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Managing uncertainty with liquid alternatives

The case for AIMS Target Return

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It takes Aviva Investors

Introduction

Peter Fitzgerald, Michael Grady and Jennie Byun make the case for including liquid alternatives within a broad multi-asset allocation in an environment where interest rates stay "higher for longer".

With developed market central banks adopting a "higher-for-longer" rates mantra and economic growth below trend amidst a petering late-cycle extension, traditional asset classes such as equities and bonds are likely to continue facing headwinds and elevated volatility. With bonds not providing as robust a portfolio hedge as they did historically, investors are on the hunt for additional sources of portfolio diversification and resilience.

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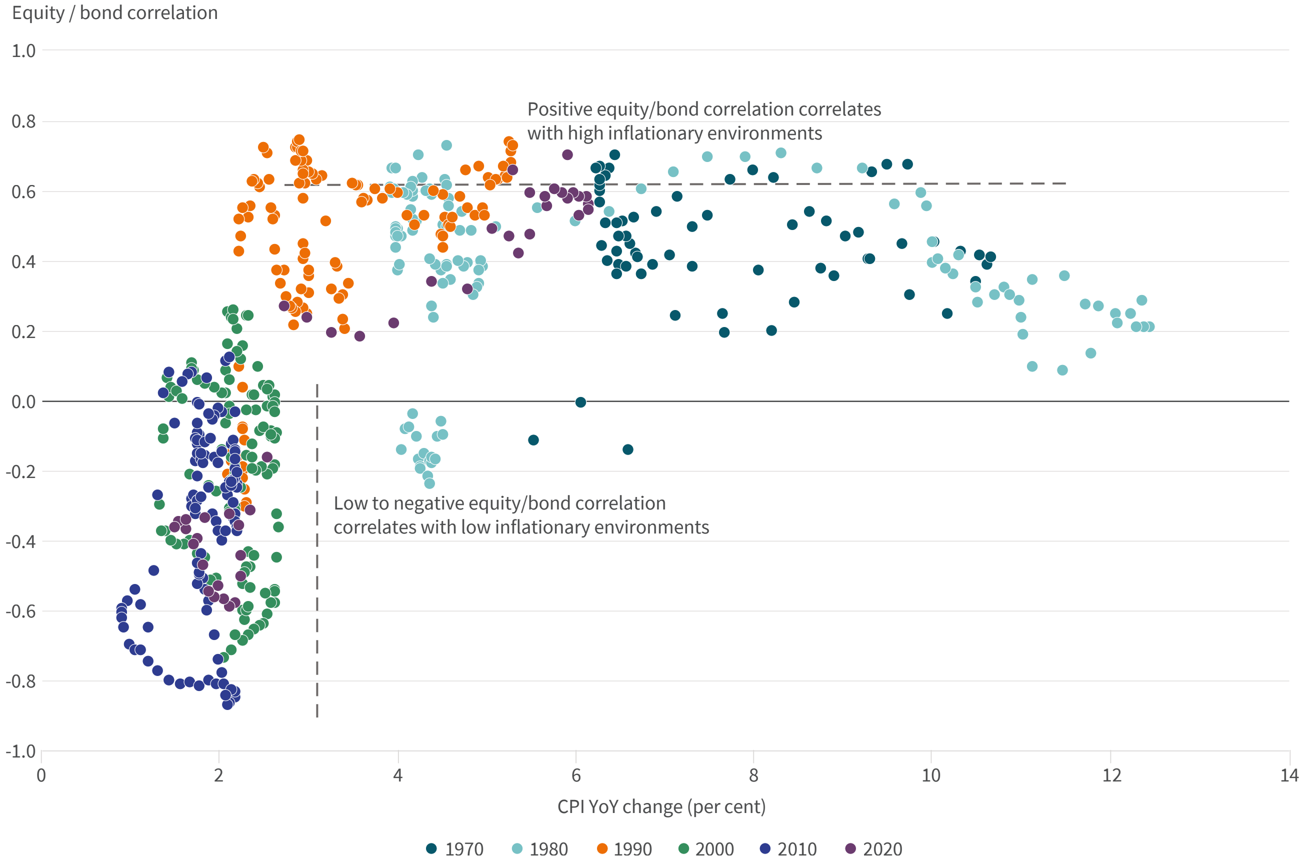
In this article, we make the case for including liquid alternatives such as the Aviva Investors' Multi-Strategy Target Return (AIMS TR) fund within a broad multi-asset allocation. As we navigate the new market regime of elevated inflation and higher-for-longer interest rates, considerations around access to genuine diversification, capital preservation and liquidity are becoming more prominent. They lie central to the investment philosophy of AIMS TR, which was able to generate strong positive returns in 2022 when equities and bonds posted double-digit declines.

