Alternatives: From lemons to lemonade?

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Liquid alternatives set to add value to portfolios as market conditions change

Liquid alternatives may have underperformed in the last decade but the asset class can still make a portfolio more robust to a range of market conditions.

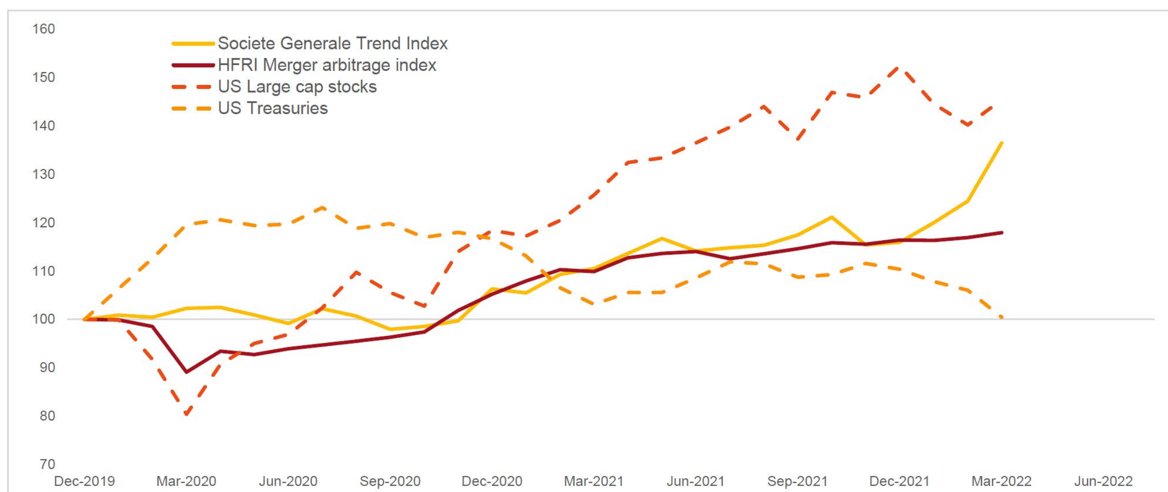
“You're getting something that brings diversification to a portfolio because the underlying drivers of hedge funds are quite different to what drives the equity market or other markets,” Frontier Advisors Head of Alternatives and Derivatives Solutions, Scott Pappas, said.

Liquid alternatives outperformed in the decade ended 2010, which included the dot-com bubble and the GFC, but underperformed in the decade ended 2020 as easy monetary policy drove equity markets steadily higher. But liquid alternatives are again performing well as inflation has risen and central banks have resumed a tightening cycle.

“It's important to understand how different investments are going to perform over different timeframes,” Pappas said. “If you have realistic expectations, it will help you stay the course and as a long-term investor, that's critical to success.”

2020 to 2030, so far…

Good for equities (but volatile), good for alts, bad for bonds



Source: Ibbotson, Société Générale, HFRI and Frontier

He said when investing in alternatives, investors should understand:

- what exactly they’re paying for
- how it represents value-for-money
- the economic rationale behind the investment
- how it will impact their portfolio in future.

Liquid alternatives (or hedge funds) were once characterised by high two and twenty fees but that is now rarely the case. Investors need to understand what the investment is adding to the portfolio and then compare the fee level to similar funds.

Transparency across the sector has also improved and the drivers of performance are clearer.

“In most cases, there's a very straightforward economic rationale for why these things make money and why they offer diversification.”

For example, merger arbitrage is one strategy where funds buy into takeover targets, cashing in a small profit on each completed takeover (and taking a loss on the small number of takeovers that fail).

“What drives that merger price is not linked to equity markets – it's actually quite different.”

Another strategy is trend following, where funds exploit behavioural biases such as the herd mentality in response to news or other trends.

“The behavioural explanation provides a really strong foundation for diversification, because investor behaviour can be quite unrelated to what's going on in the wider market.”

These alternative strategies can offer genuine diversification but investors also need to assess their performance expectations under different conditions, such as periods of higher earnings growth, higher risk premiums, or higher discount rates.