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Alternative investment strategies: part 2

Gast-AutorIn / Guest Author

Christian Süttinger,
Senior Fund Manager

Author: Christian Süttinger
Senior Fund Manager Multi Asset Management

After illustrating what alternative strategies are in part 1 of this series, how they work, and what benefits and disadvantages they come with, we would now like to discuss some of the most important representatives of this set of strategies. In the following strategies (also called hedge funds), the majority of the capital invested is allocated to alternative models.

Long/Short-Equity Market Neutral

In this strategy, the fund manager analyses individual companies with the goal of identifying winners and losers and investing in both at the same time. On aggregate, this leads to a portfolio that is composed of shares with attractive fundamental data (balance sheet ratios) and valuations (long portfolio) and on the other hand shares with negative fundamentals and/or unattractive valuations (short portfolio). The short portfolio bets on falling share price via short-selling. In the optimal case, the aggregate portfolio benefits from rising share prices (long portfolio) as well as from falling ones (short portfolio). Both components contribute to the overall return of the aggregate portfolio. Given that long and short portfolio are constructed independently, the performance of the strategy is relative stable overall.

The selection of the shares for the respective portfolio (long or short) can be handled by the investment management team directly (experts) or via computer models. The expertise lies with the manager and his/her assessment of the situation and the perspective of companies and sectors.

When the share prices de-couple from their so-called intrinsic value (which is based on fundamentals such as company earnings, dividends, sales etc.), for example in situations where “cheap” money causes asset inflows without the valuation of certain shares playing a commensurate role, it becomes tricky. An example is the European Central Bank (ECB) and its policies. The decision by the ECB to not only pursue a zero-interest rate policy but to also act as buyer of corporate bonds has led to a situation where European shares have de-coupled from their intrinsic values, experienced rising valuations, and thus become more “expensive”. Sudden changes in the earnings outlook of sectors that may be triggered by economic turning points are also problematic. For example, the expectations for global economic growth were negative at the beginning of 2016, a situation triggered by worrisome forecasts for China. But the picture brightened shortly thereafter, as a result of which the global economy returned to its growth path.

In the “market neutral” version of this strategy, the dependence of the portfolio on the stock exchanges is neutralised. This prevents the fluctuations that stock markets generally experience from feeding through to the bottom line.

Long/Short Equity Variable Bias

In the “variable bias“ version, the dependence of the portfolio on the stock exchanges is actively managed (by the manager) and, in the optimal case, is positive for rising equity markets and neutral or negative for falling ones. The fund performance thus hinges on both the analytical competence of the management team and the market assessment.

Global Macro

Followers of this strategy invest in equities, bonds, currencies, commodities, and interest rate products on the basis of a total macroeconomic picture. The strategy allows them to benefit from rising and falling prices and trends. A total macroeconomic picture is for example painted by economic indicators and sentiment barometers, historic data, and the experience of the fund management team. For instance, in a scenario of interest rates rising sustainably and causing falling bond prices as a result, a Global Macro fund may remain invested in bonds and even benefits from this development.

Global Macro involves the (risk-) controlled allocation of capital to those asset classes where economic data and historic models are suggesting the best outlook. The identification of the stage of the economic cycle a country is in, economic imbalances, and shifts between economic areas are factors that affect the composition of the fund portfolio. For example, currencies tend to react very sensitively to economic data and central bank policies.

The strategy often involves setting up a relationship between two developments prior to investing in one or both. For example, the economic development of country A relative to country B. As a result, it is the investment idea that is responsible for the success, not the sentiment on the stock exchanges overall (“relative value”).

CTA Managed Futures

CTA is short for Commodity Trading Advisors, i.e. it refers to managers of special investment products. With CTA Managed Futures, the manager looks for trends (momentum) in the asset classes of equities, bonds, currencies, commodities, and interest rate products with the help of information technology. Once a trend has been spotted (up or down), funds are invested systematically. After the expected end of the trend in an asset class, the capital is withdrawn and reinvested in another trend. In order to rule out an emotional component and to diversify the risk, investments are made across numerous different markets. In an optimal scenario, the actual length of an upward or downward trend coincides with the expected length of the trend as modelled for the fund.

Performance issues may arise in connection with this strategy if important trends, i.e. those with high asset allocation, end abruptly or many asset classes are suddenly behaving identically (i.e. are falling or rising at the same time), as sometimes happens under specific circumstances. An example of such a scenario was the announcement by the US Fed in 2013 to curb its supportive monetary policy. The market participants had not expected this to happen in quite that fashion. As a result, shares and bonds were falling at the same time. Both asset classes had been rising significantly prior to that announcement.

Conclusion

Long/short equity strategies can be beneficial if the investor wants to invest in equities but considers them expensive, i.e. overvalued.

Global Macro and Managed Futures have been quite good at shielding investors from the turbulences of the equity market in the past. They are “all-weather” strategies and are also suitable as complement in a mixed equity and bond investment strategy.

Please look out for the third part of our blog series, where we will be introducing further representatives of the alternative strategies.

The author:

Christian Süttinger has been with ERSTE-SPARINVEST KAG since 2002. He is Senior Fund Manager in the Multi-Asset-Management team for alternative strategies. He holds a MSc (Business Administration) from the Vienna University of Economics and Business Administration and has been Chartered Financial Analyst and Chartered Alternative Investment Analyst since 2009 and 2010, respectively.

Gast-AutorIn / Guest Author

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