ALTERNATIVES

Risk On, Risk Off, or Risk Uncertain?

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While big market swings can be unsettling to many investors, there are a number of alternative investment strategies that aim to turn volatility into opportunity, according to K2 Advisors' Brooks Ritchey and Robert Christian. They outline some of the market challenges they see ahead, and why they believe certain hedge strategies could find fertile ground.

Today's "risk uncertain" markets present an evolution of challenges for investors. The post-2008 massive expansion of central bank balance sheets around the developed world—one of the most dominant market-shaping forces over the last decade—is beginning to reverse. We see this in the United States and in other developed economies as well. Markets have seen increased volatility and threat of increased inflation. Earnings growth looks like it may be slowing somewhat. In addition, macroeconomic concerns—including geopolitical hot spots, growing political uncertainty in Europe and the threat of trade wars—all pose legitimate concerns for market stability.

In Favor or Out of Favor

You will often hear one asset class or strategy is in favor and another is out of favor. With alternatives the comparison may be unfair—and particularly with hedge strategies.

How do we define alternative investments? In the most fundamental sense, we consider alternatives as investments that act differently. Yes, there are a broad array of strategies typically characterized as alternatives—hedge funds, private equity, real estate—to name a handful. And there are an equally broad number of definitions. But in the simplest of terms, regardless of the idiosyncratic strategy employed, alternatives are investments whose performance and return drivers are different from the traditional markets we know. They are different from equities and fixed income—they are literally "alternative."

As such, their return streams should derive from something other than beta—or exposure to—traditional markets. They may trade in traditional markets, but directionally the performance should include alpha, which isn't tethered to equity and fixed income patterns.

So, when equity markets do nothing but go up, equity beta is the driver. Almost by definition alternatives should not do as well. Similarly, when equities and fixed income are challenged, alternative investments could provide a better experience.

In particular, the recent drawdowns in equity markets may be especially concerning. These declines are happening in the face of rising interest rates. Historically, if investors sought to manage equity volatility, they could do so by using core fixed income. Now, overweight in core fixed income carries its own risk, because of heightened sensitivity to rising rates.

Bottom line—investors have expressed concerns about what to do with their equity allocations, especially given current valuations and rising volatility. They are also concerned about fixed income allocations due to rising rates. These are risks they are seeking to mitigate. We will examine some hedge strategies to illustrate why increased allocations to alternatives may be a viable approach to addressing today's uncertainties.

When are They in Favor?

Opportunity set is key to alternatives. What we mean is that when there are more possible trades or investments, there is more chance of capturing alpha. Looking back over the last 25 years, there have been six periods of rising interest rates.[1] We found that both the performance and standard deviation[2] of long/short hedge strategies have compared favorably with stocks and bonds, and long/short hedge strategies' volatility was comparable to bonds and nearly half that of equities.[3] Additionally, we have found a significant amount of performance has come from a different source than equity beta.[4] In sum, we found the risk-and-return experience was better, and the ride a smoother one.

Why do we see a beneficial relationship with long/short hedge strategies, particularly in a rising interest-rate environment?

As central bank rates move higher, often we will see a wider variation of the specific interest rates that are applied to certain sectors, companies, or sovereign debt. For the vast majority of the past 10 years, as interest rates globally have been artificially suppressed, less economically sound companies or countries have been able to survive on a very low cost of financing. This was part of the central bankers' intent as they sought to stabilize equity and bond markets.

This dynamic started to change in mid-December 2015 when the US Federal Reserve began hiking rates and, subsequently, other central banks like the Bank of Canada followed its lead. The result: a wider gap between companies that have a higher debt-to-equity ratio and, say, technology firms that have a lot of cash and don't mind if rates rise.

As a result, we have seen a higher dispersion in the performance of winning sectors versus others, such as utilities and other high debt-to-equity industries. So, the separation of performance influenced by the impact of higher interest rates creates an alpha opportunity—alpha being defined as a measure a manager's value added relative to a passive strategy, independent of the market movement.

In addition to the impact from rates on equity and fixed income, higher volatility in the major currency markets of the world also has an impact on sectors in terms of revenue growth, and whether they are importers or exporters.

