RBC Global Asset Management

There is an alternative to high volatility

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Head of Client Solutions, David Horsburgh, explores the role that alternatives can play in managing portfolio volatility. He delves into the characteristics across credit and fixed income alternative assets and how they differ from traditional investments in delivering alpha to investors.

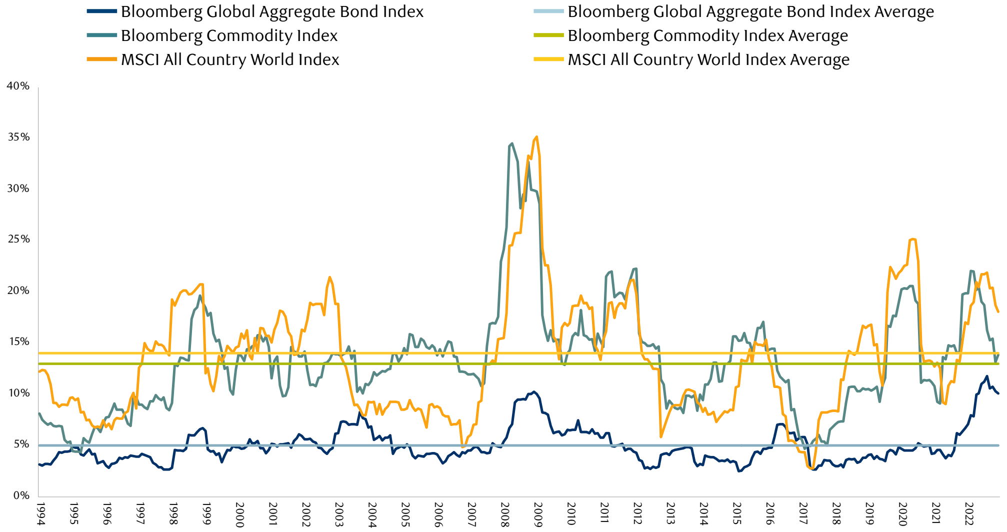
Across asset classes, volatility and high cross-asset correlations have been making portfolio diversification more challenging. Specific macro factors such as high inflation, rising interest rates, and geopolitical tensions have created a headwind for allocators looking to maximise their risk adjusted returns.

The basis of modern portfolio theory is that by combining assets (diversifying) you can reduce the volatility "cost" (see explainer on following page) on returns, allowing portfolios a higher chance of consistent outsized gains. Historically investors have done this by combining equities and bonds, though increasingly non-traditional and alternative strategies are playing a role in allocations.

A regime shift

Volatility has been on the rise as we shift away from a zero-interest rate policy and high levels of quantitative easing. This, combined with higher correlations has meant a significant shift up in portfolio volatility. We can see from the chart below how this has changed, with fixed income nearly doubling since the begining of the US Federal Reserve's rate hiking cycle in March 2022 (Chart 1).

Chart 1: Annualised monthly three-year rolling volatility



Source: Bloomberg, 31 July 2023.

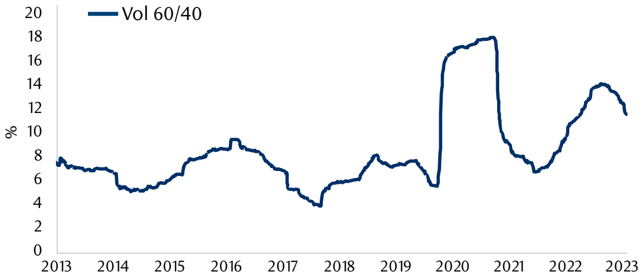
The previous decade was a regime where risk assets were supported by an underlying view that assumed central banks would support the economy if stress appeared. This reduced downside volatility expectations, and buoyed assets to a point where the expression 'TINA' or 'There Is No Alternative' became common place when talking about equities, as bond yields were pushed to unattractively low levels. There was seemingly endless support for markets in the form of fiscal support such as tax cuts and spending, and monetary support in the form of zero or negative policy rates. An expanded balance sheet also ensured plenty of liquidity in the system. In this environment, long only positioning, and the use of borrowing to increase risk exposures, was rewarded handsomely. While strategies working to maximise the Sharpe ratio, which represents the amount of return for the amount of volatility of the asset (the higher the number the more efficient the return), looked paltry by comparison. In 2022, that support began to be quickly withdrawn. The recent macro volatility has been a direct consequence of this, changing the cost of capital, while also removing leverage from the system. There is every expectation now that without the same support to risk assets we could see volatility for portfolios endure as a feature of markets going forward, characterised by more regular swings and persistent drawdowns (chart 2).

