returns (+3.8%) exceed what alts ought to be able to deliver in that scenario (+2.6%).

Table 1. GMO seven-year real return forecasts of 12/31/2018

	Full mean reversion	Partial mean reversion	No mean reversion
U.S. large	-2.9%	-0.3%	+3.8%
Developed ex-U.S.	+2.0%	+3.9%	+4.5%
Developed ex-U.S. Value	+4.9%	+6.0%	+5.5%
Alts proxy (Cash+2.25%)	+2.9%	+2.4%	+2.6%

Investors who share our conviction in mean reversion have likely been underweight U.S. stocks for quite some time. In our benchmark-free allocation strategy, we eliminated the last of our long-only allocation to U.S. quality stocks in February 2018 by converting the position into a relative value strategy and moving it to our alternatives allocation. Figure 5 shows why. It plots our *no mean reversion* forecast for U.S. stocks against our forecast for cash plus 2.25% from mid-2008 through the third quarter of 2018. The area between the two lines represents the return liquid alts need to generate above their historical track record in order to match the return from U.S. stocks (assuming valuations stay constant). The two lines crossed at the end of the third quarter, meaning alts didn't need to generate any premium over their historical track record in order to match the returns from U.S. stocks in a world devoid of mean reversion. The fourth quarter's equity sell-off and rally in short-term interest rates caused the spread to widen, but to a level that remains well below the spread seen for most of the past 10 years. Prior to 2018, if you expected valuations to stay constant, then you would have clearly preferred U.S. stocks over alts. Today, however, even if you hold that view, Figure 5 shows that there's likely an opportunity to diversify your portfolio without materially reducing your expected returns.

Figure 5. Comparing alts and U.S. equities in a *no mean reversion* world



Source: GMO. As of 12/31/18

Determining just how much of your portfolio to steer away from equities and direct toward alts depends both on your expectations for mean reversion in equity markets and on the spread you expect alts to deliver above cash. While the 2.25% spread generated by liquid alts funds historically may be a plausible forecast for future returns, we believe GMO's alts strategies have the potential to do better. To explain why, we now turn to our process for forecasting the return potential of alts.

Determining our target for GMO's alts

GMO's asset allocation team uses a seven-year framework when forecasting returns for traditional asset classes. The basic building blocks of this framework are:

1. Estimates of current valuations for each asset class,
2. Estimates of the equilibrium return that investors will demand for owning each asset class, and
3. An assumption that prices will move one-seventh of the way from their current valuation to equilibrium valuations in a year.

Unfortunately, a seven-year framework isn't much help for calculating forecasted returns (return premium above the cash rate) for many liquid alternatives due to the short duration of liquid alts strategies. Corporate takeovers will generally occur, or not, within a 6- to 18-month window; as a result, merger arbitrage doesn't fit neatly into a seven-year framework. Actively managed strategies such as our systematic global macro and relative value rates & FX strategies, which react to both valuation and sentiment signals and as a result tend to turn over their portfolios in under a year, don't fit either.

Developing return targets for alts requires that we step out of our seven-year forecasting framework. Our goal isn't to come up with a precise methodology so that we can react to small changes in forecasts, nor do we aim to forecast any and all flavors of alts that an investor may consider. Rather, our goal is to build a mosaic of inputs that help us consider the prospects for the alts managed at GMO. We aim to take advantage of both the top-down, generalist views from our asset allocation team (what Daniel Kahneman would call the "outside view") and the bottom-up, specialist views of the teams managing GMO's alternative strategies (Kahneman's "inside view"). For a given strategy, the outside view involves understanding the strategy's exposure to the main systemic risks that we believe investors are paid to incur – depression, unanticipated inflation, and liquidity shock risk – and comparing those exposures to traditional asset classes. This helps us put a range on the projected long-term returns to a given strategy. The inside view builds upon the historical track record of a strategy and the team's models for the current environment. Finally, we use our seven-year forecasts for cash as an estimate for the risk-free component of returns.

GMO's alts fit into three broad categories: equity-oriented, event-driven, and relative value. To illustrate our approach to forecasting alts, let's look at an example from each category:

- **Equity-oriented** - GMO's risk premium (put selling) strategy systematically sells at-the-money puts on equity market indices. The outside view of this strategy is rather straightforward: by selling puts we are exposed to the downside risk of equities; therefore, we ought to earn an equity-like return. As an approximation, we can think of the return to put selling as being one-half driven by equity markets and one-half driven by another risk premium, the volatility risk premium. In determining a target return for put selling, we place a one-half weight on our seven-year equity forecasts and a one-half weight on cash plus an estimate of the volatility risk premium, which our global equity team models as part of their investment process in managing the strategy.
- **Event-driven** - GMO's approach to event-driven investing centers on definitive agreement merger deals. These investments provide a return profile that is similar to investing in credit: most of the time, the majority of the positions make a relatively small amount of money and the gains from the investments that pay as planned (when the merger closes or, analogously, the bond coupons get paid) should compensate for the losses incurred by the few that don't, despite the losses on most losing positions being much larger than the gains on the winners. Both merger arbitrage and credit investing have depression and liquidity shock risk, as merger deals are more likely to break and coupons are less likely to get paid when the economy and/or markets are doing poorly.