Hedge Strategies with Widening Opportunity Sets

Currently, we have seen notable expanded opportunity sets for three hedge strategies: Global Macro, Event Driven and Relative Value. We provide our reasoning on the latter two categories.

Event Driven—Merger Arbitrage. We think it's a ripe environment for mergers in the media industry, as well as a broadly more favorable outlook on vertical mergers. Tailwinds for corporate activity also persist, including corporate tax cuts, cash repatriation, high CEO confidence, and strong credit markets. We see the most significant headwind as the potential for a trade war between the United States and China. We also view technology as a significant factor influencing deal flow. In particular, changes in the semiconductor space, where companies seek to get ahead of the technology curve via acquisition of smaller start-ups versus developing innovation in-house, may drive activity.

So-called “industrial policy” is a potential headwind to future merger and acquisition (M&A) activity. This refers to the political considerations that are increasingly coming to the fore as business and commerce evolves globally. Governments around the world—in the interest of national security—have been increasingly sensitive to businesses sharing critical technologies. This is not just the United States and China, but includes Canada, Germany, Australia and the United Kingdom as well. Still, the added risk associated with industrial policy is not necessarily all bad for hedge fund strategies. The increased uncertainty may widen spreads significantly, creating a more attractive risk/reward opportunity set.

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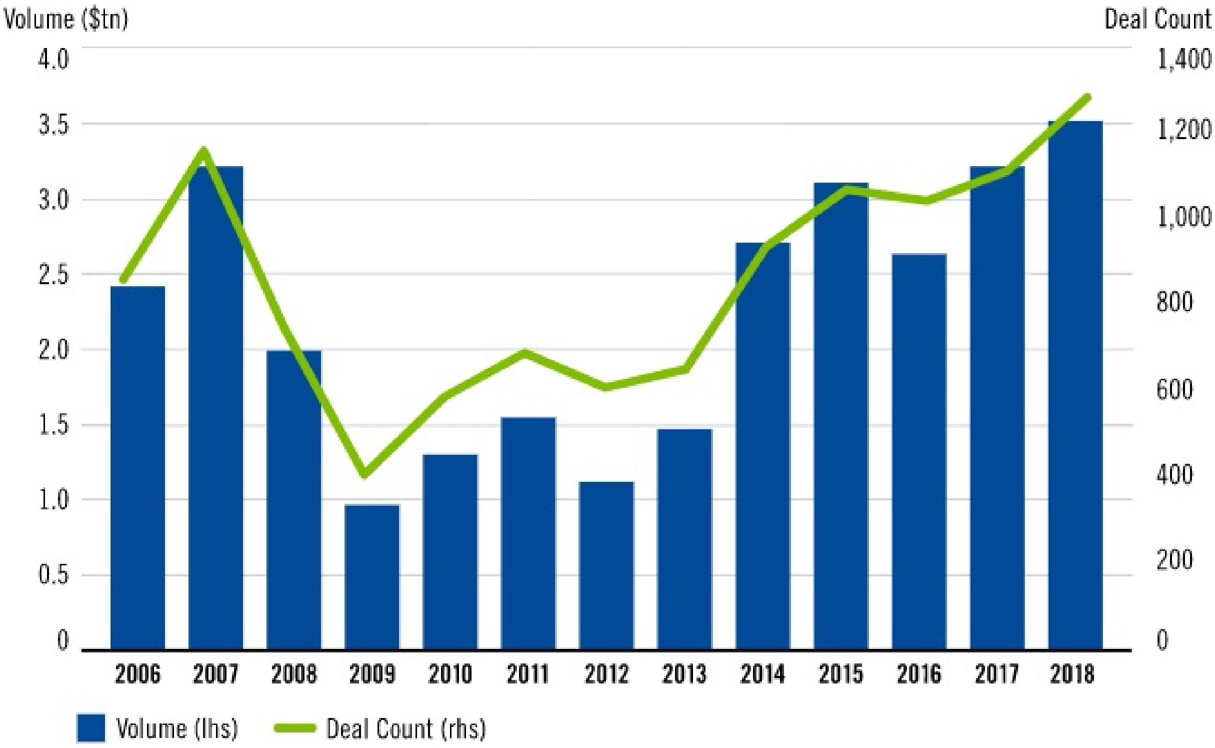
Tailwinds for Corporate Activity Persist

Deal Volumes Have Been Trending Higher

As of August 31, 2018



Source: Bloomberg as of 08/31/18. Global M&A transactions over $500mm from January to August. Past performance is not an indicator or guarantee of future results. See www.franklintempletondatasources.com for important data provider terms and conditions.