The rise in volatility

While volatility in portfolios can be a challenge to meeting long term investment objectives, volatility within asset classes can be a positive force for active strategies looking to maximise returns.

In fixed income, both the return expectations as well as the volatility, have increased during the rate hiking cycle. This has provided active fixed income a greater role in driving returns, and for alternative fixed income and credit strategies, an increased opportunity set to deploy risk. These alternative strategies cannot replace traditional fixed income approaches completely due to a number of factors such as liquidity, asset class specific risk, and reliance on manager skill, but can be complementary if used appropriately. Their lower correlation, or uncorrelated nature, and ability to protect to the downside of a portfolio by reducing drawdowns, especially during market corrections, can make them a useful tool. Clients still need to be selective, picking the right fixed income and credit alternative for the right role is key to creating positive portfolio outcomes.

Chart 2: Volatility of a 60/40 portfolio

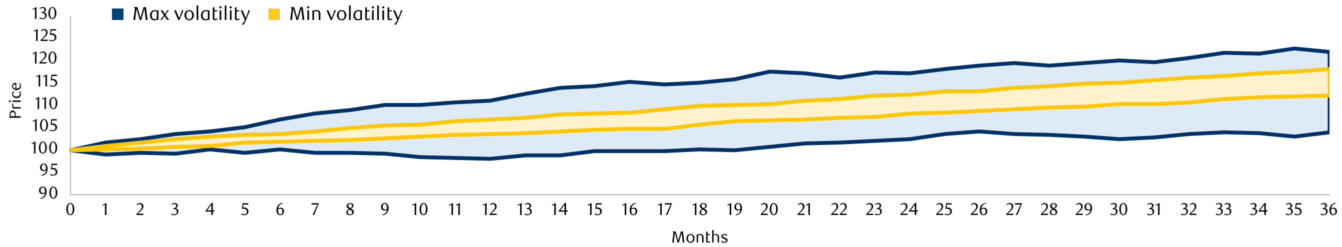


Source: Bloomberg, 60/40 = MSCI All Country World Index, Bloomberg Global Aggregate Index; Daily one-year rolling volatility; as at 30 June 2023.

The hidden cost of volatility

Volatility is a necessary tool for investors to access returns, however there is no such thing as a free lunch, and volatility exacts a cost. Looking at three-year returns for a set of simulated portfolios, despite all having the same return target of 5%, set to either a 10% volatility or 3% volatility parameters, you can see that unsurprisingly higher volatility leads to a wider spread of outcomes. In the following example, in chart 3 below, you can see that some of these are in the form of higher returns, while other are markedly lower. What is not as visible here is the impact of drawdowns on a portfolio, which higher volatility portfolios experience more frequently and more deeply. These create a hurdle against your return targets as they reduce the size of your pool available to compound. A classic example of this is that for a 50% loss, you would need a 100% return to get back to flat. With the higher volatility portfolio, by materially increasing the swings in performance, you increase the odds of negative outcomes.

Chart 3: Breadth of expected returns of 5% portfolio over three years



Source: BlueBay; simulated outcomes from a 5% return target portfolio with either 10% volatility (blue), or 3% volatility (orange).
For this simulation we apply a 5% return, adjusted for the portfolio volatility along a randomly adjusted normal distribution.

Allocating to alternatives

The range and breadth of different credit and fixed income alternative or hedge fund strategies is vast. We often think of alternatives as an asset class; however, it can be an unhelpful generalisation as they encompass so many wide-ranging assets. When considering alternatives, it can be useful to think of two things:

- the objective in terms of the volatility and return target,
- and the underlying opportunity set, either the types of investments or how they typically behave.

Depending on the style or goal of a strategy, it typically leans more towards:

- **Specialist approach:** offering idiosyncratic risk on a subset of investible markets, usually with a bottom-up focus. Goal is to produce high returns that may occasionally correlate with major asset classes. These strategies may have windows of strong performance where they deploy leverage. Hedging is carried out in specific instances, usually against a direct risk exposure.

- **Absolute return:** looking to generate consistent low correlation return in an 'absolute return' fashion which uses a global macro and top-down thematic approach, or pairs trade to limit exposure. Directionality is reduced in favour of a more neutral approach, high returns are sought, but volatility is consistently managed.

