Uncorrelated Strategies

DIVERSIFYING TRADITIONAL INVESTMENT PORTFOLIOS WITH ACTIVE GLOBAL UNCORRELATED STRATEGIES

ASSET CLASS EXPLAINER

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WHY INVEST IN UNCORRELATED STRATEGIES?

- For decades, investors have used a traditional balanced approach to asset allocation, diversifying across fixed income and equities. Investors have typically relied on fixed income to preserve capital and generate income, whilst looking to equities for capital appreciation. Although this simplified approach has served investors well in the past, from time to time, it has resulted in considerable losses on both sides of the portfolio. This provides a compelling case for investors to explore additional ways of seeking robust portfolio diversification and absolute returns.
- Uncorrelated strategies are alternative investment strategies that aim to deliver positive absolute returns, regardless of the direction of markets. These strategies seek to steadily grow capital by capturing non-traditional risk premia and skill (i.e., alpha) while offering robust portfolio diversification and a degree of capital protection in volatile markets. In contrast, traditional directional strategies aim to deliver positive returns by being exposed to directional moves of equity or fixed income markets (i.e. beta).
- Uncorrelated strategies may play a role as a strategic, long-term “all weather” allocation, potentially offering diversification to both fixed income and equities, while delivering consistent risk-adjusted returns and portfolio protection.

WHAT ARE UNCORRELATED STRATEGIES?

- Compared to traditional investments, uncorrelated strategies have a higher degree of flexibility; they may employ leverage, use derivatives, take short positions, and invest across a broad array of asset classes.
- The following alternative investment strategies tend to be considered “uncorrelated”:
    - Event-driven strategies aim to capture pricing inefficiencies between securities with respect to corporate events (i.e., mergers, acquisitions, restructurings, and liquidations).
    - Relative value arbitrage strategies aim to exploit relative price discrepancies between related securities in a situation where the manager expects prices to diverge or converge.
    - Equity market neutral strategies aim to profit from long and short equity positions while striving to neutralize directional equity market risk exposure (e.g., size, countries, sectors).

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- Global macro strategies and trend-following strategies aim to benefit from investment opportunities arising from changes in macroeconomic variables, government policies, and central bank actions. Although these strategies aim to provide uncorrelated returns over a full market cycle, they can take significant directional long and short positions in any asset class (e.g., fixed income, equities, currencies, and commodities) in the near term.
- Insurance-linked strategies ("ILS") aim to capture natural event risk premia contingent on the possible occurrence of insured catastrophic events (e.g., hurricanes and earthquakes).

WHY ADD UNCORRELATED STRATEGIES TO A TRADITIONAL BALANCED PORTFOLIO?

Firstly, in the context of traditional balanced portfolios, uncorrelated strategies have exhibited return-enhancing and risk-diversifying benefits (see Table 1). Investors may choose to fund their allocation to uncorrelated strategies from their fixed income allocation and / or equities allocation depending on investment objectives, risk appetite, and other considerations.

Based on the sample period below, long-term returns of uncorrelated strategies (annualized, net in USD) have exceeded those of global treasuries, albeit with lower volatility. Thus, when funded out of global treasuries, uncorrelated strategies may enhance returns and dampen volatility. Long-term returns of uncorrelated strategies have been similar to those of global equities, albeit with much lower volatility. Thus, when funded out of global equities, uncorrelated strategies may dampen portfolio volatility. It is worth keeping in mind though that uncorrelated strategies cannot stand up to equity market rallies.

TABLE 1: LONG-TERM PERFORMANCE (JAN 2006 – SEP 2022)

	Event-Driven	Relative Value	Equity Market Neutral	Global Macro	ILS	Global Treasuries	Global Equities
Return	4.5%	4.9%	2.4%	3.7%	3.5%	1.3%	4.5%
Volatility	7.2%	5.1%	2.7%	4.8%	3.5%	6.6%	16.3%

Past performance is not an indicator of future results.
Historical figures have been annualized. Source: Bloomberg. Data from January 2006, which represents the inception of the ILS index, to September 2022. Notes: Based on monthly returns (N > 200). Event-Driven = HFRI Event-Driven Total Index, Relative Value = HFRI Relative Value Total Index, Equity Market Neutral = HFRI EH Equity Market Neutral Index, Global Macro = HFRI Macro Total Index, ILS = Eurekahedge ILS Advisers index, Global Treasuries = Bloomberg Global Agg Treasuries TR Index, and Global Equities = MSCI World Daily Net TR Index. HFRI and Eurekahedge indices are equally-weighted and report fund returns in USD, net of all fees.

