Alternatives: A Traditional Fixed Income Replacement

As 2017 begins, a time to reconsider?

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As 2016 becomes less visible in the rear view mirror, investors are once again compelled to look forward as they construct durable portfolios. While markets may look uncertain to many sage investors, there have been some key uncertainties removed from the market including the US presidential election, crashing oil prices, Fed-direction uncertainty, and the positive/negative sign on global growth. Very significantly, one key driver of portfolios, global bond returns, appears to have come to the end of a 35-year bull run. The professional allocator is thus faced with the usual conundrum of how to position the portfolio differently, if at all, in 2017 and beyond *plus* the fiduciary pressure to replace bond exposure with another asset class. Despite the press widely reporting on the death or at least new paradigm of the hedge fund, it is again worth considering adding a lower-volatility, well-diversified hedge fund exposure to make up the gap left by traditional, long-only fixed income returns.

Traditional fixed income assets, particularly rate-sensitive ones, have had a decades long, mostly low volatility bull run that has provided a steady income source for many traditional (70% bond/30% equity, 60%/40%) institutional portfolios with mid to long range outlooks. Coupon income was reliable and maturities were easily replaced with a selection of global bonds with coupons high enough to get the portfolios well on the way to achieving their bogey rate of return. Some of the decline in yields has been offset by institutions with the addition of leverage, which obviously has not been without periods of peril. The volatility has largely been episodic, with the last big spike being the US Treasuries flash crash of 15 October 2015 prior to the more recent rate rise. The current rate rise is largely attributed to a gradual tightening of monetary policy coupled with the perceived coming fiscal policy changes of the new US Administration, led by unexpected victor Donald Trump. Regardless of impetus attribution, it does appear that the global bull market in bonds has now been supplanted by a bear market or at least a trading market. The following chart of US yields shows that this trend, which was ultimately relied upon by both discretionary and systematic managers is finally exhausted.