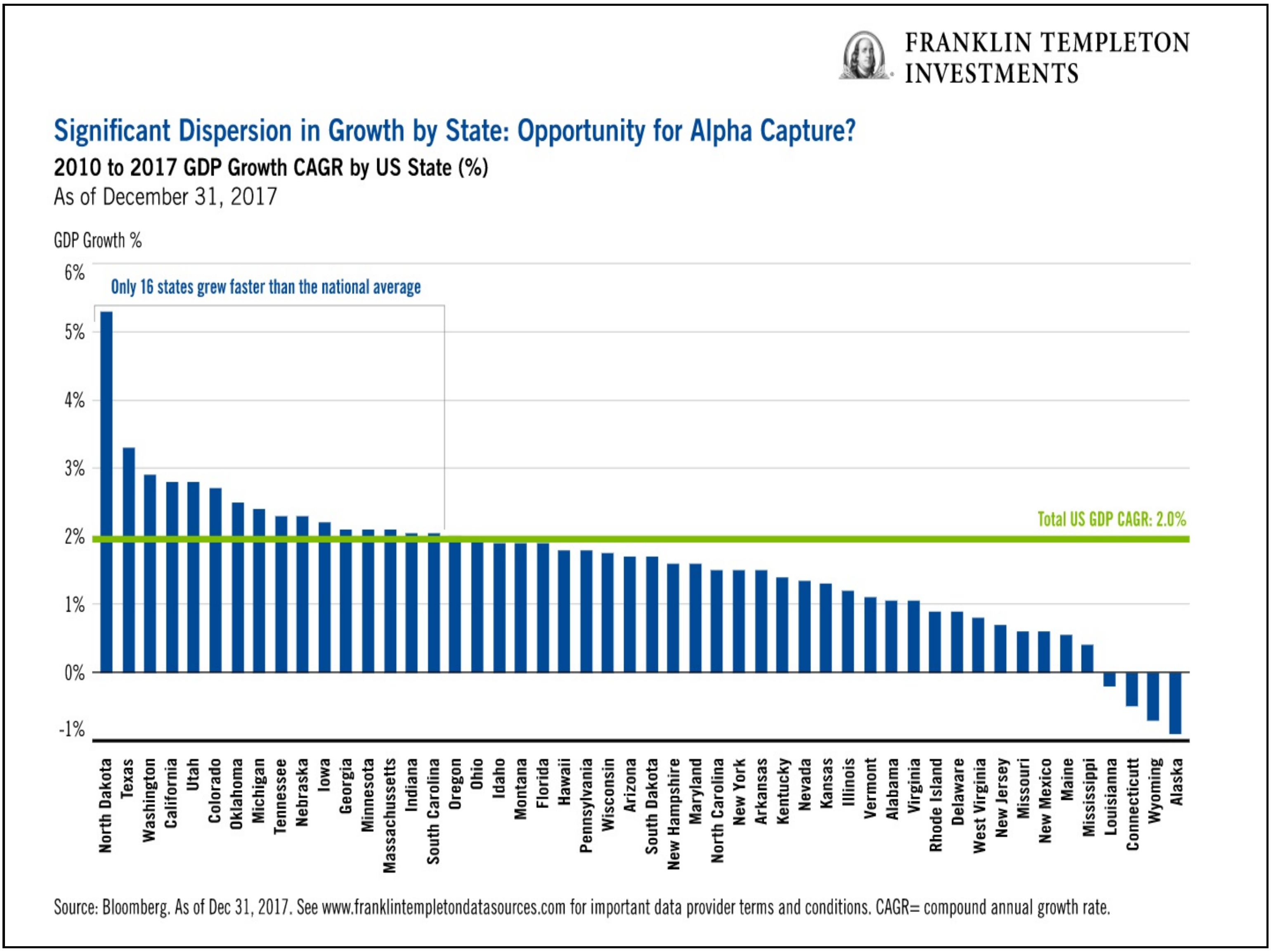
Relative Value—Fixed Income

With interest rates starting to rise we see duration[5] risk coming into focus for fixed income investors. We view relative value fixed income strategies, such as long/short credit, being well-positioned (given their shorter duration portfolios) to capture alpha form rising sector dispersion.