Secondly, pairwise correlations between uncorrelated strategies have been relatively moderate over the same sample period, providing inter-strategy diversification (see Table 2). In the context of traditional asset classes, long-term correlations to global equities have been low for global macro strategies — and ILS in particular — and relatively high for event-driven strategies and relative value arbitrage strategies. On the other hand, long-term correlations to global treasuries have been relatively low across the board.

[1] One method of quantifying a strategy's diversifying potential is by looking at its correlation relative to other strategies (i.e., pairwise correlation). Although it is not without limitations, a strategy's correlation is a common measure of market neutrality and can serve as a useful starting point. More specifically, correlation quantifies the degree and strength of association between two variables, ranging between -1.00 and +1.00. A correlation of -1.00 indicates that two variables move in the exact opposite direction and in the same proportion, while a correlation of +1.00 indicates that two variables move in the exact same direction and in the same proportion. In practice, the lower the correlation to existing strategies the greater the risk reduction (i.e., diversification) benefits. However, it is important to remember that correlations may fluctuate significantly through time. Moreover, they are backward-looking and may not be representative of future expectations.

TABLE 2: LONG-TERM CORRELATIONS (JAN 2006 – SEP 2022)

	1	2	3	4	5	6	7
1 Event-Driven							
2 Relative Value	+0.93						
3 Equity Market Neutral	+0.63	+0.57					
4 Global Macro	+0.29	+0.25	+0.48				
5 ILS	+0.20	+0.22	+0.12	+0.10			
6 Global Treasuries	+0.12	+0.11	+0.00	+0.19	+0.18		
7 Global Equities	+0.84	+0.76	+0.56	+0.28	+0.17	+0.30	

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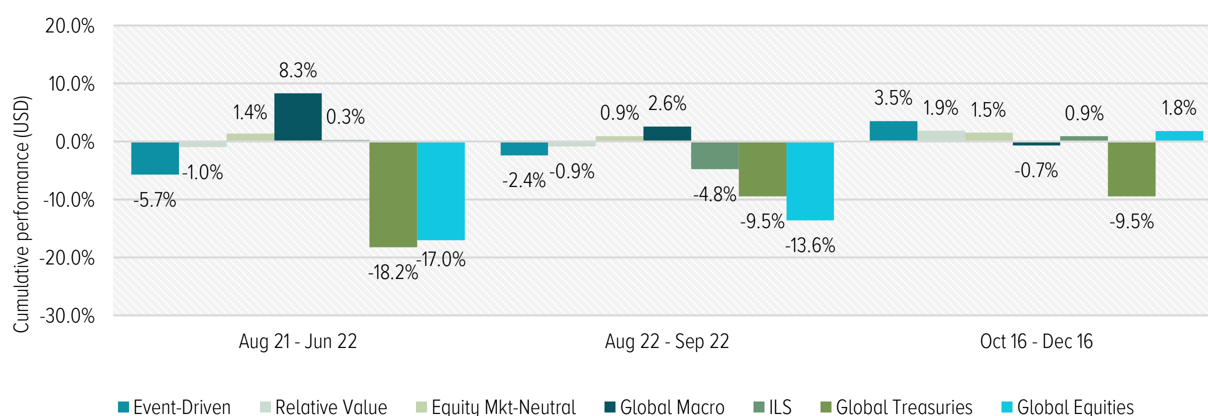
With regard to inflation, periods of elevated and unexpected inflation tend to coincide with higher levels of market volatility. This often leads to increases in cross-asset correlations, something that we saw during the particularly volatile markets in the summer of 2022. In such market environments, fixed income and equity returns may go down simultaneously, testing the efficacy of a traditional balanced portfolio's diversifying qualities. With their flexible absolute-return mandates, alternative investment strategies are generally designed to be inflation agnostic. For example, global macro and trend-following strategies may invest in commodity futures, which have historically exhibited a high and positive inflation beta.