Fig.1

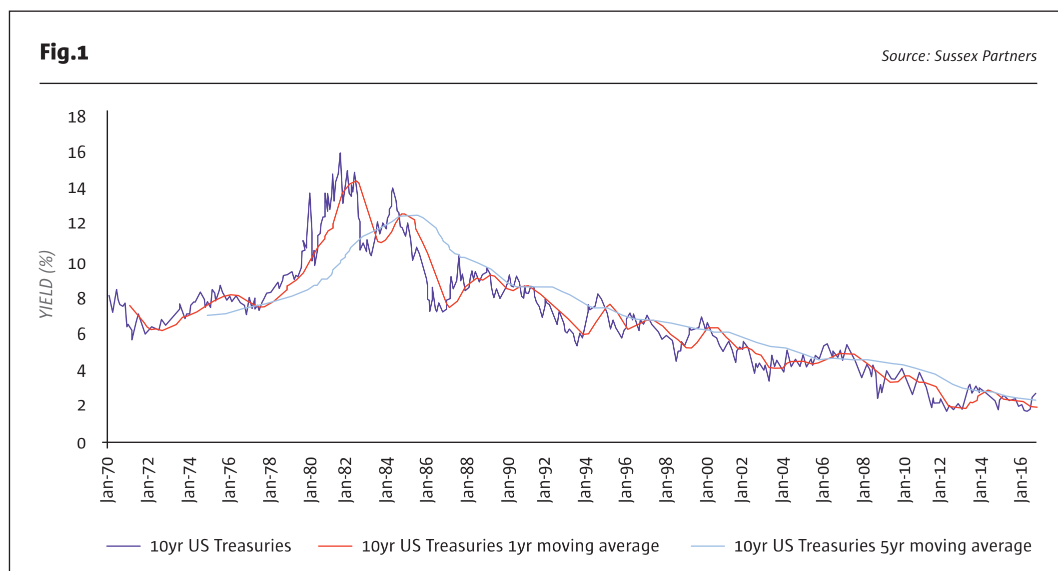
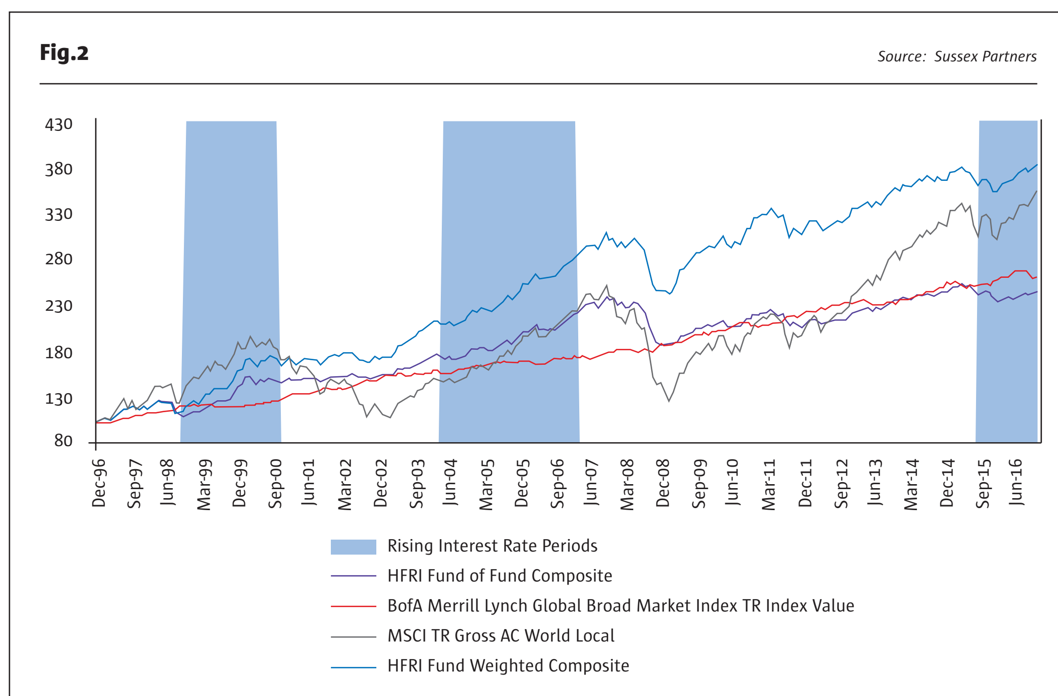


Fig.2



Both the end of the bull run for bonds and the artificially low-level of global rates due to multiple layers of quantitative easing has led investors to seek alternative sources of predictable, lower volatility returns. The bull run "bar" (long duration) is certainly set high as a buyer of 30 year US bonds in 1985 returned 9% with 12% standard deviation prior to the current rate rise, which equated to 90% of equity returns with 68% of the risk. Those kinds of yields are ancient history and a trend towards higher global rates with increasing volatility, and in many cases fed by decreased liquidity, seems firmly in place. The liquidity issue of global bonds is another topic, but clearly plays into a desire to shift away from what was formerly the most liquid of markets and is now one dominated by government purchases (especially in Japan and Europe). There has been much written on the lack of liquidity of the US Treasury market, past the on-the-run issues, brought about by the reduction in balance sheets, participants and risk budgets. Even if 10-year yields hover around the recent highs of 2.60% and riskier credit assets stay around current spreads there is scant room for rate compression (or arguably spread improvement). There has been a fair amount of movement over the last few years out of the liquidity spectrum of more credit-sensitive fixed income as yield-hungry investors made that trade-off to try and match their liabilities. Investors are now becoming increasingly wary of low illiquidity premiums and are beginning to avoid seeking additional yield in those arenas. Since this is all largely known and has been on the horizon for some time, the issue is what are investors doing about the need for return, or planning on doing?

