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Alternative investment strategies: part 1

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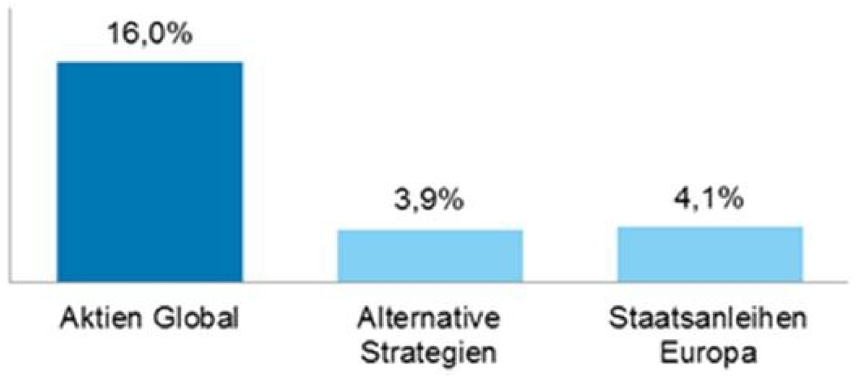
In the USA, gradually rising interest rates have already become reality. In Europe and in another large economic area, i.e. Japan, the subdued economic development has prevented interest rates from increasing to date. The European Central Bank manages interest rates in such a way as to support the economic upswing and the cohesion of the Eurozone.

The search for alternatives amid low or rising interest rates

In order to avoid inflation, the rates in Europe could be raised gradually. In such an environment, the expected return to be gained from bonds and securities with bond-like features is limited. Indeed, capital losses are possible over the long term. Investors would therefore shift their focus on investments with higher risk such as equities or emerging markets assets.

Alternative strategies provide the opportunity of basing one's portfolio on independent pillars. The independence (i.e. low correlation) of performance in comparison with equities or bonds makes alternative strategies its own, interesting asset class. For example, the risk associated with this asset class has been clearly below that of equities in the past ten years. The most important representatives of the asset class in particular, i.e. “trend following”, “global macro”, and “long/short equity”, are a **good investment also in times of rising interest rates**.

This chart illustrates the risk* of alternative strategies as compared to equities:



*Risk as measured in terms of standard deviation (volatility)
Chart: Volatility of selected asset classes over 10 years
Source: Bloomberg; own calculation; MSCI ACWI Local; Lyxor Hedge Fund Index; JPM GBI EMU; daily data; 03/2007-03/2017

The volatility of equities over a period of ten years amounts to 16.0%, while the referential percentage for bonds is 4.1%, and for alternative strategies 3.9%. Low volatility means a smaller fluctuation range and thus a higher degree of stability.

What are typical alternative investment strategies?

The strategy of **Trend Following** (“Commodity Trading Advisors – CTA Managed Futures“ – for more information, please wait for the upcoming part 2 of this blog series) uses software in an attempt to identify trends across financial markets. These could be rising trends as well as falling ones. What market forms the trend is not that important. Trend followers therefore do not only invest on stock exchanges, but also on bond, commodity, and currency exchanges. CTAs can earn a return on **falling prices** as well. Alternative strategies can always invest both in rising prices (“long”) and in falling ones (“short”), which traditional investment strategies cannot do.

Chart: Global equities and the alternative strategy of trend following; 10Y
Sources: Bloomberg; MSCI ACWI Local, SG Trend Index; weekly data; 03/2007-03/2017

The **Global Macro** strategy constructs a broadly diversified portfolio from different asset classes on the basis of thorough research and the experience of the fund management team. This approach also allows for investments in rising and falling prices.

Long/Short-Equity analyses individual companies in an attempt to identify winners and losers and invest in both. Part of the strategy involves “long” positioning (winners) and “short” positioning (losers). Both sides are independent of each other, which is why the overall strategy is stable. Here, rising interest rates cause an increasing impact of capital costs on company balance sheets. This makes it easier to differentiate between robust and weak business models.

Imagine for example you could borrow money at 0% – even if you were to live way beyond your means, this would have little effect on your financial situation. It would only be at a rate of, say, 6% that the financial effect would be enormous. This rational easily translates into the corporate sector. High interest rates also mean rising costs for a company. This means that in times of high interest rates, it becomes clear which company can absorb them due to its robust business model and which cannot do so.

Four criteria that have to be met for an investment strategy to be considered alternative:

- The potential of producing return also amid low or rising interest rates
- Lower risk than equities
- Performance largely independent of equities and bonds
- The option of also benefiting from falling prices

The main difference between alternative investment funds and traditional funds is the fact that alternative strategies allow investors to also benefit from falling prices. Given that on the markets, prices tend to rise and fall over longer periods of time and alternative investments can gain from both, the resulting overall **stability** of the strategy is closer to that of bonds than to that of equities.

Conclusion

Alternative strategies offer stable performance and diversification, especially during times of rising interest rates. In the next two articles, we will describe the available strategies in more detail.

The author:

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