SelectAlts

Wisely Managed Absolute Return Portfolios

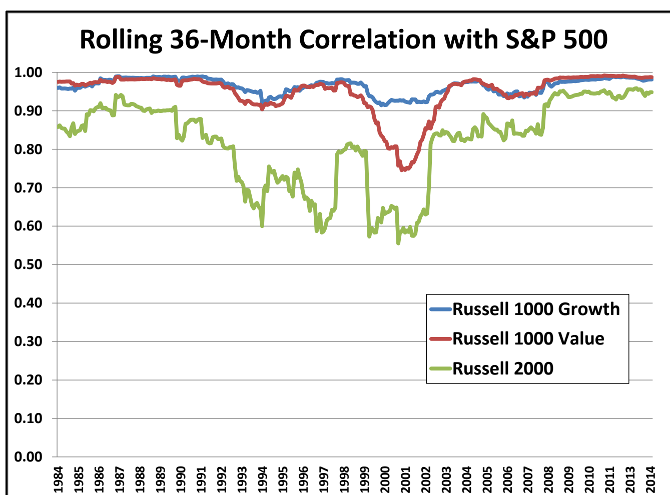
THE SELECTALTS VALUE PROPOSITION

In my previous articles I've mostly explored investment strategies that I have employed. This time, however, I want to lay out succinctly why you might want to consider allowing me the privilege of investing at least a part of your assets.

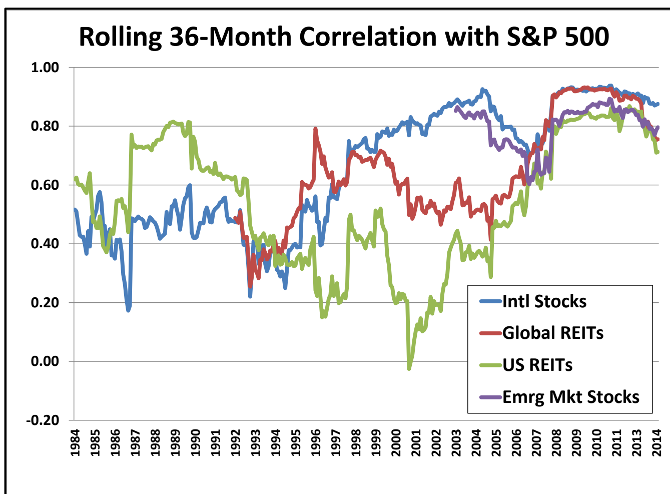
Diversification

Most investors, particularly most individual investors, are poorly diversified but don't realize it. They believe that if they have a stock portfolio that includes a mix of value, growth, large, small, U.S. and international stocks, they are well diversified.

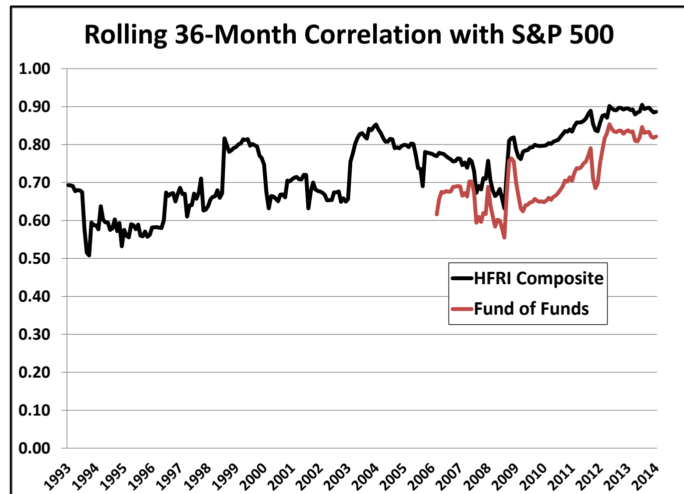
While that may have been true once, the graphs at right show that today all of those types of equity investments tend to move together, with a correlation of greater than 80% in most cases. (Correlations vary from a low of -100% to a high of +100%, and measure the return relationship of two assets over time. When two investments have a 100% correlation to each other, they move up and down together in perfect lockstep.) Frankly, growth and value never provided much diversification except during the internet bubble period (Russell 1000 Value in red, upper right), and small cap stocks, which once had correlations as low as 60% are now at 90% or more (Russell 2000 in green, upper right).



Many asset classes that once provided attractive diversification, such as international stocks (in blue, lower right), U.S. REITs (in green, lower right), global REITs (in red, lower right), and emerging market stocks (in purple, lower right) are now all above 70%. Volatile market environments such as we have had since the Great Recession of 2008 tend to make "all correlations go to one" (or 100%) and make the need for investments that behave differently that much more critical.