If one merely read financial press headlines assuming they were well supported by statistics, it would be easy to conclude that hedge funds offer no solution to the current return issue and are in fact a part of the problem. It is true that there is pressure on funds to perform, cut or substantiate fees, or even survive, in what has been a low return environment since the "beta bounce" post-crisis. However, behind the scenes an interesting

Fig.3 *Source: Sussex Partners*

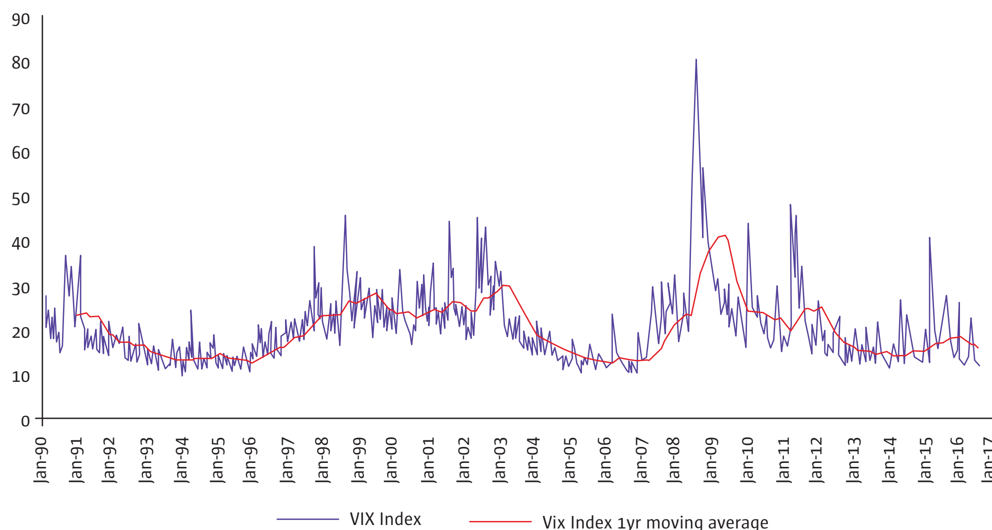
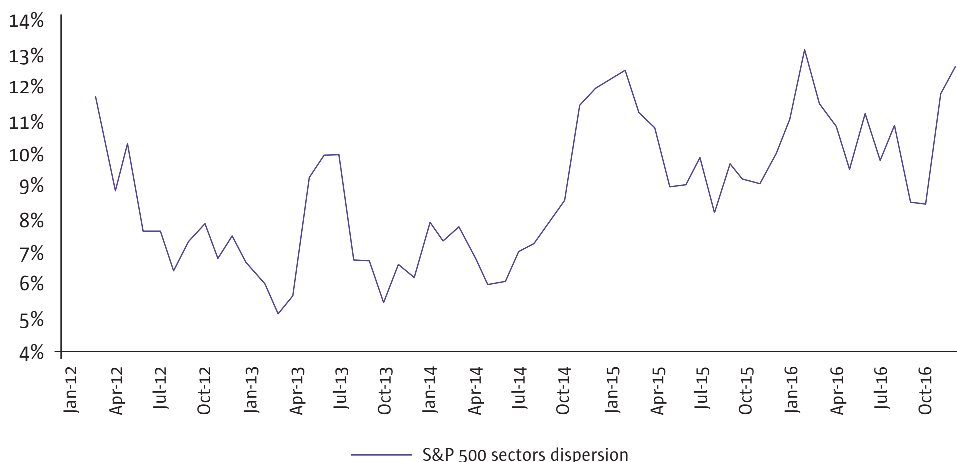