The "new" old market regime – breakdown in equity/bond correlation in periods of high inflation

With investing come challenges and uncertainty. Investors are compensated with proportionate prospective returns for taking risk. The role of diversification is to mitigate, or at least smooth, those risks over time. And, for the larger part of two decades, the idea equities and bonds would provide sufficient diversification benefits, buoyed by central bank largesse, was intact.

This assumption was shattered in 2022. As we explored in our October 2022 paper Inflation and the correlation conundrum, the equity-bond relationship is not static but driven in large part by the inflation backdrop. In fact, its inverse relationship in the early part of this century is more of an anomaly when compared to the previous three decades.[1]

Figure 1. **Elevated inflation correlates with positive equity/bond correlation**



Note: Equity-bond correlation is calculated using monthly returns with equities represented by the S&P 500 Index (total return) and bonds represented by US Treasuries (Bloomberg Global Agg US Treasuries Index).
Source: Aviva Investors, Bloomberg. Data as of September 30, 2023.

Fixed income remains a source of portfolio protection against material negative growth shocks. However, if we remain in a period of elevated inflation, it will not provide the same level of diversification it has in the past. As such, investors need additional sources of diversification.

Liquid alternatives in a higher inflation/ interest rate environment

Alternative asset classes take many forms, including private equity, venture capital, hedge funds and real assets. Each of these asset classes can offer benefits to investors, such as an enhanced risk-return profile and/or diversification, but there may be a compromise in terms of liquidity.

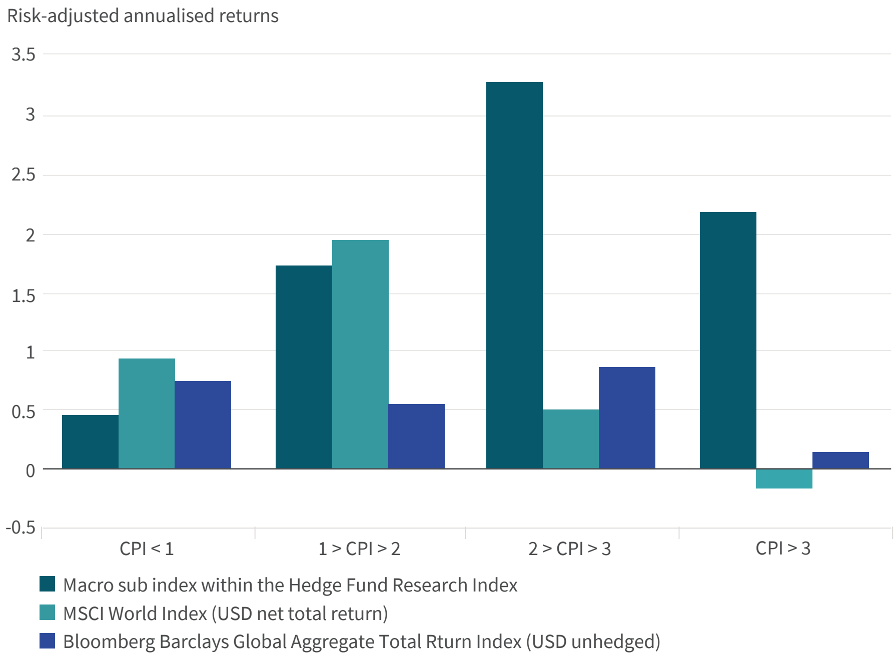
Hedge funds, particularly global macro funds, stand out for providing access to return drivers that are unrelated to traditional risk premia. While varied in style, macro funds such as AIMS TR are typically unconstrained, in contrast to traditional funds that are benchmarked. Their ability to go long and short, deploy market-neutral relative-value positions and utilise derivatives to improve the distribution of pay-offs can enable them to reduce their sensitivity to equity and bond markets versus private equity and real-asset counterparts.

