



An Alternative Take on Alternatives: Not Just Adding a Slice, But Rethinking the Whole Pie

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At GMO, we have a deep appreciation for alternative asset classes. We manage nearly \$10 billion in hedge funds and have an experienced team offering timberland and agriculture investments. Yet we are nervous about the increasingly uncritical embrace of all things alternative. Just as with traditional assets, investors must always ask the key question: Is the asset priced well? Rather than embracing alternative assets, we believe investors should embrace an alternative way of thinking about the investment equation.

Let's first review what alternative assets are and how they are being marketed. When we say alternative assets we are referring to the usual suspects: hedge funds, private equity, commodities, and real estate. But there are more esoteric and illiquid categories including timber, infrastructure, and volatility. Each is typically being marketed to advisors by highlighting one or more of the following key selling points:

- Alternative assets offer low correlations to other asset classes.
- Alternative assets can act as an inflation hedge.
- Alternative assets can be a source of pure alpha.
- Alternative assets can provide protection in down markets.
- Alternative assets should be a "slice" of your strategic mix.

The purpose of this article is to throw a bit of cold water on each of these selling points and to propose an alternative to evaluating alternatives. Let's go one by one.

Low Correlations

The conventional thinking in the capital markets today is that all risky assets are moving together or, in the parlance, "correlations are going to 1.0." Therefore, the argument goes, an advisor *must* consider adding alternatives because they behave so differently. Alternative thinking, on the other hand, asks the more critical question:

"Are correlations the right risk to obsess about?" We would argue no. Advisors should focus on the most important risk, overpriced assets. Let's explore how focusing on correlation risk can be dangerous.

GMO's investment process seeks to identify cheap and expensive asset classes (see Exhibit 1).¹ On December 31, 2001, our models considered emerging equities to be cheap and U.S. large cap stocks, as represented by the S&P 500 index, to be expensive. Now, look at Exhibit 2. On the day we made the forecast, the correlation between emerging market stocks (as represented by the MSCI Emerging Markets Index) and the S&P 500 stood at 0.71, already high. Over the next 10 years, the correlation increased even more, to 0.86. But look at the actual realized *returns*. During this decade of rising correlations, the cheap asset outperformed the expensive one by *11 percentage points, per year, for 10 years*. Advisors that did not put money into emerging markets because they were obsessing about rising correlations may have missed out on the investment opportunity of their careers. The takeaway here is to focus on identifying cheap and expensive assets and to not lose sleep over correlations.

Inflation Hedge: Commodities

The second conventional marketing pitch for commodities is two-fold. First, there is the belief that a long commodities portfolio can hedge inflation; and second, that growing consumption in the emerging markets ("the changing diet of the Chinese household," or, "a car in every driveway in Mumbai") and shrinking supplies paints a very bullish picture.

GMO's Focus Is On Identifying Cheap vs. Expensive Asset Classes

GMO's 10-Year Forecast on December 31, 2001

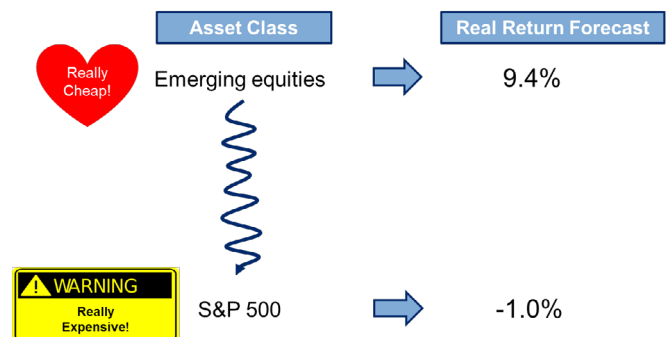


Exhibit 1 GMO's Focus Is on Identifying Cheap vs. Expensive Asset Classes

Source: GMO

What Matters: Correlations vs. Cheapness?