Fig.4 Monthly S&P 500 Sector Returns Dispersion - Maximum Minus Minimum Returns (3 months average) *Source: Sussex Partners*



re-allocation has begun to gain momentum, particularly involving the traditional fixed income portion of investors' portfolios. Investors have shifted to lower volatility fixed income hedge funds and well diversified multi-strategy hedge funds in an attempt to find a diversified (especially away from equities) return stream instead of re-investing in more traditional fixed income. In the case of the fixed income hedge fund managers, the move is largely a pivot from long-only to long-short given the environment and outlook. Objectively, from a quality standpoint, there are not a lot of post-crisis surviving choices and most funds that pass institutional-level due diligence have now at least soft-closed from the influx, in some cases despite not outperforming any relevant benchmark. The multi-strategy allocation began as a return chasing exercise to some of the largest, more levered/historically volatile managers which have performed well post-crisis. Several of these $15 billon+ managers are also now closed or have established less-liquid share classes to curb growth. The multi-strategy hedge fund shift has now expanded to include some of the higher quality multi-strategy managers that have exhibited strong single-digit returns post-crisis with fixed income-like volatility, which generally means less net equity exposure. It seems clear that thus far, only a very small portion of the fixed income bucket has been re-allocated, something that is destined to change barring an unexpected paradigm shift. The barrier to such a shift may be as simple as a restrictive mandate or a lack of internal resources to make the change in a fiduciary manner. Mandates will evolve to meet the environment, and resources to evaluate managers can be supplemented using external advisors.

While the goal is to drive looking through the windshield, there is some historical basis for hedge funds outperforming fixed income during periods of rising rates. The survivorship bias of hedge fund indices aside, hedge funds have produced better returns than fixed income during these few rising rate periods. This can be shown simply by looking at a plot of the HFRI indices vs. bond indices and observing the performance during periods of rising rates (in this exhibit determined by using T-bill data). Keep in mind that these "rising rate" periods are embedded in the longer 35-year bull run of bonds, which has arguably come to a close.

The dearth of returns broadly in hedge funds during the 2012-16 period has led to some, very publicly, abandoning the space or at least reducing exposure using returns as a guide. Given that the equity market has returned 48.0% in the five-year period and hedge funds have returned 8.5%, the frustration is understandable. Arguing for increasing exposure, even as a fixed income alternative, at this juncture can be viewed as contrarian by this group of investors. The reason for the view is both defensive and offensive in deference to a rapidly changing landscape. Offensively the argument is that the opportunity set is vastly improved from the doldrums of the prior period. Global equity markets are on the move and have certainly had an impressive rally off the back of the US election. Equity volatility is showing more normalised levels and single stock and sector dispersion is picking up. Strategies like global macro and distressed/event are seeing clearer opportunities in which a reasonable amount of capital can be deployed. Convertible arbitrage, capital structure arbitrage, and merger arbitrage have begun to produce robust risk-adjusted returns. This is against a backdrop of reduced capital for the first time since 2008, which results in fewer players operating within a diverging set of global economies.

The key to any portfolio shift using external managers is manager selection. Since the thesis here is to re-allocate the fixed income portion of the portfolio while staying broadly diversified, two alternatives seem reasonable. The first, underway as discussed above, is to seek out lower volatility multi-strategy managers. The managers sought should have provided steady returns since the 2008 period with lower volatility (Sharpe of over 1). The correlation to equity markets should also be low, certainly in comparison with broader hedge fund indices as that exposure is garnered elsewhere. Direct equity exposure should be tightly controlled at the strategy level, and utilising long/

short towards equity market neutral is favoured. Clearly multi-strategy funds that have big long, concentrated, albeit active, equity positions would not fall into this category. Investors should seek managers that actively re-allocate among strategies guided by a proven framework with discernable resultant alpha. This is a tall order and not easily achieved for a lot of reasons including firm structure. In some cases, managers argue against a top-down allocation, believing that the quality of the portfolio managers will hold sway in all market environments. Larger mangers deal with the issue by running very diversified firms with very tight risk controls. This debate aside, it is also imperative that there is a documented method, including a funding source or commitment of principals, to deal with netting issues among the different PMs/teams in preparation for disparate returns. The worst outcome for investors is a manager who needs to cut performing risk in order to minimise business cash flow problems. Fig.5 takes a look at the relative outperformance of the best performing multi-strategy funds of less than five billion AUM in the fund. Hindsight is easy, but the point is that there is real outperformance possible, even if all the funds are not chosen.

