# Manager's Report
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## Does It Still Make Sense to Own Alts?

Given an increased interest surrounding the role of alternatives in the context of portfolio construction, it seems fitting to address the role that alternatives play in a well-diversified portfolio. Indeed, one of the most common questions we get from investors is regarding the benefits of investing in alternatives. The way this question is typically presented is interesting to me. Specifically, the question is not "does it make sense to own alternatives", but "does it ***still*** make sense to own alternatives". In other words, investors appear to have accepted, and even embraced, alternative investing in the past; yet, something has clearly changed to cast doubt on their conviction.

In this report, I will cover what alternatives are, why investors may have begun to question them, and our view of the role of alternatives in a diversified portfolio.

### Defining Alts

"Alts", or alternatives, are investments that fall outside of the traditional paradigm of equity or debt exposure. To be fair, over time I've heard both professional and individual investors give somewhat different definitions, so there is some inconsistency depending on who's involved in the discussion. At Baystate Wealth, we have a relatively straightforward definition that we prefer. Specifically, "A*lternatives are investments that are something different than stocks or bonds, or a portfolio of stocks and/or bonds designed to behave substantially different than those respective asset classes"*.

Alternative investments are by no means a homogeneous asset class. Some are less complex and more easily understood by the average investor than others. Examples of some of the more basic types of alts include Real Estate Investment Trusts (REITs), funds that track the price of a commodity like oil or gold, or even a currency. On the other hand, some alternatives are a little more eclectic, such as a managed futures fund, an absolute return fund, or a strategy that invests in equities but overlays the positions with option contracts. Taking it a step further, some alts are just as risky and volatile as stocks, while others exhibit bond like behavior. Indeed, it is a diverse asset class.

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## Why the Recent Concern

I'm confident the reason investors have expressed concern about alts is remarkably simple – it's the returns. On both an absolute basis, and relative to expectations, some alternatives have had low, and even negative returns over the last few years. That said, the key word in the prior sentence is "some" because not all alternatives have disappointed. In fact, I believe the real culprits behind the recent perception of alts are commodities and those strategies that pursue an "absolute return" with behavior that is independent of traditional stock and bond markets.

As evidence to support my theory, let's review the distribution of performance for a variety of alternative asset classes.

**Alternative Assets for Trailing 3 Years**

*Graph 1, Source: Baystate Wealth Management, Factset*

Graph 1 displays the total return for a handful of funds and an index over the last 3 years. To represent commodities over this time-period we used the Bloomberg Commodity Total Return Index (yellow line). The funds that are used to represent different areas of the market are:

- IQ Hedge Multi-Strategy Tracker (light blue line): Hedge Fund Beta/Absolute Return
- iShares MSCI ACWI (purple line): Global Equities
- iShares Core U.S. Aggregate Bond (grey line): U.S. bonds
- Vanguard REIT (green line): Real Estate Investment Trusts
- Gateway Fund (dark blue): Options Overlay

As can be seen, over the last 3 years, stocks and bonds have gained 21.58% and 8.75%, respectively. Solid returns for those asset classes and in our opinion, about what should be expected by investors based on history and traditional asset pricing forecasting models. Conversely, over that same period the alternatives have been a mixed bag. On the positive side, REITS have outperformed the stock market and the Gateway Fund, which owns U.S. equities in conjunction with derivatives, performed just a little less than the equity market. On the negative side, commodities are down significantly (almost 30%) and the

IQ Hedge Multi-Strategy, a hedge fund replication strategy, was barely positive and retuned less than the bond market.

Although Graph 1 does not show all alternative asset classes and strategies, it does represent what we find to be the most commonly used alternatives (REITS, commodities, options and absolute return/hedge funds). Considering the relative performance, it is understandable why many investors are asking if it still makes sense to own alts.

As I mentioned earlier, it seems as if investors used to appreciate the inclusion of alternatives in a portfolio, but the recent performance on a relative basis appears to have lowered conviction levels. Although the poor performance of commodities has understandably left a bad taste with some investors, I'm inclined to believe the primary source of frustration is the absolute return/hedge fund space. My reasoning is based on two factors. First, at Baystate Wealth we talk to a lot of investors and advisors who have clearly lost some confidence in absolute return. Second, not only have these strategies had low returns relative to the stock and bond market, but they are complicated. Alternatives like real estate and commodities are tangible, and quite frankly things that most people interact with daily. In contrast, absolute return strategies, like hedge funds, are far from tangible and not something the average person encounters every day. This lack of understanding combined with low returns likely contributes to elevated levels of concern with this type of investment.

At Baystate Wealth, despite the complexity and recent modest level of returns, we continue to believe that this type of alternative is still a good addition to a properly diversified portfolio. There are three reasons for our conviction: 1) We don't use short term history as a guide to the future, 2) Lower volatility is more desirable, 3) We have concerns about the future of the bond market.