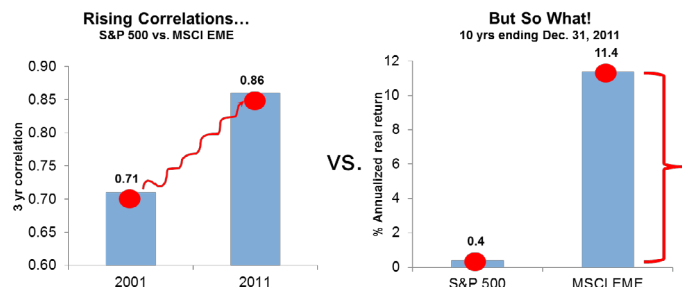


Exhibit 2 Asset Class Valuations Matter, Even in Highly Correlated Assets

Source: GMO

Alternative thinking asks this: “Are commodities such a good inflation hedge if they’re expensive?” Theoretically, being long a basket of commodities should be a source of excess return. A wheat farmer, for example, may not want to bear the risk of a wild price swing between planting season and harvest. He wants to lock in his price today, if possible. The futures markets allow him to do this. The farmer takes a haircut on current spot prices in order to entice a speculator to take on this risk. When most commodities markets are functioning normally, as fair compensation, futures prices should sit below the current spot price. Unfortunately, the markets at times, do not behave normally. During the last decade, the creation of new structured products such as exchange-traded funds (ETFs) combined with the compelling story of higher emerging market consumption have conspired to attract too many players, primarily from the hedge fund and institutional communities. There was a period not too long ago from 2003 to 2011 wherein roll yields were actually negative — there was too much money on one side of the trade. Investors, rather than getting paid to take risk, were actually *paying the farmer*.

Negative roll yields prevailed, and roll yields have been one of the main drivers of returns, historically. A dedicated strategic allocation to commodities at that time was absolutely the wrong thing to do. Now, there may come a time when pricing normalizes and commodities are an excellent investment opportunity, but that should be the reason — that they are priced well, not because they are an alternative asset class.

Cumulative Roll Yield on S&P/GSCI Reduced Energy Index

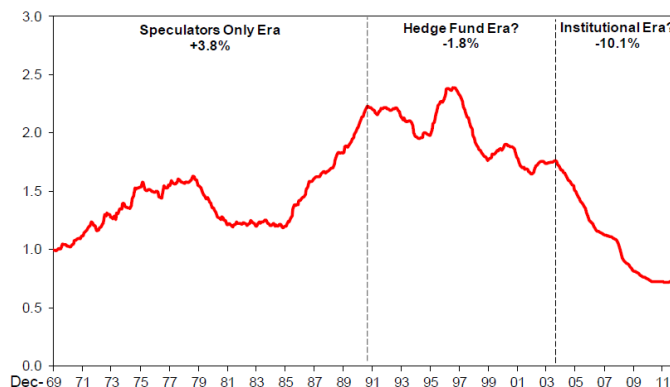


Exhibit 3 Roll Yields for the S&P GSCI Reduced Energy Index — Which Tracks a Range of Liquid Commodity Contracts — Have Declined Over the Past 10 Years.

Source: S&P, Federal Reserve

Pure Alpha

Alternative investors, especially hedge fund managers, have convinced the marketplace that they alone have the necessary engineering tools to deliver “pure alpha” or absolute return. Alternative thinking says that the practice of separating alpha from beta is well established, even in boring old mutual funds. You most certainly do not need a hedge fund to engineer this kind of return profile. As shown in Exhibit 4, an actively managed U.S. large cap equity strategy benchmarked to the S&P 500 is trying to deliver two return streams — first, the return of the benchmark, or beta; and second, the excess return, or alpha.

The problem with this structure is that it is a package deal. If you want a manager’s alpha, the beta comes along with it. Suppose you believe, as we do today, that the S&P 500 is dramatically overvalued and you don’t want that beta in your portfolio. While you would love to have the manager’s alpha, you really don’t want the attached beta, but you’re stuck with the package.

However, an engineering technique called portable alpha unsticks you. What if you had at your disposal a method of investing that allowed you to isolate the alpha component? For example, invest \$1,000 in an actively managed fund and simultaneously short or hedge the S&P 500 by the same amount. The alpha generated by the fund is ported to cash. The market’s beta is completely neutralized.