The second path is not yet well-travelled and that is allocating to multi-managers (formerly known as FoHFs) which have many of the same characteristics as the multi-strategy managers. The reasons all but the very largest of this group has fallen out of favour since 2008 are well publicised. However, those that have survived or have emerged since the crisis have been (re)structured to resemble multi-strategy managers much more closely. This includes the use of customised funds from managers, better risk systems, aggressive fee reduction at all levels, and an increasingly active management style. For purposes here, funds that are less than $5 billion but still institutional in quality, more relative value focused, low net/gross equity (if any long/short), with solid mid to high single digit returns are ideal. This universe, depending on the level of comfort with smaller managers (meaning those under $2 billion), is still quite large. Some of the managers are adopting more investor-respectful fee structures that are tiered based upon returns, inspired by the difficulty of raising new assets. The funds should be reasonably concentrated, not unlike the number of portfolio managers at a mid-sized multi-strategy manager. An added benefit to this approach is avoiding the single manager business risk inherent in multi-strategy managers, including that resulting from netting issues. The returns of a sub-set of these multi-manager funds are indeed differentiating for 2016, with some achieving returns meeting or exceeding the typical 7% portfolio bogeys.

Investors that seek to meet return bogeys, whether publicly released or internal, are being forced to

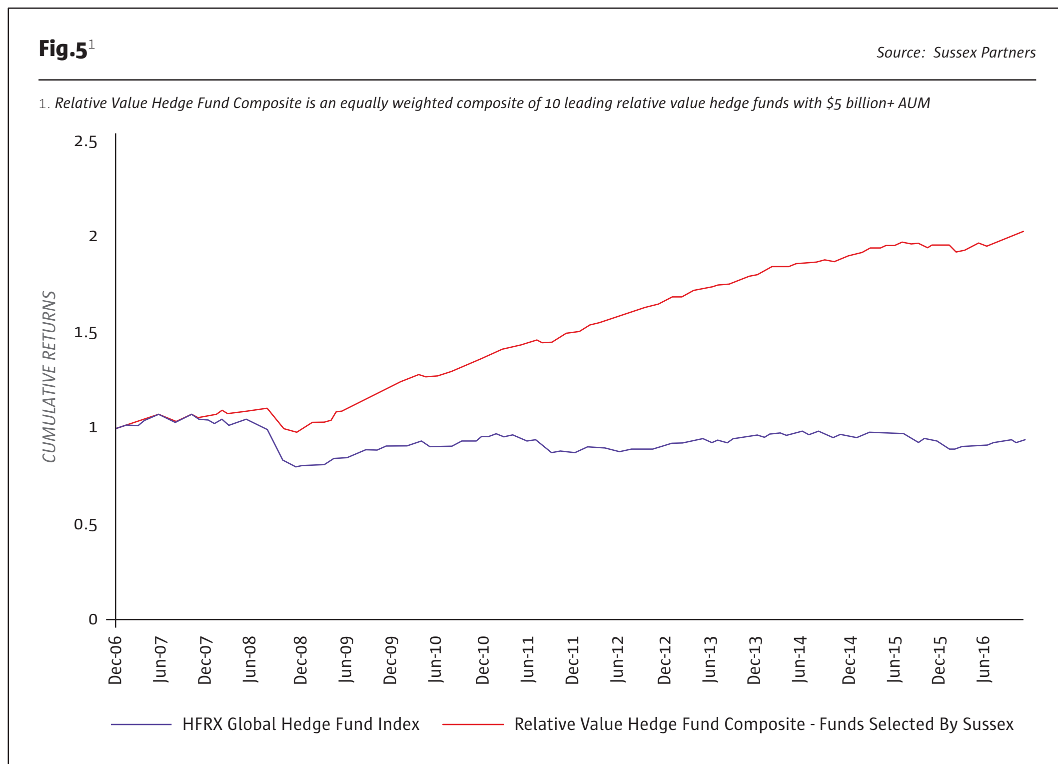


Fig.5[1] *Source: Sussex Partners*

1. *Relative Value Hedge Fund Composite is an equally weighted composite of 10 leading relative value hedge funds with $5 billion+ AUM*

