The Alternatives to Alternatives

Are there limits to growth? Have we reached the limits? What is the future?

By Matthew Murphy, CFA

The use of alternative assets by investors, both institutional and retail, has gained favor through the past decade and is poised to continue to grow as a percentage of overall portfolio allocation. As alternative assets gain a larger share of investment funds, questions arise. What are the alternatives to alternatives? Are there limits to the growth that alternative assets will experience? What is the future for alternatives?

The Alternatives to Alternative Assets

Traditional portfolio construction historically has focused on long-only, benchmark-focused strategies. Traditional strategies fit neatly within certain well-defined asset classes and style boxes. Investment professionals used historical return datasets and computer models to determine the appropriate weightings across asset classes and style boxes according to targeted risk-and-return parameters. Investment managers then were selected to populate the asset class allocations based on expectations for them to produce consistent excess returns. These long-only and benchmark-constrained investments that trade within traditional asset classes and style boxes are the alternatives to alternative asset classes.

While defining nontraditional investment options as “alternative” implies that the choice between a traditional asset manager and an alternative asset manager is mutually exclusive, in practice alternative assets can be either sources of excess return (alpha) or sources of nontraditional market exposure (beta). Alternative assets expand the opportunity set available for investment professionals by providing access to new trading strategies, which are alpha-focused, and providing exposure to new markets, which are beta-focused.

A long/short hedge fund is an example of an alternative asset that trades securities within existing asset classes. A long/short debt hedge fund can have any number of mandates, but the securities it trades are usually within the fixed-income asset class. 130/30 hedge funds trade stocks and therefore can be positioned within the equity asset class. These investments do not necessarily have to provide beta despite the strategies trading within existing asset classes. Market-neutral funds attempt to eliminate equity market beta, while 130/30 hedge funds often will try to keep beta at or close to one. Regardless of the beta objective, the primary reason that investors choose to invest in these strategies is for alpha generation.

Absolute-return funds also trade instruments within an existing asset class. Some absolute-return funds can invest in markets beyond the traditional equity and fixed-income markets, but these funds typically are grouped with long/short hedge funds because one of their primary objectives is to provide alpha. In contrast with some long/short hedge funds, particularly 130/30 funds, absolute-return funds usually are managed to have low correlation and beta to multiple financial market risk factors. Exchange-traded funds (ETFs) may provide investors access to specific market risks within existing asset classes. ETFs provide investors with a means to access distinct betas that otherwise might be difficult to obtain. For example, within the equity asset class investors can gain exposure to a basket of stocks within any sector or industry. Investors also can acquire exposure to stocks that fit within specific style boxes such as large-cap value, mid-cap blend, or small-cap growth. These ETFs are not designed to deliver alpha; rather, they offer a targeted beta exposure within traditional asset classes.

Some alternative assets provide access to market risk factors beyond traditional asset classes. Alternative assets such as commodities, currencies, and real estate are examples of nontraditional market exposures. These asset classes historically have had strong diversification benefits because their returns may have low correlations and betas to traditional fixed-income and equity markets.

Limits to Alternative Asset Growth

A basic premise for investing in alpha-seeking alternative assets is the belief that markets are not entirely efficient and that excess returns can be generated by exploiting perceived informational advantages. As such, the limits of growth in alpha-seeking alternative assets are constrained only by the limits of the opportunities available to exploit. The absence of benchmark constraints, the ability to trade both long and short, and the access to inefficient markets contribute to the ability of alternative assets to provide excess return and overall portfolio diversification benefits.
Removing the constraints of the long-only benchmark, an alternative investment manager can seek to add excess returns by adding securities that are outside of the benchmark, zero-weighting securities within the benchmark, and/or choosing to sell short certain securities. The investment mandate can be market neutral, in which case the returns from the index are effectively stripped out of the portfolio and pushed to zero, leaving only excess returns. Or the investment mandate can call for a market beta of one, in which case the market risk premium is captured, and the tools to generate excess return are more prevalent than within a long-only vehicle.