Since the Global Financial Crisis (GFC) a decade ago, gross-domestic product (GDP) growth in the United States has progressed at a steady, albeit unremarkable, rate of about 2%. But this growth is not uniform; there is tremendous variation if you deconstruct its components at the state level. Viewing the data from this perspective in the chart below, we see that only 16 US states have either met or exceeded the national average of GDP growth since the crisis. Four have had negative growth for the entirety of the recovery.

So, the US economy is not homogeneous, and in fact GDP growth is rather dispersed. Tax changes probably amplify this dispersion.

Our takeaway is that when hedge managers look at fixed income investments in the United States, they consider where those issuers do business. Not in terms of where they are headquartered, but where the underlying commerce takes place. The disparity in state growth rates may impact these companies very differently, which we believe ultimately can create opportunity for relative value fixed income hedge managers to capture alpha or seek different returns.



Finding a Smoother Road

There are three main allocations in portfolios: equity, fixed income and alternatives. How much and when to shift allocations is a key component of risk management. There is significant uncertainty going forward: Can global growth sustain? Will there be a de-coupling between the United States and the world? How will trade tensions between the United States and China resolve?

Whatever the results, in this type of evolving environment, we think understanding the types of investments that can act differently can potentially be a powerful tool to manage to your desired outcome.

We also believe that an increased allocation to alternatives may help buffer a portfolio for risks.Depending upon an investor’s objective, alternatives can potentially benefit from things like volatility, sector rotation, asset class dispersion, and de-coupled global growth. In the case of hedge strategies, their potential for a widening opportunity set helps signal when to expect them to be particularly useful.

What Are the Risks?

All investments involve risks, including possible loss of principal. Hedge funds are complex instruments and may not be suitable for all investors. Investment in these types of hedge-fund strategies is subject to those market risks common to entities investing in all types of securities, including market volatility. There can be no assurance that the investment strategies employed by hedge fund and liquid alternative managers will be successful. It is always possible that any trade could generate a loss if the manager’s expectations do not come to pass. Hedge strategy outlooks are determined relative to other hedge strategies and do not represent an opinion regarding absolute expected future performance or risk of any strategy or sub-strategy. Conviction sentiment is determined by the K2 Advisors’ Research group based on a variety of factors deemed relevant to the analyst(s) covering the strategy or sub-strategy and may change from time to time in the analyst’s sole discretion.

This information contains a general discussion of certain strategies pursued by underlying hedge strategy managers, which may be allocated across several K2 strategies. This discussion is not meant to represent a discussion of the overall performance of any K2 strategy. These materials reflect the analysis and opinions of K2 Advisors, and may differ from the opinions of other portfolio managers, investment teams or platforms at Franklin Templeton Investments.

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1. Rising rate environments are defined as a minimum 100 bps increase in at least one portion of the yield curve (2-Year, 5-Year, and 10-Year Treasury Constant Maturity Rates) lasting at least one year, over the last 25 years as of June 30, 2018. If peaks and troughs are on different dates, the date with two out of the three Treasury rates meeting that criteria is picked.

2. Standard deviation is considered a measure of volatility, representing deviation of a set of data from a mean.

3. Sources: Morningstar, Hedge Fund Research (HFR), Bloomberg. Based on HFRI Equity Hedge-Alpha calculated against the MCSI World Index. Alpha is a mathematical value indicating an investment's excess return relative to a benchmark. Past performance is not indicative or a guarantee of future results. Indexes are unmanaged and one cannot invest directly in an index. They do not reflect any fees, expenses or sales charges. Unlike most asset class indexes, HFR Index returns reflect fees and expenses. See www.franklintempletondatasources.com for additional data provider information.

4. Source: HFRI.

5. Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years.