Market direction is no longer a factor because you are long and short equal amounts. All that matters is whether the manager you've hired is adding 1% or 2% above the beta. If so, then you or your clients actually receive cash plus 1% to 2%. Voilà! Absolute return in a boring old mutual fund.

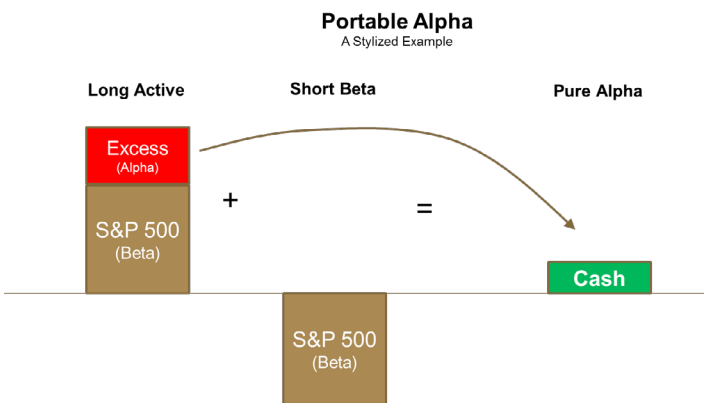


Exhibit 4 By Simultaneously Investing in an Actively Managed Fund While Shorting the S&P 500 Index, Investors Can Come Close to Capturing an Active Manager's Alpha Without Taking on Market Risk
Source: GMO

Protection in Down Markets

The conventional thinking about hedge funds and their managers is that they alone have the tools and skills to protect you in down markets. We offer an alternative point of view. As Exhibit 5 shows and we all remember far too well, equity markets suffered a devastating blow in 2008. Risk assets suffered huge losses. Yet the HFRX index, a common hedge fund index, lost almost as much as the average, plain-vanilla 60% stock/40% bond portfolio² in spite of the benefit provided by those much ballyhooed, sophisticated tools and skills. The index posted a loss again in 2011, by the way. Ouch!

In 2008, the GMO Benchmark Free Allocation Strategy, which is an unconstrained, go-anywhere portfolio, lost a relatively moderate 12.1%, net of fees.

The silver lining of that relatively modest loss was that even though the hedge fund and global equities indexes were still under water more than four years later, the GMO Benchmark Free Allocation Strategy was back in positive territory by March 2009, with a string of 10 consecutive positive months to finish 2009 with a gain of 19.9%, followed by positive net annual returns for each year from 2010 to 2014.

Alternative Thinking In A Down Year...

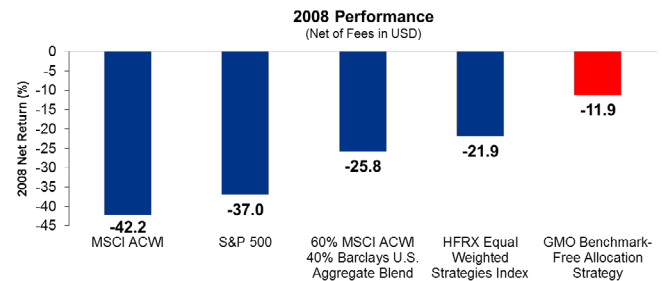


Exhibit 5 Alternative Thinking Helped Us Deliver a Narrower Loss than Many Market Benchmarks During the Global Financial Crisis of 2008

Source: GMO

An Alternative Way to Think About Core Managers — It's Not About Adding a Slice

The conventional thinking on alternatives says that you should carve out a dedicated slice of a strategic allocation, such as 5%, for an alternative asset class. Alternative thinking, on the other hand, asks “*Are you kidding?*” A 5% slice, even if it did everything it promised to do, would barely move the dial for an entire portfolio. In addition, these strategies can be complex, necessitating a new analyst or team of analysts to understand the wide array of alternative asset classes. All that effort for a 5% allocation?

