Could Liquid Alternatives Provide Answers?

Disruptive Forces in Investing **November 8, 2022**

Anu Rajakumar: As we shift into what appears to be a new economic regime, investors are rethinking how they approach asset allocation. With slowing growth, high inflation, tighter monetary policy, and numerous geopolitical uncertainties, all contributing to lower expected capital market assumptions going forward, investor demand for diversifiers have come into focus.

Many are asking whether liquid alternatives, which typically have low beta and correlations to traditional markets, are part of the solution. My name is Anu Rajakumar, and today I'll be discussing the topic of liquid alternatives with Paresh Shah, a senior portfolio manager of the Neuberger Berman Alternative Investment Management Team. Paresh, thanks for joining us today.

Paresh Shah: Thanks for having me.

Anu: So, Paresh, to get us started, tell us about the development and growth of liquid alternatives and explain why this era of the investment opportunity set is considered a disruptive force in investing.

Paresh: Sure. So liquid alternatives are essentially hedge fund strategies that are run in '40 Act mutual funds in the US and in use of its vehicles outside of the US. They are given the label liquid, given the typical profile of the underlying strategies, as well as the more frequent subscription and redemption windows available to investors in these types of structures.

Now, you know, there wasn't much by way of these kinds of products before the financial crisis, and they have really only become more prevalent over the last decade or so. And so historically, that meant that access to hedge fund strategies had been limited to high-net-worth individuals and institutions who were accredited or qualified investors able to invest in private investment vehicles.

But the advent of liquid alternatives has truly democratized access to various hedge fund strategies for a much wider variety of investors who would otherwise have no way of including hedge fund strategies in their portfolios.

Importantly, I'd say with liquid alternatives, the access to hedge fund strategies is provided in a way that actually improves the end product. You have better liquidity, more transparency, stronger control of underlying assets, and lower all-in fees compared to accessing similar strategies through private funds.

Now I think having access to different kinds of hedge fund strategies through liquid alternatives is particularly relevant today, uh, given the market environment we're in and likely will be in over the near to medium term where investors are trying to figure out, frankly, what to do with their portfolios.

Anu: You know, I think that's a very good place to dig in a little bit, Paresh. So tell us about what you've learned from the past environment and how that's shaping the outlook for liquid alternatives going forward.

Paresh: Sure. I think, at the end of the day, the impact of QE ending cannot be overstated. Traditional long-only equity and fixed-income allocations enjoyed a massive tailwind to performance over the last decade plus driven by quantitative easing. And importantly, QE also served to suppress the volatility of these allocations as well.

So you were really able to earn outsized returns with a much more limited volatility profile as well. That era, unfortunately, is now unequivocally over, uh, regardless of whether the Fed begins to cut rates at some point in the next year or two, because cutting rates, in and of itself, is different than quantitative easing.

So this means that there are likely dramatic implications for the traditional 60/40 portfolio construct, not just from a return perspective, but from a volatility perspective as well. The end of QE means the end of volatility suppression, which means more elevated volatility is here to stay, and likely for longer than we expect.

Anu: Yep, absolutely. I know that's, that's the issue that so many people are grappling with at the moment. So moving forward, what do you think some of the possible scenarios are that you think may unfold in the medium term?

Paresh: Yeah, I think there are three fairly obvious higher probability states of the world over the near to medium term. Scenario one is a continuation of the environment we're currently in, where we have elevated inflation and rising interest rates with some fairly modest economic growth. Scenario two, you know, rates rise to a level that reigns in inflation but causes an economic recession. And scenario three, stagflation, inflation remains elevated at the same time as a recession unfolds.

I think we all tend to gloss over the idea that inflation is harder to get under control than we assume, especially now, given its numerous causes, some of which, frankly, monetary policy might not be able to fix. At any rate, in any of these three scenarios, volatility will be elevated. Obviously, we see that right now with scenario one, but volatility is typically higher during recessions as well. And obviously, stagflationary environment combines the worst of both worlds and would also coincide with elevated volatility.

And also, in any of these scenarios, interest rates are likely to be higher than they were during the QE era, and liquidity will be harder to come by as well. So across each of these scenarios, the return potential from traditional risk assets is likely to be more constrained than it was over the last decade-plus, as the tailwinds of the QE era now become headwinds.

So moving from zero rates into meaningfully non-zero interest rates, liquidity injections becoming liquidity drains, and low inflation giving way to higher inflation.

I think that there are issues even beyond QE as well, you know, we're seeing globalization unwinding in real-time. We're seeing supply chain issues, as well as changes in the cost and availability of labor. And that's to say nothing of the geopolitical issues that we're currently experiencing. So I think that there are a number of changes that have pretty meaningful implications for investing going forward.

Anu: Yep. So I think, Paresh, all those points that you just made certainly support the idea that we're in a regime shift. That has a number of implications for investors, why don't you run us through what those are?

Paresh: Yeah. It means that investors have to position themselves to protect capital and generate returns in a world that is likely to be more volatile for longer and in which money will no longer be free. That is a very different world than the world that we've lived in for the last 10-plus years.

You know, I think we all tend to have some level of recency bias and expect some type of reversion to what we've just experienced, so it's hard to contemplate a world that will stay different, let alone act and invest accordingly. The power of inertia is very strong, especially when it comes to investing.

Anu: Okay, so now let's take everything that you've said so far and translate it into the liquid alternatives world. How can investors use this area of the investment opportunity set to diversify and better position themselves for this environment?

Paresh: One way to do this is to utilize hedge fund strategies that can benefit from a lot of the things that we've talked about. So higher volatility, higher interest rates, the potential for a real credit cycle, which we haven't really talked about, and other potential market dislocations that may unfold as well.