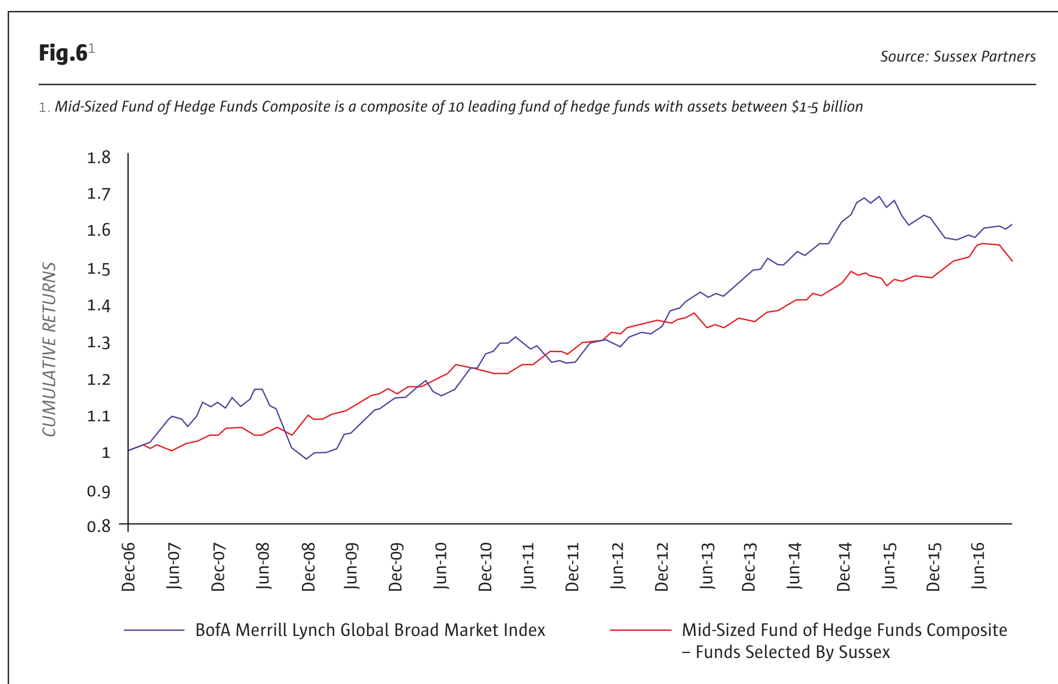


Fig.6[1] *Source: Sussex Partners*

1. *Mid-Sized Fund of Hedge Funds Composite is a composite of 10 leading fund of hedge funds with assets between $1-5 billion*

lower those levels as the market returns have fallen. In particular, the lack of contribution to return from global long-only bond portfolios now and for the foreseeable future, without adopting unpalatable risk, is resulting in re-allocation conversations amongst institutional investors. Replacing maturing fixed income exposures in this low to rising rate environment, without going way out on the risk/liquidity spectrum, is next to impossible. Similarly, taking on additional equity exposure, which is already in rebalance territory given the rally, seems to be a high-risk option. As the markets, governments, and central banks wrestle with the new low-to-higher rate regime, there are options for investors in the hedge fund arena. While the first move may have been moving to relative value/macro fixed income hedge fund strategies, increasingly investors are utilising lower-volatility multi-strategy and the closely related multi-manager funds to capitalise on an improved opportunity set. As the new reality of 2017 begins, it is an excellent time to consider a measured reaction to the environment. **THFJ**