Asset Allocation & Alternative Assets

With traditional assets experiencing high levels of volatility, investors are concerned with how to better manage the risk to capital and the income expectations of each asset class.

Alternative Assets are generally non-traditional assets. They may derive their returns from sources that have links back to traditional assets such as shares and bonds but do not necessarily hold any of these assets directly. Instead the modern market offers many access points to gain market exposure to a variety of different assets such as currency and commodities. The same old principles apply: buy low and sell high but the opportunity set is quite broad.

A key differentiator with non-traditional assets is that they offer further diversification to a client portfolio. At the moment, shares and bonds globally are being impacted by the aftershocks of the GFC and other global conflicts. The low interest rate environment and the search for yield is forcing investors into chasing returns from familiar sources but this is driving the valuations of some of those sources into unrealistic levels and the downside risks are becoming too great to accept from a risk verses return perspective. So where do you look for Alternatives?

There are two potential areas within a client portfolio where Alternative Assets can help mitigate some of these risks:

* Growth Assets; and
* Defensive Assets

**Growth Asset Alternatives**

I consider Growth Alternatives as market exposure that derive their underlying exposures from physical assets that have a growth bias. Assets on this side of a client’s portfolio (shares and property) are expected to derive their returns from the growth in price of the underlying assets together with, a level of income from company dividends or rental receipts from property assets. Growth Alternatives exposure includes:

1. Private Equity;
2. Long / Short Equity;
3. Infrastructure;
4. Commodities; and
5. Currency.

**Defensive Asset Alternatives**

The income return source best describes how I look at this side of a client’s portfolio. If there is a cash return paid regularly and the underlying asset valuation displays similar characteristics in terms of volatility to the existing assets (bonds and cash) then the use of such strategies would appear attractive especially if they are able to consistently deliver return outcomes higher than the traditional assets without the price volatility of riskier assets. Defensive exposure includes:

1. Hedge Funds;
2. Mortgages; and
3. Credit.

**Asset Allocation**

Many Asset Allocation constraints are imposed to limit the exposure to Alternative Assets due to the sophistication of the underlying exposures which for hedge funds, may involve complex derivatives such as options, futures, swaps and currency exposure derived from listed exchanges or direct from financial counterparties (banks) via over the counter contracts.

The exposure to Alternative Assets is generally limited to the maximum Tactical Asset Allocation (TAA) allowed from the Strategic Asset Allocation (SAA) and constrained by the Growth/Defensive split for each risk profile.

For example, a 70% Growth / 30% Defensive portfolio, with a maximum TAA tilt for each asset class of 10%, the maximum amount of Alternative Asset exposure would be 10% if the SAA did not have a specific weight allocated to Alternatives.

This also means that the maximum tilt between Growth Assets and Defensive Assets is also 10%. So in the event an external shock such as the GFC was experienced again, the maximum asset class risk exposure to Growth assets an adviser could take off the table would be 10%. The portfolio could be adjusted to sell down share exposure and buy Alternative Growth exposure to the maximum of 10% as well as sell down shares and re-invest in bonds to the maximum extent of 10%. This would mean that potentially a 20% underweight to shares would be possible if taken from 10% global shares and 10% domestic shares and buying 10% Alternative Growth assets and re-weighting the maximum 10% into Defensive assets.

For Example:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| 70/30 Portfolio | TAA | SAA | TAA | TAA |
| MODEL PORTFOLIO | **MIN %** | **SAA** | **MAX %** | **TILT** |
| GROWTH | **10%** |  | **10%** |  |
| Australian Shares | 20% | 30% | 40% | **20%** |
| Global Shares | 20% | 30% | 40% | **20%** |
| Australian Direct Property | 0% | 5% | 10% | 5% |
| Global Property | 0% | 5% | 10% | 5% |
| Growth Alternatives | 0% | 0% | 10% | **10%** |
| SUB-TOTAL GROWTH | **60%** | **70%** | **80%** | **60%** |
| DEFENSIVE |  |  |  |  |
| Australian Fixed Interest | 5% | **15%** | 25% | **15%** |
| Global Fixed Interest | 0% | **10%** | 20% | **10%** |
| Australian Cash | 0% | **5%** | 15% | **5%** |
| Defensive Alternatives | 0% | **0%** | 10% | **10%** |
| SUB-TOTAL DEFENSIVE | **20%** | **30%** | **40%** | **40%** |
|  |  |  |  |  |
| GROWTH | **60%** | **70%** | **80%** | **60%** |
| DEFENSIVE | **20%** | **30%** | **40%** | **40%** |
| TOTAL PORTFOLIO |  | **100%** |  | **0%** |

In this example, I have simply added to the Defensive Alternatives rather than add to the other asset class exposures given the low interest rate environment and the Federal Reserve in the US having a tightening bias to monetary policy at present.

Note: Hedge Funds come in many sizes and structures. Some are offered as diversified multi-manager exposures like fund of hedge funds where there are other funds that offer specific areas such as Managed Futures where there is both daily liquidity in the underlying exchange traded futures contracts and ample diversity from the range of traditional and non-traditional assets covered.

Each sector of a portfolio can be constructed to provide a more diversified approach to investment markets without necessarily adding to the risk bucket. I will look at risk budgeting in my next blog.

Author: **Graham Fox, Principal Consultant, FOX Asset Management**. Published 7th April 2016

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