	Portfolio Objective		
Credit and Fixed Income Alternatives	**Diversify Exposure**	**Minimise Volatility**	**Extend Returns**
Specialist Approach			
Illiquid Credit			✓
Asset Backed Securities	✓		✓
Opportunistic Credit	✓		✓
Absolute Return			
Unconstrained	✓	✓	
Global Macro	✓		✓
Diversified Multi Strategy	✓	✓	
Long/Short Credit	✓	✓	✓

Introducing fixed income alternatives can change the shape of an efficient frontier, however there is no one size fits all with alternatives, so understanding the nature and focus of the strategy is key to understanding its impact. Depending on the strategy, they can **Extend Returns, Minimise Volatility, or Diversify Exposures** by reducing correlations. All of which can be used to improve the overall risk return profile.

Outside of the specific opportunity or style there are a number of additional levers an alternatives manager can use to generate alpha:

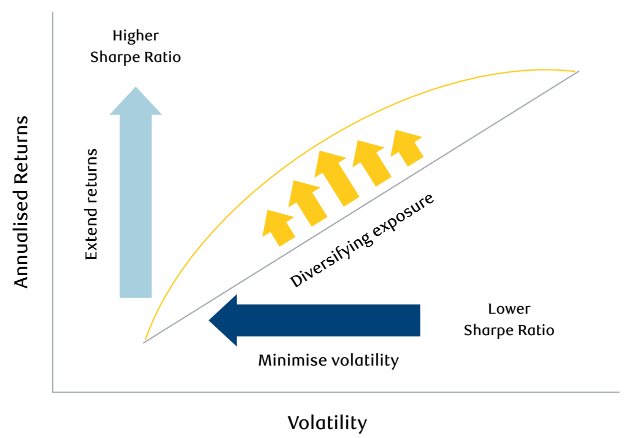
- **Shorting**: Owning shorts, or having a negative directional exposure through derivatives, allows investors to benefit from assets declining in value. This is a core tool, as it allows investors to exploit downside volatility at either an instrument or asset class level.
- **Idiosyncratic vs thematic:** Idiosyncratic can be thought of as another name for 'bottom-up' with the converse being top-down or 'thematic'. Top-down and bottom-up approaches are methods used to analyse and select investments. Top-down investing strategies usually focusing on opportunities that follow market cycles. Whereas bottom-up approaches start with local or company-specific variables and then expand outward.
- **Trading and turnover:** Execution alpha, especially in fixed income, can be especially important. The spread, a difference in price between people buying and selling, can be significant, and entering positions at the right price is a necessity. Alternative strategies can have high turnover, with average holding periods in days and hours rather than weeks or month. Executing well can reduce the performance drag on a fund.
- **Vehicle and asset liquidity:** Traditional mutual funds and ETFs can be limited in their exposure to illiquid assets, this is because the structures allow daily or instantaneous redemptions. By contrast alternatives can align their vehicle structure with the underlying assets. This ranges from daily for those using derivatives and other liquid instruments, to multiyear lock up, for work-out or hold to maturity loans. As assets decline in liquidity (an increase in time it takes to convert an asset to cash), investors can earn an illiquidity premium, by picking preferable moments to transact, which is especially relevant for assets that are traded infrequently.
- **Diversification and opportunity set:** While some strategies can be narrowly focused in small asset classes or instruments, others can be very broad in their approach allowing for an unconstrained shift to more favourable markets as the environment changes.
- **Hedging or risk pairing:** Alternative funds can remove outright risks by combining exposures to isolate risks or limit downside. Sometimes this can take the shape of market hedging, while other times it might be as granular as hedging out a part of a single exposure such as currency or interest rate risk. The goal here is to create a purer representation of the investment thesis.

Risk sizing and asset allocation

While portfolio efficiency remains an enduring problem, heightened macro volatility is creating a bigger challenge today. This uncertainty can be a challenge, but this does not have to be the only way. By taking advantage of the tools at their disposal, alternatives managers can help harness the volatility into portfolio returns and become a useful tool within a diversified portfolio.

Unfortunately, when choosing the right strategy, there is not one size that fits all. So it is important to start by knowing what you are trying to solve for, and then look for solutions that meet your objective. Understanding how they can fit in your portfolio, and how they work with your existing investments, is key to making sure they contribute positively to a diversified approach.

Chart 4: How strategies can effect the efficient frontier



Source: RBC BlueBay.

Portfolio Manager Perspectives
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