While we think comparing merger deals to high yield bonds is helpful for thinking about the long-run returns to merger investing, we don't expect the two activities to be so tightly related as to use changes in our high yield forecasts as a time-varying component of our forecasted returns for merger arbitrage.

- **Relative value** - Unlike put selling or merger arbitrage trading, we do not think investors should earn any premium above cash for systematically engaging in relative value trading of securities within the same asset class. Systematically buying a basket of stocks and shorting a different basket of stocks without any insight as to the composition of those two baskets should underperform cash due to transaction and financing costs. That means our relative value strategies rely on differentiated alpha views to earn a place in our portfolios. An example today is our view that a long position in developed non-U.S. value stocks, hedged with short positions in U.S. stocks and the relevant currencies, offers an attractive investment opportunity due to the valuation discount of non-U.S. stocks relative to U.S. equities. Although we use our seven-year forecasts when analysing the relative value opportunity, the forecast return of a spread trade is not simply the forecast on the long asset less the forecast on the short asset. We must account for average returns over our rebalancing window, the transaction costs associated with rebalancing, and the optimal hedge ratio implied by the covariance of the asset classes in which we're positioned.

As we look at our alternatives book strategy by strategy, we estimate that we can target a return of cash plus 3–4% from these strategies before any value added from specific security selection. Differentiating the return to an activity such as merger arbitrage from specific security selection is more of a theoretical distinction than a practical one. The distinction is clearer for the non-U.S. developed value stocks vs. S&P 500 relative value trade: our cash plus 3–4% target includes an assumption for the projected return of this trade if both legs of the trade were indexed. In practice, we actively manage the long book of this position because we believe that our global equity team can generate security selection alpha within the non-U.S developed value universe. Therefore, we hope to do better via security selection than the cash plus 3–4%.

While we arrive at our range of targeted returns for alts by considering the risks and opportunities embedded in GMO's specific strategies, we are comforted by the fact that the historical 2.25% return premium delivered by liquid alts funds is close to what we hope to achieve from our own strategies. Whether our return target for GMO's alts proves conservative, aggressive, or spot-on remains to be seen. But what we have already seen – that today's cash yields are about the best they've been in the post-GFC period – in our view makes the future for liquid alts look brighter than the recent past.

Conclusion: targeting 5% real

With the rise in cash rates to the point where cash now may provide a positive real return, we think alternatives broadly have the potential to deliver 2.5–3% real returns for investors. We believe the alts in our portfolio may be poised to perform even better, with the potential to deliver up to 5% real returns in the coming years if our underlying investment teams can deliver the security selection alpha that we currently target. Alts join emerging market value stocks – our asset allocation team's favorite asset class – in offering attractive return possibilities. Together, alternatives and emerging market value stocks comprise over 50% of GMO's benchmark-free allocation strategy. As the name implies, we manage this strategy without concern for its tracking error relative to any particular benchmark. That said, we believe benchmark-free has the ability to outperform a traditional balanced portfolio over the medium-to-long-term. For context, a traditional portfolio that allocates 60% to the MSCI All Country World Index and 40% to fixed income will invest about 3.3% in emerging value stocks and will not hold any alts. With so little exposure to attractively priced equities and alternative investment strategies, we believe the traditional portfolio looks likely to disappoint. Our ability to invest a significant portion of the benchmark-free portfolio in alternatives is an important reason why we believe this portfolio is positioned to outperform traditional portfolios in the coming years.

While we still believe a 5% real return goal will prove a challenging bogey for a diversified portfolio over the next seven years, the improved return prospects for alts and emerging market value stocks may help us to position our portfolios to deliver against this objective. That said, in order to earn 5% real we need a few developments to break our way: we need the fundamentals of value stocks in emerging markets to be less bad than their valuations imply; we need our value-oriented security selection processes within asset classes to prove fruitful; and we need some volatility across asset classes to provide profitable rebalancing opportunities. We believe all these developments are reasonably likely, but whether or not they occur remains to be seen. In prior years, it also remained to be seen if, and when, cash rates would turn positive in real terms, thereby providing a needed boost to alternatives and other short duration strategies. Thanks to the recent rise in cash rates, we can check this development off our wish list. That is an important development for our portfolios, and a development that has us increasingly optimistic about their prospects. **FS**