Thirdly, uncorrelated strategies have performed relatively well during some of the worst cumulative loss periods for global equities and global treasuries, thus proving their risk-diversifying benefits during these historical periods of market stress (see Figure 1 and Figure 2).

FIGURE 1: UNCORRELATED STRATEGIES' PERFORMANCE DURING WORST CUMULATIVE LOSS PERIODS IN GLOBAL TREASURIES



Past performance is not an indicator of future results.
Historical figures relating to a period shorter than one year are not annualized. Source: Bloomberg.

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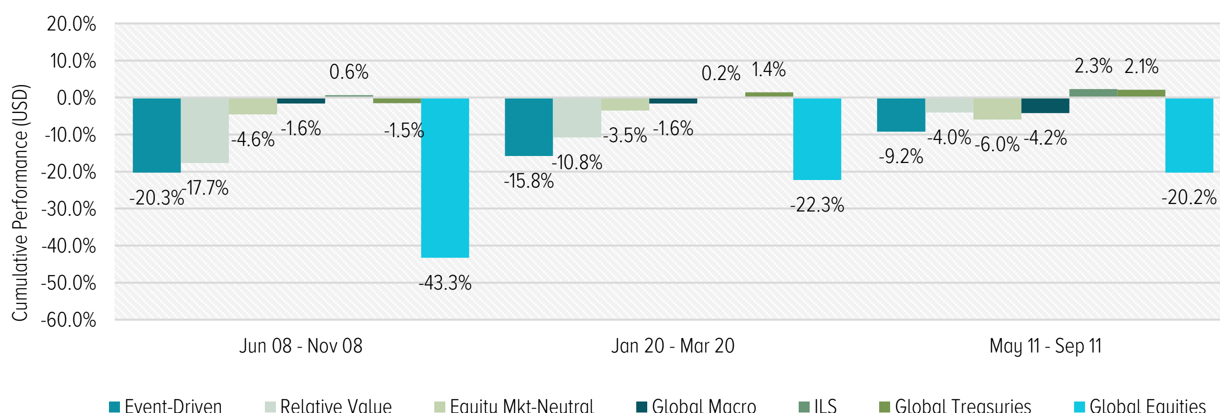
FIGURE 2: UNCORRELATED STRATEGIES' PERFORMANCE DURING WORST CUMULATIVE LOSS PERIODS IN GLOBAL EQUITIES



Past performance is not an indicator of future results.
Historical figures relating to a period shorter than one year are not annualized. Source: Bloomberg.

Finally, most uncorrelated strategies had their worst cumulative loss during the 2008 Global Financial Crisis (see Table 3). While that was in the same period that global equities had its worst cumulative loss, uncorrelated strategies experienced a lower drawdown. ILS's worst cumulative loss occurred during a different period: the 2017 U.S. hurricane season, a time when the country was hit by several strong hurricanes (e.g., Harvey, Irma, and Maria), highlighting its uncorrelated nature.

TABLE 3: WORST LOSSES IN UNCORRELATED STRATEGIES (JAN 2006 – SEP 2022)

	Event-Driven	Relative Value	Equity Market Neutral	Global Macro	ILS	Global Treasuries	Global Equities
Cumulative Loss	-21.5%	-17.9%	-8.3%	-5.0%	-9.3%	-18.2%	-43.3%
Period: Start	*Jun '08*	*Jun '08*	*Jul '08*	*Jul '08*	*Aug '17*	*Aug '21*	*Jun '08*
Period: End	*Dec '08*	*Dec '08*	*Dec '08*	*Sep '08*	*Sep '17*	*Jun '22*	*Nov '08*
Monthly Loss	-13.2%	-10.3%	-2.9%	-3.8%	-9.0%	-6.0%	-21.0%
Calendar Month	*Mar '20*	*Mar '20*	*Sep '08*	*Feb '18*	*Sep '17*	*Apr '22*	*Oct '08*

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This evidence suggests that uncorrelated strategies may play a role as a strategic, long-term "all weather" allocation, potentially offering diversification to both fixed income and equities and producing consistent, reliable risk-adjusted returns across market conditions.