Hedge funds stand out for providing access to return drivers that are unrelated to traditional risk premia

Historically, macro funds have performed well in higher inflationary environments. Their ability to access instruments that can more precisely express inflation and interest rate themes is one factor. Additionally, higher volatility is typically accompanied by higher dispersion in markets, making it a ripe feeding ground to generate alpha. AIMS TR demonstrated that in 2022.[2]

Given most periods of elevated inflation preceded the launch of AIMS TR, we use the HFRX macro index as a proxy of performance through various inflationary regimes. Figure 2 outlines the risk-adjusted performance of macro hedge funds versus the MSCI World equity index and Bloomberg Global Aggregate bond index across different inflationary periods.

Figure 2. **Performance of equities and bonds versus macro hedge funds across inflationary periods, 1990-2022**



Note: Inflation is defined as US CPI YoY figures. Performance is based on the annualised monthly returns divided by the 3-year rolling standard deviation for each inflationary period.

Source: Aviva Investors, Macrobond. Data as of October 31, 2023.

Another, often overlooked, tailwind for macro funds in a rising rate environment is the interest earned on unencumbered cash positions. For example, a fund like AIMS TR may hold between 50-75 per cent of its portfolio in cash instruments as collateral for derivative positions. That cash will be invested in short-term government bond or money market instruments that earn the prevailing cash rate, providing a natural boost to the portfolio.

The importance of being liquid

Liquidity is an increasingly important consideration within portfolio construction. This began with the 2008 global financial crisis (GFC), was accentuated by the COVID-induced market shock of 2020 and peaked more recently in the UK with the mini-budget crisis of September 2022. During these crises, having a pool of liquid assets, especially those that can minimise losses or even rise in value during periods of volatility, can mitigate the self-perpetuating cycle of crystallising losses and driving further sell-offs.

Liquid alternatives, as the name suggests, offer alternative sources of returns to traditional asset classes but in a liquid format; they are effectively a liquid hedge fund. Typically structured as UCITs regulated fund structures, they offer a higher degree of governance, with transparency around underlying holdings, safeguarding of funds and more favourable liquidity profile. Another key advantage is the fact liquid alternatives are usually priced much more competitively than traditional hedge funds and with lower minimum investments.

Liquid alternatives offer alternative sources of returns to traditional asset classes but in a liquid format

Figure 3. **Hedge funds versus liquid alternatives characteristics**

	Liquid alternatives	Hedge funds
Liquidity	Daily or weekly dealing	Quarterly dealing plus lock up and notice period
Minimum investment	$100,000	$1 million
Fees	Typically a flat fee between 0.75-1.5 per cent	1.5 per cent management fee and 15 per cent performance fee
Transparency	Holdings published monthly	No requirement
Regulatory oversight	Yes	No

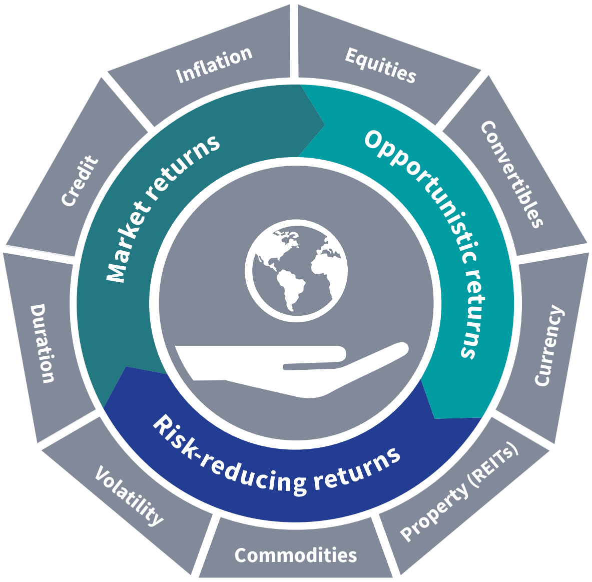
Source: Aviva Investors. Data as of October 31, 2023.

Improving portfolio resilience

To maximise the probability of achieving excess returns through good times and bad, the AIMS TR fund seeks to construct a well-diversified and risk-controlled mix of strategies that express our medium-term views. AIMS TR is a discretionary macro fund, deploying traditional macro-driven trade ideas alongside quantitative insights and systematic strategies to generate alpha.

