ALTERNATIVES

An Alternative View on Volatility

March 10, 2016

Many investors fear the type of market volatility we have seen in recent months, but it's not necessarily a bad thing—particularly for investors in some types of alternative investment strategies. Brooks Ritchey, senior managing director of K2 Advisors, explains why.

Every investment manager has his or her own collection of favorite adages. One of mine is "each fresh crisis is an opportunity in disguise." I've been given a chance to test this maxim thus far in 2016. While it has been a rocky start for markets globally, the subsequent volatility has brought with it opportunity in the form of market inefficiency. When the market is inefficient, it means investors are generally allowing fears—rather than fundamentals—to overwhelm their decisions, and prices of securities may not reflect their underlying value.

In general, the majority of hedge strategies seek to capture gains from market inefficiencies by taking advantage of pricing differences and relative discrepancies between securities, technical market movements, deep fundamental valuation analysis, and other quantifiable trends and/or inconsistencies.

As investors in hedge strategies through our liquid alternatives (liquid alts) portfolios, we expect that inefficiency may provide us with better opportunities to generate excess returns, or positive alpha.[1] In other words, volatility typically gives investors in hedge strategies a better chance at separating the winners from the losers. (That's not to say that hedge-strategy investors always try to avoid "losers," but we'll touch on that topic later.)

Based on our current economic outlook, with financial markets still coming to terms with, among other issues, China's slowing growth rate and uncertainty about global interest rates, we anticipate volatility will be around for some time—and may even escalate. Of the four common hedging strategies typically employed within our liquid alts portfolios—long-short equity, relative value, event driven and global macro—we believe global macro and long-short equity are best positioned in the near term to benefit from this anticipated increase in market volatility.

Global Macro: A World of Opportunities

Global macro strategies focus on top-down macroeconomic opportunities across numerous markets and numerous investments, including currencies and commodities. These strategies take into account many factors, which may include a country's or region's economic indicators, as well as central bank trends and divergences. Recent events in China have created opportunities for global macro hedge strategy managers. Below is an example of one such opportunity:

[frk_blue_box title="Global Macro: China and Australia's Housing Market" width="95%" align="right"]As its economy—and construction sector—has boomed over the last two decades, China has been a significant importer of Australian commodities, especially iron ore. Concurrently, Chinese nationals have invested substantial amounts of money in the Australian real estate market, which has helped to boost Australian housing prices.

Amid double-digit annual gains in housing prices over the past few years, foreign speculators, many of them Chinese, increasingly comprised a larger portion of home buyers in Australia. But, as China's growth slowed and commodity prices sank, economic conditions have become more challenging in Australia in recent months, dampening home sales among the domestic population. And some analysts have noted diminished demand from Chinese real estate investors in recent months, particularly since the August 2015 devaluation of China's currency, the yuan.

In our view, Australian banks appear acutely vulnerable to a correction in housing prices, because they account for much of the market share for Australian home loans. In addition to this recent substantial exposure to housing, banks in Australia are legally responsible for assessing the credit risk of home buyers, which may end up exposing the banks themselves to increased risk. Additionally, our analysis suggests that many large Australian banks trade at premiums relative to their global banking peers, suggesting additional downside risk. Considering all of these factors, hedge strategy managers may short[2] Australian banks because they believe the stocks of these banks will likely underperform.[/frk_blue_box]

Long-Short Equity: Volatility and Equity Price Spreads

As volatility increases, the spreads between the share prices of companies that are considered healthy and those that are facing challenges typically widen. Long-short hedge strategies seek to take advantage of this widening by buying (going "long") the good companies and shorting the weaker ones. Remember, hedge strategy managers aren't focused solely on finding "winners." They can fine-tune their hedges to identify the companies that may be negatively impacted by, for example, a collapse in oil prices, and capitalize on that negativity.

We also believe long-short equity strategies are poised to benefit from a continued rise in interest rates in the United States, and the rate moves do not have to be dramatic to have an impact. Even gradual increases may bring opportunities for long-short hedge strategy managers.

In a low interest-rate environment, many mediocre companies can survive on cheap credit. When rates move higher, those mediocre companies tend to see their growth path limited because rising interest expense is a drag on their earnings. These circumstances can help separate the winners from the losers much more clearly, and the inefficiencies created by these variances promote the potential capture of alpha.

Also affecting valuations and further separating winners from losers has been the strong US-dollar run of the last year or so. Export-led sectors and companies in the United States have been challenged more than importers or locally driven companies in terms of earnings growth. We expect that trend to continue throughout 2016, as US monetary policy has diverged from that of many other major countries and regions, and higher US interest rates will likely keep the dollar on its upward trajectory relative to other major currencies.

Benefiting from "Disruption"

Other developments that we believe could potentially enhance the opportunity set for long-short equities include so-called "disruptive" technologies. We have long seen the impact on traditional media of Google and other online digital media companies. Looking forward, we may see a similar shakeup in some areas, including the motel and leisure sectors, as new technologies come to market and disrupt the status quo. Dynamic technological advances can create a broad set of winners and losers.

Disruption—and volatility—are often thought of negatively, but, as we've seen, both phenomena may provide positive investment opportunities for hedge strategies that seek to take advantage of the market inefficiencies they typically bring.

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1. Alpha is a risk-adjusted measure of the value that a portfolio manager adds to or subtracts from a fund's return.

2. A short sale is the sale of a security that the seller has borrowed, typically from a broker, and promises to return at a future date. The broker sells the borrowed shares, and the proceeds are credited to the seller's account. On a specified future date, the seller must buy the same number of shares borrowed and return them to the broker. If the share price has dropped in the interim, the seller can now buy the shares back at a lower cost and

make a profit on the price difference. If the share price rises in the interim, the seller will pay a higher price for the shares, which will result in a loss. Please note: There is unlimited downside potential associated with short-selling strategies.

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