Furthermore, adding a 5% slice misses the bigger picture. We believe that even a modified 60/40 portfolio still suffers from two major flaws. First, it completely ignores valuation. It didn't ask in 1999 or in 2007 whether stocks might be expensive. And it's not asking today, with historic low bond yields, whether bonds might be expensive. It simply holds the mix. Second, a 60/40 portfolio *never moves*. It stares at an oncoming train and never gets off the tracks. The classic 60/40 needs to give way, not to a small slice of alternative assets, but to an alternative way of thinking about the entire portfolio. We believe advisors should combine three, or perhaps four, different managers that think alternatively and are willing to challenge the conventions of modern portfolio management. Break free from benchmarks. Think in absolute returns, not relative. Define risk the way your clients define risk: don't lose money by trying not to lose money! Identify these managers and then make them the core of your clients' portfolios.

Conclusion: Alternative Thinking is Unconstrained and Dynamic

So what does Alternative Thinking really mean? First, it means being willing to own an “unconventional portfolio.” As an example, take a look at Exhibit 6. In July 2003, the GMO Benchmark Free Allocation Strategy held an unconventional mix of assets, including 31% in international small cap, a then esoteric class. The portfolio also held 14% in emerging equities, a smattering of real estate investment trusts, and a small allocation in international value. While it was unconventional in what it owned, the real story is what the portfolio did *not* own, which was essentially no U.S. stocks. U.S. equity is the most commonly held asset in any 60/40 mix, yet we owned essentially none because in our view U.S. stocks looked expensive at that time. A 60/40 portfolio, in contrast, will always hold the conventional assets, even if they are priced for sub-par returns in the future.

It is far more logical that a portfolio’s allocations would shift in response to current valuations. As an example, in the early 2000s, as interest rates were rapidly declining and helping to inflate a global asset bubble, we became nervous.

Must Be Unconventional And Dynamic

Benchmark-Free Allocation Strategy

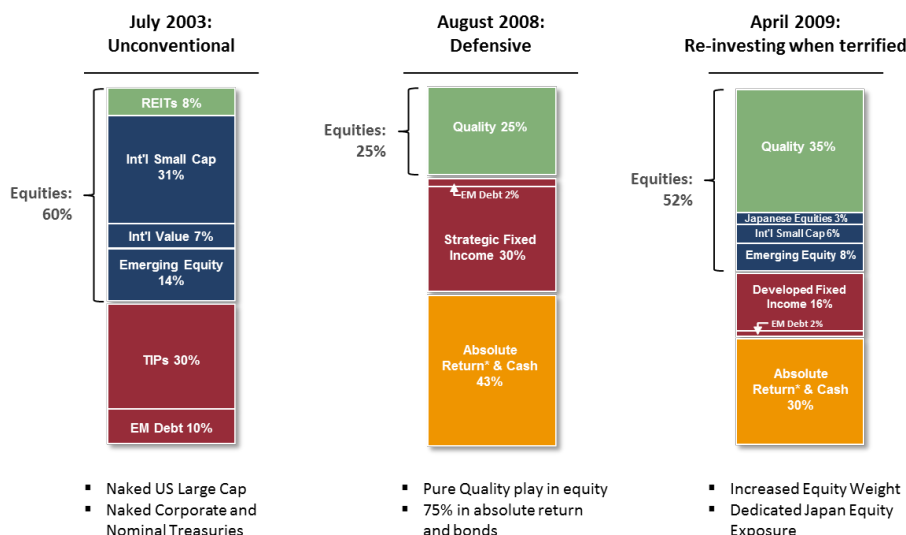


Exhibit 6 Alternative Thinking Is Dynamic, Not Strategic

Source: GMO

In the April 2007 GMO Quarterly Letter we warned our clients about this bubble. At that time, we also dramatically reduced our exposure to risk assets. We all know what happened when the global bubble burst, but after the collapse we published a short piece in March 2009 titled “Reinvesting When Terrified.” Risk assets had gone from being ridiculously expensive to ridiculously cheap in less than two years, and we responded by shifting our portfolios to take advantage. We believe our long-term performance (see Exhibit 7) shows the benefits of such a strategy.

