Transcript

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Ken:

Hi, everyone. I'm Ken Kozlowski, CIO of Equitable Investment Management, and I'm here with two members of my team: Portfolio managers Xavier Poutas and Kevin McCarthy. Today, we'd like to give you an overview of the alternative investment space. Xavier, if you can get us started and just define what alternatives are, and why should an investor consider alternatives in their investment plan?

Xavier:

Yeah. Good idea, and thanks, Ken, for having us today. So, let's start with what they are and compare and contrast with more traditional investments such as stocks, bonds and cash. Alternative investments can include a wide variety of assets and strategies. I make the distinction between the two, where alternative assets can be real estate, either investing in property directly or through a real estate investment trust (REIT).

Commodities are another type of alternative asset. Those include precious metals like gold and silver, but also oil and agriculture. Another example would be private assets. You've heard about private equity and private credit. So the other type of alternative would be alternative strategies. For example, long-short equity, merger and acquisition (M&A), or trend-following strategies like managed futures.

To address the second part of your question, I would say the main benefit of incorporating alternative investments in a portfolio is to increase diversification. That assumes that they do have low correlations to traditional asset classes. And when you think about the traditional asset allocation framework of blending equities and bonds, the issue is that some of the risk- management tools, like bonds, working historically were dampening volatility, they have become less effective.

If you look at the past 30 years, we have had a bull market for bonds. But also the other phenomenon that took place is that interest-rate volatility has been pretty elevated since 2022. So we believe that alternatives can really benefit a wide range of investors. And it's really an evolution of asset allocation. Alternative investments have different risk characteristics, when you compare those to bonds and stocks. But what makes them particularly valuable is the risk diversification.

We really view these alternatives as portfolio diversifiers and dampeners of volatility, if you will.

Ken:

Xavier, what are the considerations when you select alternatives?

Xavier:

Sure. I would say first that alternatives are not a homogeneous asset class. So the framework that we found helpful is to categorize each alternative and decide whether it's an asset class or strategy; analyze how they may diversify specific portfolio risks; as well as understand the role that each alternative asset or strategy can play in a portfolio.

What I mean by that is making a determination of whether a particular alternative is a diversifier, a risk reducer or return enhancer. We want to analyze the correlation of each alternative asset to equities and to fixed income. And one thing to keep in mind is the fact that alternatives may offer some attractive correlation statistics for investors, but also some of them may show stock-like volatility. So this is an area where, when you combine multiple alternative assets and strategies that may help dampen the overall portfolio volatility by capitalizing on the low correlation that exists among the various alternatives.

Ken:

So, Kevin, we touched upon some of the more well-known alternatives such as real estate and commodities. How about we spend a few minutes on some of the lesser-known sectors and strategies? Maybe you can start with talking about managed futures.

Kevin:

Sure. Thanks for the question, Ken. So managed futures is a strategy that involves identifying trends across a broad range of asset classes, including equities, interest rates, commodities and currencies. Investors implement these strategies by going long or short futures contracts based on price trends using quantitative models to analyze past prices., Research has shown us that investor behavior biases causes this phenomena for prices to exhibit momentum.

By monitoring such [a] broad range of asset classes, this [managed futures] strategy can seek opportunities wherever trends may emerge, making them less dependent on the direction of equity or fixed-income markets. Additionally, these strategies tend to benefit from significant market movements and volatility, such as those seen during 2008 and 2022, when managed futures delivered two of their best years on record.

Their role in portfolio boils down to diversification. Managed futures tend to have lower negative correlations with traditional asset classes like stocks and bonds, and this can help reduce overall risk of a portfolio by providing a hedge against market volatility, given that managed futures can profit in both rising and falling markets.

Ken:

And Kevin, if you could talk about another lesser-known strategy: merger arbitrage.

Kevin:

Sure. Merger arbitrage is a strategy that seeks to capitalize on the price discrepancies that occur around a merger or acquisition announcement. The strategy typically involves buying the stock of a company that will be acquired at a discount to the proposed acquisition price. This is generally coupled with a market hedge to isolate the performance impact of the merger arbitrage strategy.

This thereby removes the return impact of the broader equity market. As a result, merger arbitrage strategies often generate returns with relatively low volatility and correlations to the broader equity market, while providing diversification benefits to the overall portfolio. Furthermore, this is a topical strategy given the current environment, as research indicates that merger arbitrage returns tend to be higher during periods of increased merger activity.

After a period of lower levels of M&A transactions, there's a positive outlook for dealmaking in 2025. Given the pick-up in activity in the second half of 2024, and the tailwinds of proposed U.S. tax reform and deregulation, merger arbitrage may be a strategy that can deliver uncorrelated sources of performance in the medium term.

Ken:

Thanks, Kevin. Xavier, can you talk about some of the risks associated with investing in alternatives?

Xavier:

Sure. So, earlier we discussed how alternatives can provide some diversification benefits, but some of them can be rather complex and require a good understanding of the strategy and its risk. I mentioned earlier, some of them have higher volatility than traditional investments. Commodities for instance, are well known for being particularly volatile. So I would mention two other things to keep in mind when it comes to alternatives:

First, the need to truly understand the liquidity profile of the underlying investment. And what I mean by that is to what extent they can be sold without incurring a substantial loss in value. And second, some alternatives may be less regulated and transparent than other publicly traded instruments.

Ken:

Kevin, any last insights you want to share with us about alternatives?

Kevin:

Thanks Ken. I'd like to highlight that alternative investments can provide a differentiated source of returns. They are less dependent on rising stock markets, and as a result, have low correlations to traditional assets. By introducing diversifying alternative investments to a traditional stock-and-bond portfolio, clients may be able to shift their efficient and generate better risk-adjusted returns.

Editor's note: efficient frontier refers to an approach that seeks the highest return for an anticipated level of risk.

Ken:

Kevin and Xavier, thanks again for your insights. And I just want to say thanks again to our listeners for tuning in. Thank you very much.

Kevin:

Thank you.

Xavier:

Thank you.

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