Fortunately, you know, many of these strategies already exist in liquid alternative products today. One subset are what we call uncorrelated strategies. These are hedge fund strategies with correlations to traditional long-only asset classes that are minimal to negative.

So, for example, managed futures and global macro strategies take long and short positions across asset classes. Year to date, these strategies have been able to do well by being short interest rates, by being short various currencies against the US dollar, and by being long energy commodities earlier on in the year.

Other uncorrelated strategies include things like volatility arbitrage, statistical arbitrage, equity market neutral, short-term trading, to name a few. These strategies, in general, tend to benefit from many of the characteristics that we've discussed and expect to be present over the near to medium term.

So in the case of macro and managed future strategies, the shift away from QE means less central bank intervention in markets, which in turn means that there's less distortion of traditional relationships across asset classes and the macroeconomic fundamentals and technical signals that these strategies typically rely on to generate trades become more relevant.

In addition, a higher volatility environment means moves in asset classes are bigger, so potential returns are greater, uh, especially because these strategies can go both long and short across asset classes. And with strategies like statistical arbitrage or equity market neutral, a lot of the factors that we've been talking about, things like higher interest rates, i.e., a higher cost of capital, higher inflation, currency effects, a potential recession, et cetera. All of these things help drive differentiation in the operating performance of businesses, which should also drive greater dispersion across stocks. In addition, a higher volatility environment helps amplify those moves.

Now that's sort of, you know, a number of the uncorrelated strategies that we think about. There are other kinds of hedge fund strategies that can also help diversify a portfolio in this kind of environment. For example, merger arbitrage. Merger arbitrage typically involves taking a position in a target company after a deal to acquire it has been announced but before the deal closes.

During this period of time, the target typically trades for less than the purchase price because there is time until the deal closes as well as some uncertainty about whether the deal will close and if it will close at the announced price. While there can be some modestly positive equity market correlation here given that merger arb positions are largely long individual equities, returns are ultimately a function of whether or not specific deals close, which is largely about understanding valuations, strategic deal rationales, the deal approval process, the view of regulators and the strength of potential challenges they could make to the deal.

And as a result, returns aren't ultimately a function of whether markets are up or down X% in any given period of time. In fact, this is another strategy that has been able to do well year to date while equities have been down meaningfully. The other point that I'd make about merge arbitrage is that it can also benefit from higher interest rates because deal spreads tend to be positively correlated to interest rates.

Anu: Okay, that's very helpful. You know, you mentioned a number of different strategies. Just out of curiosity, from a portfolio construction perspective, how do you ensure that the strategies that you have, the alpha they're generating are complementary? Or how can you avoid crowded trades from some of these managers kind of all chasing the same idea?

Paresh: Yeah, that's a great question. You know, I would say that you look at the underlying profile of the different strategy. So you can look at correlations that they have to one another, correlations that the managers might have to one another. But you also wanna understand what is actually driving, you know, the return generation and the volatility profile of the underlying strategies, and you wanna make sure that these strategies are essentially doing different things, right?

So, you know, you can have a number of different strategies in a portfolio that look different, but if they're all, let's say, long-only equity strategies that are focused on the US and then maybe one's focused on Europe, and then maybe one's focused on tech, and one's focused on a different sector, you can say, "Oh, look, I'm diversified because I have four or five different underlying strategies," but at the end of the day, they're all gonna be highly correlated because they are long-only equity allocations, right?

So the way we think about portfolio construction is to understand the different strategies that we have, what the correlation profiles are across those different strategies in different market environments, and what our expectations are in those different market environments. But fundamentally, we wanna make sure that they're doing different things.

Anu: Great. Perfect. Thank you very much. All right, Paresh. Well, those are the end of the-the formal questions, but you can't leave today without having a bonus question. So get ready, brace yourself. Paresh, as we head into the end of the year, would love to know, is there anything special that you're looking forward to?

Paresh: Yeah, that's a great question. Um, we have two young kids, and my youngest is turning one at the end of this month, you know, so we're-we're obviously having a party, but importantly, it's just one of those special milestones. Right?

You know, we always talk about the common adage is the days are long, but the years are short. And, you know, this year has flown by, frankly. So it's good to sort of take that opportunity to sort of soak it all in and see where she's-- you know, see the journey that she's taken and the journey, frankly, that-that we've taken, uh, over the last year.

And so, you know, we're- we're looking forward to that. And interestingly, this is a bit-a bit of trivia, her birthday's at the end of November, and we were expecting her around sort of the second half of November. We were a little bit worried that, you know, she could be at Thanksgiving.

Anu: Yeah.

Paresh: Maybe a Turkey. Um, but thanks to FDR, we actually changed some of the, I think the regulation around when the holiday was supposed to be. She now will never have her birthday fall exactly on Thanksgiving. It might be Thanksgiving adjacent, but it won't ever be on Thanksgiving.

Anu: She doesn't have to share the day with, uh, with the turkey.

Paresh: Exactly.

Anu: So that is great. Well, congratulations and happy early birthday to her. Paresh, we really appreciate you joining me today to discuss the opportunities for liquid alternatives as we navigate the current market. Um, looking forward to see how things evolve.

Paresh: Thanks again for having me.

Anu: And to our listeners, if you've enjoyed what you've heard today on Disruptive Forces, you can subscribe to the show via Apple Podcasts, Google Podcasts, or Spotify, or you can visit our website, www.nb.com/disruptiveforces for previous episodes, as well as more information about our firm and offerings.