What Next for Alternatives?

Partner Content (Wellington) – The first-quarter market drawdown was severe and fast moving, driven by an unprecedented global economic shutdown. Notwithstanding the recent market recovery, asset allocators are preparing for a challenging environment with higher levels of volatility and uncertainty. Bouts of market stress are possible as investors weigh news on the virus, the policy response and expectations about the severity of a recession. Against this backdrop, I've been engaged in conversations with allocators about the impact on the alternatives space and on potential opportunities. A few thoughts on each of these topics:

How have alternatives been affected?

Based on discussions with dealers and others, my takeaways on industry performance during the first quarter include:

- **Performance dispersion was high across strategy types and individual managers —**Tail-risk strategies and certain global macro strategies with long duration/long volatility positioning generated the most significant positive returns. Fixed income relative-value strategies, structured credit products and emerging market strategies were most challenged, given dislocations and extreme volatility in rate and credit markets. Quant continued to be challenged by the underperformance of value and low-volatility investing. Lastly, long/short equity strategies, broadly speaking, performed in line with beta exposure, with modest alpha (crowded long positioning was the main pain point on risk-off days).
- **The anticipated COVID-19 shock to global payments and the seizing up of funding markets affected highly leveraged strategies most —**Fixed income relative-value and quant equity strategies felt the greatest impact, followed by risk arbitrage and less-leveraged long/short equity strategies. As the US Federal Reserve's funding programs take hold, I believe the same order of re-leveraging would likely be an indication that liquidity is on the mend.
- **Alts investors saw more of the desired outcomes —**The industry's performance experience was mixed. But, relative to the generally negative sentiment of the past few years, investors appeared pleased with the risk mitigation provided by their alternatives allocations.

Where are the potential alts opportunities going forward?

I think market dislocations may drive opportunities in a number of areas:

- **Credit relative value** could be compelling given that it has been an epicentre of the crisis. Investors might consider tactically allocating to areas where relative-value relationships are still distorted and where the liquidity profile has inflected positively, recognising that these opportunities can be relatively short-lived (there may be similar opportunities in areas besides credit, such as merger arbitrage).
- **Fundamental long/short stock-picking strategies**(not tactical beta) may be positioned to outperform as issuer-level differentiation has been overwhelmed by macro moves.
- Despite more synchronised monetary policy globally, I think **global macro strategies** may find high relative-value volatility to trade (particularly in currency) in an environment of increasing deglobalisation and idiosyncratic and active fiscal policy.
- I see the potential for **value stocks**, which have continued to underperform growth stocks, to re-emerge. Value has been beaten down broadly and, as a result, the potential for mean reversion could offer opportunities for price appreciation on an absolute and relative basis.

- More broadly, I would expect **liquidity-driven price dislocations** to revert to more fundamental fair values.
- Assuming we are near or past peak illiquidity, I would expect reversals/reversion to start working and **momentum** to be more challenged. But, if the crisis deepens and liquidity gets worse, I would expect momentum to continue to do well and reversals to do poorly (CTA/trend).

In considering these and other opportunities, it's important to acknowledge that the catalyst for this drawdown is very different from other recent drawdowns (pandemic/science driven versus volatility driven, rate-policy driven, or trade-policy driven) and, therefore, the profile of recovery is also likely to be different.

To learn more about our long track record in alternatives investing visit https://www.wellingtonfunds.com/alternative-investments/or please get in touch:

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