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Are alternatives underwhelming or simply underappreciated?

Dalton Street Capital wants you to be the judge.

In an absolute sense, the alternatives sector has been incredibly underwhelming in recent times.

That's the view of Dalton Street Capital's Alan Sheen[01] and, as an alternatives manager, he would know.

However, putting the sector's performance into perspective, Sheen says: "It's no different to any other asset class. You'll have property underperform for a decade or more and you'll see the same for equities from time to time."

"Unfortunately, this is just the time for alternatives to go through that."

Illustrating this, over the last two decades the Dalton Street strategy has achieved a long-term track record of producing returns in the realm of 20% per annum. More recently, those returns have sat around the 6% mark.

"This is personally frustrating however it is common across the vast majority of absolute return strategies," Sheen says.

And it doesn't have to mean all is lost for would-be alternatives investors.

Portfolio manager of the Dalton Street strategy, Sheen says an allocation to alternatives is an effective means of diversifying an investment portfolio which, in turn, offers protection. This remains true no matter the recent difficulty the asset class has seen.

"The only free lunch you'll ever receive is diversification," Sheen says.

"If you diversify your portfolio you can reduce your risk without reducing your returns. So, when you have a period of underperformance, it's not the time to start allocating away from it.

The Dalton Street strategy is an absolute return strategy which invests in the alternatives space and comprises a managed futures strategy and an underlying long-only equity portfolio for protection.

Some may view this as counterintuitive for an alternatives manager and Sheen doesn't disagree.

"What needs to be remembered is the only portfolio that can be constructed to protect against equity market drawdowns is a derivative portfolio," he says.

People don't realise a strategy of that kind could cost somewhere between 6-8% per annum to achieve very short-term protection, he adds.

"So, if you consider the market has been going up for 10 years now and people have been waiting for a drawdown, that would have cost an investor 60-80% of their capital for just a short period of protection," Sheen says.

That's where the Dalton Street strategy comes in, combining two completely uncorrelated asset classes - equities and futures – in a move which has been shown to protect investors during periods of sustained market dislocation.

"This equity portfolio also allows investors to enjoy equity market returns during sustained periods of low volatility," Sheen says.

But what part of a portfolio would an adviser look to allocate to alternatives from?

While it depends on the product and the strategy, InvestSense director Jonathan Ramsay says in this case alternatives form part of a growth allocation.

"In this instance, you've got an underlying equities strategy and a futures-based strategy and they could draw down at the same time. While we think these strategies combine well over the longer time, over shorter periods you might expect even greater volatility than for equities," Ramsay explains.

However, there are naysayers out there who believe systematic futures have a so-called half-life and that their return potential for risk adjusted outperformance diminishes over time.

"They absolutely do and they absolutely don't," Sheen says.

It depends on the type of systematic strategy being run, he adds, explaining that systematic strategies can come in two different styles: risk-based and behavioural-based.

Risk-based strategies will always be arbitraged away relatively quickly as people find out about these strategies, Sheen says.

"On the other hand, behavioural-based strategies are predicated on human behaviour and human behaviour hasn't changed for, what we can tell, the last 250,000 years," he adds.

At the end of the day, while there will be periods of underwhelming performance as with any asset class, with a behavioural strategy you will achieve the returns that you expect to achieve.

"This is because, as humans, we can't help but behave the same way today we did yesterday, as we did a decade ago," he says.

"Our fear and greed manifests in exactly the same way all the time."

Holding alternative assets over the medium to long-term that are uncorrelated to traditional asset classes can really boost an investor's portfolio, according to Dalton Street Capital.

But, as with anything, there are key considerations for an adviser to work through before making a recommendation, not least of all because returns are difficult to come by at the moment.

The quote

Look for things that are a little off the beaten track.

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And, if and when they do opt for an allocation, what should they look to invest in?

When it comes to alternatives, Ramsay says, there is currently a real supply and demand issue at play.

"On the one hand, there is increased demand for alternatives as the opportunity cost investing in everything else, especially cash and bonds, is quite low in a low rate environment," he says.

"On the other hand, there has been a crisis of expectations as more money is chasing fewer opportunities in alternatives and just because you want higher, less correlated returns doesn't mean that will be the case."

In fact, at an aggregate level across the market, the opposite may well prove true, Ramsay says.

And this presents an opportunity for the Dalton Street strategy, with the equity component of the portfolio robust over the long term and liquid.

"It arguably provides liquidity and seeks undercapitalised parts of the market, of which there are not many these days," Ramsay says.

"At the other end of the spectrum is the managed futures strategy which is more idiosyncratic and capacity constrained."

Capitalising on the undercapitalised parts of the market is the key point here for Ramsay, believing that's what advisers and investors should be looking to do. That, and not investing in anything that's been over-invested in.

"This is an area where Alan and I tend to disagree, the suggesting that these investments can have a kind of half-life," he says.

"But in this case, we actually think the two underlying strategies are quite robust because what could be more undercapitalised at the moment than Asian deep value equities? And that's setting up, we hope, for a sort of asymmetric risk/return profile and we've seen that in markets recently."

There's a lot of upside to this approach and when the news is bad, it's not really that bad, he adds.

"This is complemented by the futures strategy which is smaller, niche and capacity constrained, and that's the kind of idiosyncratic risk we think advisers should be looking for – things that are a little off the beaten track or undercapitalised." FS