The need for diversification has led many investors into alternative investments, including real estate, private equity, and hedge funds. However, even hedge funds have seen their correlations with the S&P 500 increase in the past few years. The HFRI Composite Index (in black at right) is perhaps the broadest and most authoritative hedge fund index available. The HFRI Fund of Funds Index (in red at right) includes a wide variety of funds of funds, which in turn invest in hedge funds.



Clearly, diversification has become harder to find.

<u>Expected Return</u>

Correlation measures only one aspect of an investment—its ability to diversify another investment, such as U.S. stocks as measured by the S&P 500 Index. The lower the correlation, the more likely an investment is to diversify. That's good.

However, betting on a roulette wheel would also be a low correlation "investment," albeit one that has a negative expected return and a very high level of volatility. Ideally, you would like your investments to have an attractive expected rate of return, particularly when adjusting for their level of expected risk (or volatility).

Over long holdings periods, **stocks** tend to deliver attractive returns, so having a reasonable percentage of your portfolio in stocks makes good sense. Much of the reason that stocks provide attractive long-term returns is that they are able to raise their dividends as the underlying earnings of the companies grow. They are also able to increase prices in step with inflation, generally.

Not so with **bonds**. Although bonds, particularly U.S. Treasury bonds, are a safe haven investment, and therefore often increase in value when stocks fall, their long-term returns do not participate in economic growth nor are they indexed for inflation. With a bond, you know at the outset what your expected return to maturity will be—the yield. That's it.

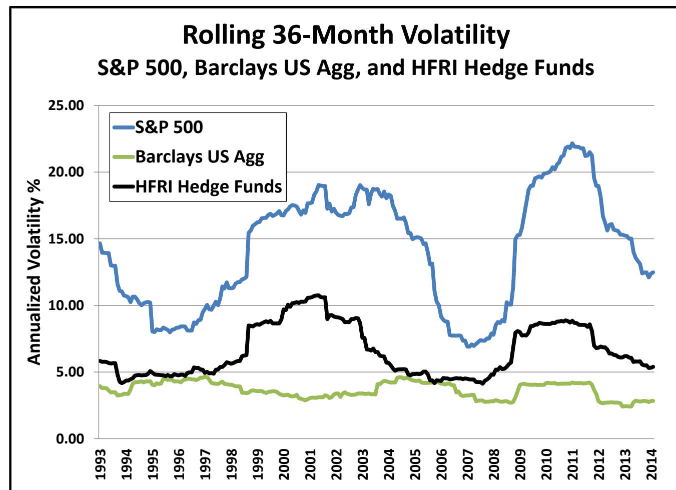
The problem right now is that bond yields are quite low—below the expected rate of inflation in many cases. So, although bonds go a good job of diversifying stocks, right now they do not provide very attractive expected returns.

Investors need a better option than bonds for diversifying their stock investments.

Alternative Investments

Investments in assets other than stocks, bonds, and cash are considered "alternative investments." These types of investments have **often behaved differently than stocks and bonds, though as seen above, not as much in recent years.** Generally speaking, an investment is usually labeled "alternative" either because of its asset class (e.g., real estate, commodities, and private equity) or because of its form of organization (hedge funds). Often, leverage, short-selling, and incentive fees are involved.

Unfortunately, many people have the mistaken impression that alternative investments are inherently risky. In fact, **the volatility of most alternative investments, including hedge funds, is considerably less than the volatility of most equity mutual funds**. As shown at right, the average 36-month rolling volatility of the hedge fund index has been less than half of the S&P 500. Also, to the extent that they have a low correlation with both stocks and bonds, including alternative investments can *reduce* the risk of an overall portfolio.



Alternative ETFs

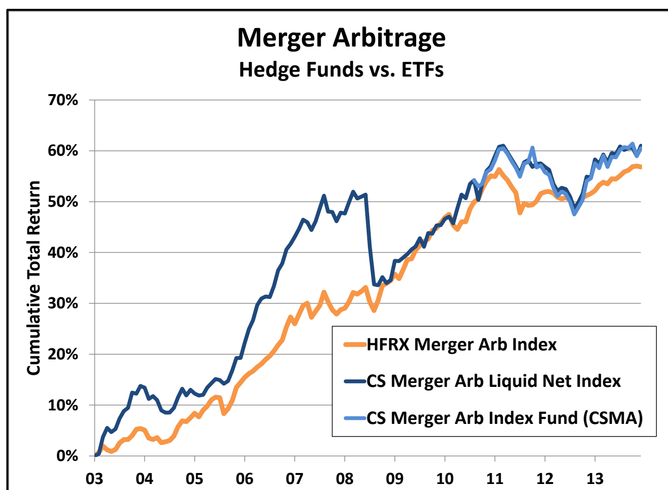
Until just a few years ago, the only way to invest in most alternative strategies was through a hedge fund or other private vehicle. By law, hedge funds are limited to "accredited" investors, generally those with $1 million in net worth (excluding their primary residence) or joint income of $300,000 or more ($200,000 for individuals). These vehicles tend to be very illiquid and their fees tend to be very high. Also (in part because of the high fees), in recent years, the average returns have been disappointing.