HOW TO ACCESS UNCORRELATED STRATEGIES?

Investors commonly access uncorrelated strategies through single- or multi-manager fund solutions; multi-manager structures can appear attractive but also present challenges that investors should be aware of.

BENEFITS OF A MULTI-MANAGER APPROACH INCLUDE:

- Access: Compared to single-manager solutions, multi-manager solutions typically offer convenient, efficient, and immediate exposure to a diversified set of uncorrelated strategies. Multi-manager solutions also tend to have a lower minimum investment requirement, and they may provide investors access to highly sought-after managers that are often closed to new investors.
- Diversification: Performance tends to vary substantially across and within uncorrelated strategies. Opportunities are not always found in the same place, and certain uncorrelated strategies may go through periods of being in and out of favor as market environments evolve. Diversifying through a multi-manager approach avoids strategy concentration which can be a source of risk, but may also benefit from the multi-manager's active top-down allocation decisions.
- Manager Selection: Performance dispersion between managers *within* a particular uncorrelated strategy tends to be high, highlighting the need for extensive manager selection to find the best managers within each strategy. Manager selection requires skill and expertise, and finding the right manager takes time and resources. Experienced multi-manager teams with in-depth sourcing, due diligence, portfolio construction, risk management, and monitoring processes take care of the operational and investment details, adding peace of mind for clients.
- Active Portfolio & Risk Management: A multi-manager fund needs to be actively managed by an expert investment team to provide a simple solution for clients, designed to perform in a range of market conditions. The investment team may also optimize risk-return by actively adjusting their strategy allocations, manager selection and positions sizes to take advantage of changes in the opportunity set and avoid unrewarded risks. Investors may also benefit from "operational unburdening" (e.g., reporting and currency hedging at the portfolio level).

DISADVANTAGES OF A MULTI-MANAGER APPROACH INCLUDE:

- Additional Layer of Fees: In addition to the fees charged by individual managers, there is typically a fee at the multi-manager level. These fees vary and are designed to compensate multi-manager teams for activities related to the investment process. It is worth keeping in mind that multi-manager teams may negotiate with underlying managers to obtain fee discounts on behalf of clients. It is up to the investor to decide whether the advantages of a multi-manager solution outweigh the additional fee layer.
- Netting Risk: Performance-related fees may be payable to individual managers in the fund structure when the individual manager performs well; this applies even if the multi-manager fund's overall performance is negative.
- Lack of Control: By delegating the investment process to a multi-manager team, investors may perceive that they have less flexibility and control over how their capital is being managed. Clients can be one step removed from the managers of the underlying strategies as the relationship is intermediated by the multi-manager team.

Disclaimer

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Uncorrelated Strategies: General risks to take into account when investing in Uncorrelated Strategies

Please note that all investments are subject to market fluctuations. Investing in Uncorrelated Strategies may be subject to risks arising from the volatility of securities, financial futures, derivatives, currency and interest rate markets, the leverage factors associated with trading in such markets and instruments, and the potential exposure to loss resulting from counterparty defaults. Under unusual market conditions the specific risks can increase significantly. Potential investors should be aware that Uncorrelated Strategies often pursue a more aggressive investment policy than traditional investment funds and may have a reduced liquidity, indicating that they may not be sold or purchased as quickly at the preferred time as more liquid investments.

The value of your investment may fluctuate, past performance is no guarantee for the future. Do not take unnecessary risks. Before you invest, it is important that you are aware of and are informed about the characteristics and risks of investing. This information can be found in the available documents of the strategy and/or in the agreements that are part of the service you choose or have chosen.

Profile of the typical investor in Uncorrelated Strategies:

The strategy may be suitable as a core or supplemental investment for qualified and professional investors (depending on country specific regulations) that are:

- Interested in a convenient way of gaining exposure to (diversified) alternative strategies with a wide array of strategies ranging from Distressed Debt to Global Macro and Insurance Linked Investments;
- Seeking long-term growth of their investment (5 years or longer);
- Who can bear the possibility of reduced liquidity and significant losses, especially in the short term; and
- Who have experience with the risks and rewards of investing in various securities markets such as equities, bonds, property and commodities.

It is important that investors understand the asset class before investing, however, and that capital may be at risk.