**History as a Guide**

There is no shortage of evidence that using relatively short time periods to predict future asset price movements is a bad idea. Markets are mean reverting, meaning that asset classes that have had periods of underperformance tend to outperform in subsequent periods and vice versa. From our experience this is true of stocks, bonds, and even alternative asset classes.

Over shorter periods of time these strategies have, like other types of investments, experienced both above and below average returns. However, over longer periods of time hedge funds have had similar returns to the price returns of equities. (Including dividends equities have outperformed by a couple of percentages on an annual basis). This can be seen in the table titled "HFRX Global Hedge Fund Index Statistics" which is a commonly used benchmark for these types of strategies. The statistics in the table go back to the inception of the index (1998) and compare the index to another hedge fund index (column B1), short term rates (column B2) and the global stock market (column B3).

Diving deeper into the index reveals times where equities were negative and hedge funds, on average, were positive. As an extreme but relevant example in 2000, 2001 and 2002 when the S&P 500 was down -9.03%, -11.85% and -21.97, this hedge fund index was +14.29%, +8.67% and +4.72%, respectively. During my career navigating markets, I've experienced times when investors hate this type of strategy and times when they wished they owned more. Then again, I can say that about many, if not all, areas of the market.

The bottom line is that the using short term history to forecast future returns is not an ideal strategy. Consequently, alternatives can really carry their weight in a well-constructed portfolio when broad

traditional asset class behavior becomes increasingly idiosyncratic (e.g. rising rates accompanied by falling stock prices).

## HFRX Global Hedge Fund Index Statistics

BENCHMARKS | **B1** HFRI FUND OF FUNDS COMPOSITE INDEX | **B2** 3-MONTH LIBOR USD | **B3** MSCI INDICES US$ WORLD INDEX

**RISK/RETURN**

| TYPE | HFRXGL | B1 | B2 | B3 |
|---|---|---|---|---|
| Geo. Average Monthly | 0.37 | 0.33 | 0.2 | 0.31 |
| Std. Deviation | 1.74 | 1.61 | 0.18 | 4.42 |
| High Month | 5.95 | 6.85 | 0.57 | 10.9 |
| Low Month | -9.35 | -7.47 | 0.02 | -19.04 |
| Annualized Return | 4.51 | 4.09 | 2.41 | 3.83 |
| Annualized STD | 6.03 | 5.59 | 0.63 | 15.32 |
| Risk Free Rate | 1.94 | 1.94 | 1.94 | 1.94 |
| Sharpe Ratio | 0.44 | 0.4 | 0.7 | 0.2 |
| % of Winning Mo. | 64.83 | 64.83 | 100 | 57.2 |
| Max Drawdown | 25.21 | 22.2 | 0 | 55.37 |

*Statistics calculated since inception of index*

**REGRESSION**

| TYPE | B1 | B2 | B3 |
|---|---|---|---|
| Monthly Alpha | 0.07 | 0.05 | 0.28 |
| Monthly Beta | 0.91 | 1.66 | 0.25 |
| Mnt. R-Squared | 0.71 | 0.03 | 0.41 |
| Correlation | 0.84 | 0.17 | 0.64 |
| Up Alpha | -0.11 | 0.05 | 0.66 |
| Up Beta | 1.03 | 1.66 | 0.16 |
| Up R-Squared | 0.61 | 0.03 | 0.09 |
| Down Alpha | 0.09 | 0.00 | 0.11 |
| Down Beta | 0.88 | 0.00 | 0.24 |
| Down R-Squared | 0.53 | 0.00 | 0.25 |

*Statistics calculated since inception of index*

*Source: HFRI*

## We Prefer Lower Volatility

Lower volatility is undeniably more desirable. Aside from the obvious advantage of the reduction in stress that naturally comes with higher levels of portfolio stability there is an additional benefit. Specifically, increased portfolio longevity for those investors who are withdrawing money on a regular, or even somewhat regular, basis.

Investors who are actively withdrawing money from their investments face additional risk than those in the accumulation phase. The order of returns, often called the “sequence of returns”, and volatility impact how long it will take for an investor to deplete their portfolio. It may not sound intuitive, but two investors with the same annual return, same size portfolio and same withdrawal rate can have very different experiences regarding how long their investments last them. Volatility should be closely budgeted, monitored and controlled for investors in the withdrawal phase.