Achieving an alternative pattern of returns does not result from simply adding alternative assets. It’s not about adding a slice — it’s about re-thinking the whole pie.

Endnotes

1. This example was chosen solely to illustrate that GMO's decision-making is based on how cheap or expensive we believe an asset class is and to coincide with an example of how a high correlation can exist between two asset classes with very different 10-year performances. The accuracy of these forecasts does not guarantee that current or future predictions will be accurate and may in fact be incorrect. The accuracy of forecasted returns for asset classes generally varies from period to period. In 2002, GMO stopped using 10-year forecasts and began using 7-year forecasts. The forecasts above were, at the time they were made, forward-looking statements based upon the reasonable beliefs of GMO and were not a guarantee of future performance.

2. 60% MSCI All Country World Index (ACWI)/40% Barclays U.S. Aggregate Index.

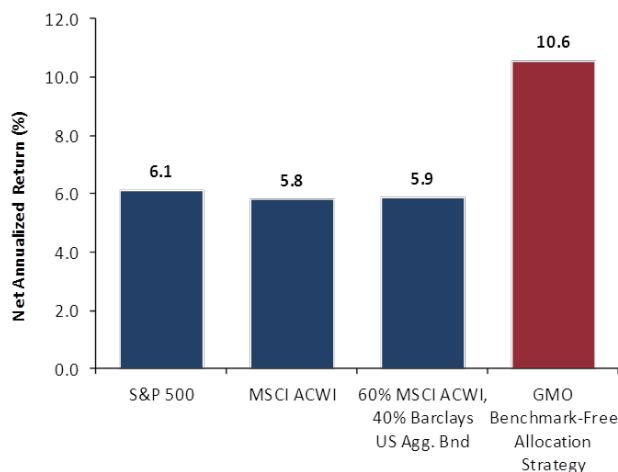
Author's Bio



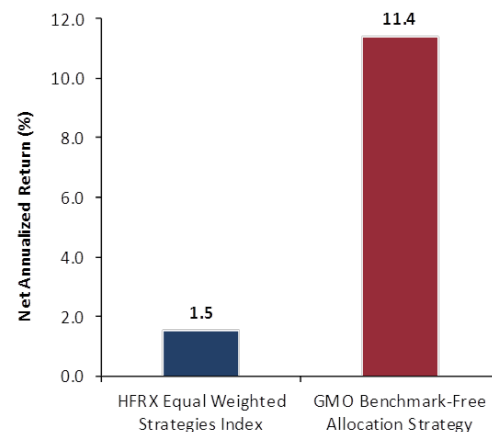
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Mr. Chiappinelli is a member of GMO's Asset Allocation team. Prior to joining GMO in 2010, he was an institutional portfolio manager in the asset allocation group at Pyramis Global Advisors. Previously, he was the director of institutional investment strategy and research at Putnam Investments. Mr. Chiappinelli earned his MBA from The Wharton School at the University of Pennsylvania and his B.A. from Carleton College. He is a CAIA charterholder, and is the founder of the CAIA Boston chapter. He is also a CFA charterholder.

Inception of Benchmark-Free Allocation Strategy to 12/31/14



Inception of HFRX (3/31/03) to 12/31/14



Source: GMO

Inception date of GMO Benchmark-Free Allocation Strategy: 7/31/2001

The chart above shows the past performance of the Benchmark-Free Allocation Composite (the "Composite"). Prior to January 1, 2012, the accounts in the Composite served as the principal component of a broader real return strategy. Beginning January 1, 2012, accounts in the composite have been managed as a standalone investment.

Performance data quoted represents past performance and is not indicative of future performance. Returns are shown after the deduction of model advisory fees, transaction costs, and other expenses. The returns assume the reinvestment of dividends and other income. A GIPS® compliant presentation of composite performance has preceded this presentation in the past 12 months or accompanies this presentation, and is also available at www.gmo.com. Actual fees are disclosed in Part 2 of GMO's Form ADV and are also available in each strategy's compliant presentation.

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Exhibit 7 If You Seek Unconventional Returns

Source: GMO