Over the last few years, a number of ETFs (exchange-traded funds) that invest in alternative strategies have been launched, including funds investing in the following (to name just a few):

- Commodities
- Currencies
- Volatility-linked instruments
- High-yield debt
- Real estate securities
- Merger arbitrage
- Global macro
- Publicly traded private equity
- Market neutral equity
- MLPs

Because these ETFs are nearly all passively managed based upon an index**, their fees are quite low compared to hedge funds**—typically 0.75% or less. That is a world away from the "2 and 20" of the typical hedge fund! Unlike the $1 million minimum typical of most hedge funds, alternative ETFs can be bought in very modest dollar amounts. As registered vehicles, ETFs provide **solid investor protection against fraud**. Also, because they are traded on public exchanges every day, these ETFs facilitate **tactical shifting** as return and risk conditions change. This means that, perhaps for the first time ever, it is possible to quickly, easily, and cheaply increase or decrease allocations among various alternative strategies.

Perhaps best of all, **these alternative ETFs perform quite well compared to the average hedge funds in their strategy categories**. In fact, I did a recent comparison and found that the ETFs beat the return of the average hedge funds *in each and every case*! I show one illustration at right comparing the largest merger arbitrage ETF (and its underlying index) with the HFRX Merger Arbitrage Index which averages hedge funds using a merger arbitrage strategy. (Merger arbitrage involves buying long the stock of takeover targets and shorting the stock of acquirers.)



Managing the Asset Mix

By far the most important investment decisions have to do with managing the overall asset mix of a portfolio. How much to allocate to stocks, bonds, cash, and alternatives will depend upon an investor's financial goals, risk tolerance, wealth level, and many other factors, all beyond the scope of this article.

My two strategies (Multi-Strategy and Long/Short Multi-Strategy) are designed to enable me to actively manage the asset mix for my clients. Alternative investments cover a wide range of risk exposures, some more related to stocks and bonds, and some less. I work to tactically shift these exposures to take advantage of changing risk and return conditions. The long-only **Multi-Strategy Portfolio** tends to have a level of sensitivity to the stock market in the range of 20% to 80% (aka a "beta" of .2 to .8), with much lower levels of bond market sensitivity. Because of increased flexibility to hedge risks, the **Long/Short Multi-Strategy Portfolio** has much lower levels of risk, with stock market sensitivity generally in a range of 0% to 60% and near zero for bond market risk.

Co-investing with Me

I am fully committed to my two strategies. **100% of my IRA is invested in the Multi-Strategy Portfolio, and 100% of my taxable savings is invested in the Long/Short Multi-Strategy Portfolio.** My clients and I share in the same returns. This is my own money and I manage it very intensely. Every day that the market is open I am critically examining the portfolio to see if its return/risk tradeoff can be improved.

My investment process is highly active and highly selective. I want only the best 20 to 25 ETFs in the portfolio, long or short, at any point in time**. Although I use index-based ETFs to implement my two strategies, the result is anything but index-like.** In fact, I strive to be quite different from (and have a low correlation with) stock and bond indexes over the long-term.

The process I use to select and weight ETFs is **based upon my own proprietary risk and return models designed specifically for alternative ETFs.** The return forecasts **combine yield, momentum, and value using an empirically-driven process** to blend these various elements. In essence, I measure statistically how well these various factors have worked over the long-term (10 years) as well as the short-term (last 3 years) to blend them into an overall return forecasting model. **This is the kind of factor modeling work I have done very successfully for more than 25 years.**

The Goal: Higher Returns

Many alternative investments are more about risk reduction than about return enhancement. Although my intent is to provide a return with a relatively low correlation to both stock and bond returns, **I will not be satisfied unless I provide an attractive level of absolute return.** In particular, my investment process is designed to emphasize "residual" return, or return not explained by risk.

The most tangible satisfaction I hope to receive will be when I tally up the extra return I have earned for my clients over many years, knowing that I have helped them achieve their financial goals, which for most of us (myself included) means **a more secure retirement.** This will be my last job, and I expect to be at it for many years to come. In fact, I don't really feel like I'm working at all because I love what I do!

If this sounds appealing to you, I'd very much like to hear from you.

Kevin Means, CFA
Principal
Select Alternative Investments LLC

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SELECT ALTERNATIVE INVESTMENTS LLC

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