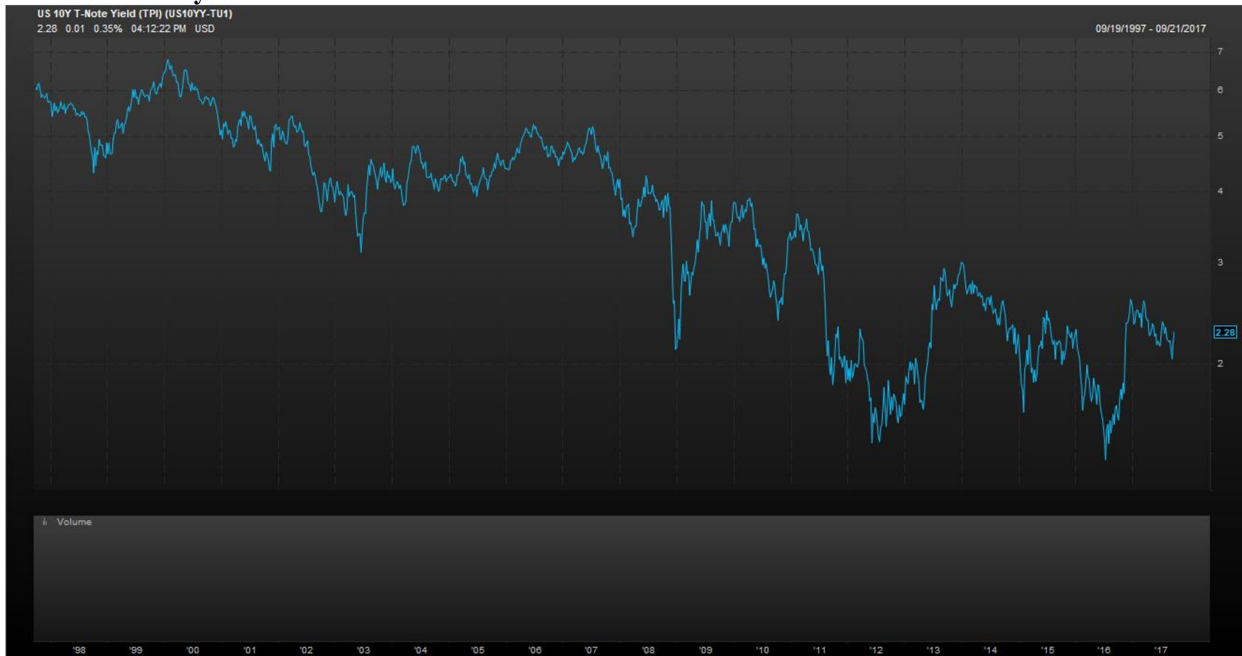
How does owning absolute return strategies help volatility? There are two data points in the chart above that are direct evidence that having this type of exposure reduces volatility. The first is standard deviation, a pure measure of volatility. Directly under the annualized returns we can see that the volatility, written annualized STD, is less than half of the stock market (column B3). The second metric is correlation. Correlation is a measure of how similar, or different, the movement in price changes are between two

assets. For this hedge fund index the correlation to short term rates is only .17 and .64 to the equity market. For reference a correlation of 1 would mean that two assets behave the same and there is no reduction in volatility. In contrast, a correlation of -1 would mean the two investments are moving in the opposite direction of each other.

## The Future of the Bond Market

Finally, what does our concern with the future of the bond market have to do with this type of strategy? To start, the graph (Graph 2) below has a lot to do with it.

**10 Year Treasury Yield Over 20 Years**




**Graph 2** *Source: Baystate Wealth Management, Factset*

The bond market has effectively been in a bull market for a long time. Graph 2 above shows the 10 year U.S. treasury yield over the past 20 years. There has certainly been some volatility but it's clear to see the trend has been a falling yield which means higher bond prices. Although we are off the lows during July of last year when the yield closed at 1.36%, potentially marking the top of the 30-year bull market in bonds. The current yield is only about 2.3% and by all accounts still at historical lows.

A common concern with asset managers, which we share, is that rates will trend higher in the future and will be a headwind for bond returns. It could be the case that as interest rates rise some bonds will have zero, near- zero, or even negative returns. One solution, which we have embraced at Baystate Wealth, is to focus on bonds that are not as sensitive to changes in interest rates and could have decent returns in a rising interest rate environment. This is a prudent strategy but the cost is limiting the diversification of the fixed income allocation of a portfolio as some bonds are simply "off the table" as an option because of the interest rate risk. A resolution to the issue of decreased diversification within bonds is an alternative source of returns with low volatility and low correlation to traditional stock and bond markets. This is where absolute return strategies could help. Owning absolute return strategies instead of, or as an alternative to, traditional bonds could lead to better performance on both an absolute and risk adjusted basis.

To be fair, many investors, including us, have believed rates would, and should, rise a few years ago. This belief was a factor in the decision to incorporate hedge fund like exposure into the portfolios. Over that period these types of strategies have generally lagged both stocks and bonds as they have both performed well. That being said, just because rates haven't risen over the last few years doesn't mean they won't over the next few years.

Investors in these types of alternative strategies may very well have a different experience in the future than those looking in the rear-view mirror.

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