Accessing inefficient markets is another means by which alternative assets attempt to generate excess returns. Defining a market as “inefficient” is difficult, but it can be thought of generally as a market where there is not a significant breadth of knowledge about the factors that influence security prices. For example, compare the U.S. Treasury bond market (the most-liquid bond market in the world with a multitude of market participants and tight bid-ask spreads) and emerging market and frontier sovereign bond markets (which have fewer market participants and relatively wider bid-ask spreads).

Here the emerging market sovereign debt is the inefficient market because it provides a better opportunity for investment managers to exploit a perceived informational advantage to generate excess return.

Note that “inefficient” does not always mean “less-liquid.” The markets for most currencies and commodities generally are considered liquid. These nontraditional markets offer opportunities to generate excess returns even if the markets are fairly liquid. Institutions such as central banks and government agencies influence prices within these markets and create opportunities for managers to capture alpha by taking advantage of market inefficiencies.

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We believe that alternative assets have very few limits impeding their growth. Removing benchmark and trade-direction constraints gives investment managers a better chance to generate active return, whether adding positions in securities outside the benchmark or choosing to short securities that are perceived to be overvalued. Further, investment managers that operate in inefficient markets with various levels of liquidity provide investors access to nontraditional market exposures as well as the opportunity to generate excess return. Financial markets continue to evolve and mature, and while the ability to generate alpha or gain alternative beta will change over time, it is unlikely that the growth in alternative assets has reached its limits.

The Future for Alternative Assets

The future of alternative assets is best viewed within the framework of their effects on overall portfolio construction. The adoption of alternative assets has changed strategic asset allocation, and therefore the future of portfolio construction also has changed. Most of the effort in historical portfolio construction focused on how best to capture alpha by evaluating the long-only active managers within a specific style box. Future effort should shift toward selecting the appropriate market exposures and alpha-generating strategies that together have the potential to meet targeted portfolio risk-and-return expectations.

The presence of alternative assets influences the allocation of investor capital to market exposures and the opportunity set has widened beyond the traditional equity and fixed-income allocation. Now investors can choose from specific systematic returns within existing asset classes, via specific ETFs, as well as outside traditional asset classes, via investment managers that specialize in commodities, currencies, and real estate. A portfolio with a number of risk factors may provide better risk-adjusted returns than a traditional equity/fixed-income-only portfolio because the risk factors will tend to be less correlated with each other.

The use of alternative assets also affects investment professionals’ selection of active or passive management. Is the manager constrained to a long-only benchmark, in which case it might be less expensive and more efficient to allocate capital to a passive management vehicle? Or is the manager unconstrained to a benchmark and able to invest both long and short, a much more active management approach? Additionally, is the investment manager a pure alpha generator that manages a portfolio that is designed to have low correlations to traditional market exposure? Or is the investment manager trying to generate consistent alpha attached to a certain beta? The answers to these questions most likely will guide the future of alternative assets in portfolio construction.

Summary

A sample, and albeit simplified, portfolio that consists of both alternative and...
Active management attempts to capture alpha and 80 percent of the sample portfolio is allocated to active managers, which strongly supports that many markets are not perfectly efficient.

Finally, the future of alternative assets is well-represented by the sample portfolio in which more than half of the capital is allocated to some form of alternative asset class. Alternative asset classes are challenging the concept of strategic asset allocation that calls for diversification among segments of the equity and fixed-income markets with an emphasis on selecting managers that can add excess return within the constraints of a benchmark-focused and long-only trading strategy. The sample portfolio contains a blend of both alpha-seeking managers and alternative-beta investments outside of traditional strategies.

Overall, alternative assets provide investors with additional options for capital allocation. With more options, the ability to build portfolios expected to meet targeted risk-and-return expectations is enhanced. As such, investment professionals are more likely to use alternative assets as a key component of portfolio construction in the future.

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