Embedding diversification and resilience is a key area of focus in our investment process. The fund is composed of 20-30 diversified strategies; with its unconstrained approach, it can take both long and short views across multiple risk drivers, as outlined in Figure 4.

Figure 4. **AIMS TR portfolio overview**



Market returns

Utilising quant tools and convex implementation strategies to set **dynamic allocation to traditional risk premia**. Historical equity beta averages 0.2.

Opportunistic returns

Macro and idiosyncratic investment themes that typically exhibit lower market correlation e.g., volatility, relative value strategies, currencies.

Risk-reducing returns

Seeks to protect the portfolio in the event the world plays out differently to our **central scenario, through discretionary and systematic hedging strategies**.

Note: Historical equity beta averages calculated over rolling 26-week periods. Source: Aviva Investors. Data as of October 31, 2023.

In our October 2022 paper, we outlined a few case studies to illustrate how AIMS TR utilises its unconstrained mandate and extensive quantitative and systematic capabilities to access uncorrelated returns to traditional markets.[3]

Bringing it all together, we provide a few proof points on how AIMS TR has been able to demonstrate resilience in a challenging period for markets.

1. Resilient returns

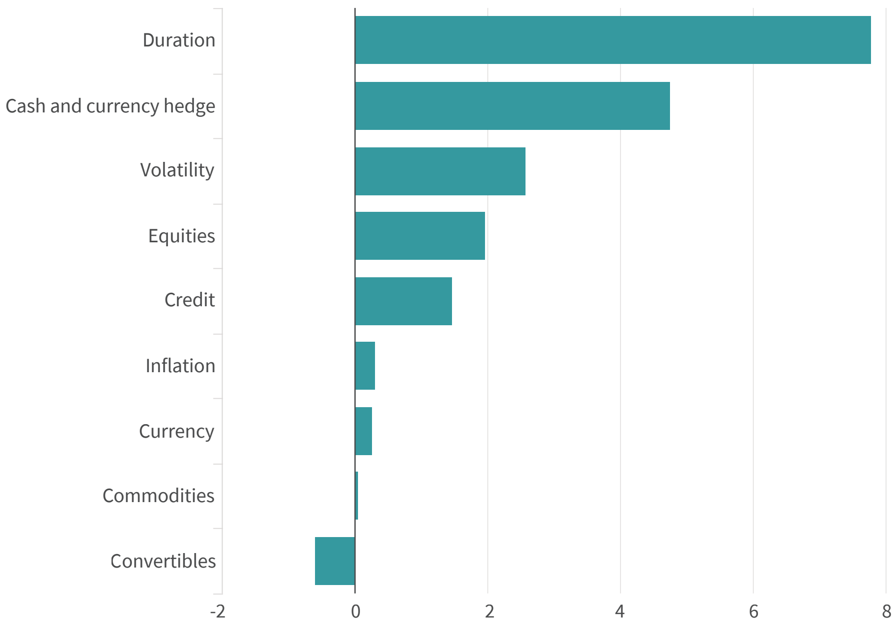
Figure 5 outlines the distribution of performance within AIMS TR by risk driver. In an environment of rising interest rates, AIMS has delivered positive returns across most of its risk drivers. A dominant theme in the portfolio over the last three years has been duration, which included long and short positions at different points of the interest rate curve across markets.

Volatility has been another theme the portfolio managers have successfully harnessed. Investing in volatility markets has been described as either "picking up pennies in front of a steam roller" on the short side or a waste of premium on the long side. However, with the right expertise and oversight, volatility markets can offer attractive risk-adjusted returns.

With the right expertise and oversight, volatility markets can offer attractive risk-adjusted returns

As highlighted earlier, the fund has generated a material positive return from the portfolio's cash and currency hedge positions.

Figure 5. **AIMS TR three-year performance attribution by risk driver (per cent)**



Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested.
Note: Performance contribution is shown cumulative gross of all fees. Inception date July 1, 2014.
Source: Aviva Investors. Data as of October 31, 2023.

2. Low sensitivity to equity markets

Despite taking market directional views, the overall portfolio exhibits relatively low beta to global equity markets (historically 0.2 to 0.25 per cent), as seen in Figure 6. Even during periods when the fund exhibited slightly higher beta, the actual sensitivity to equity markets was lower due to the convexity embedded in the portfolio through options.

Figure 6. **Rolling 26-week beta of AIMS TR (per cent)**

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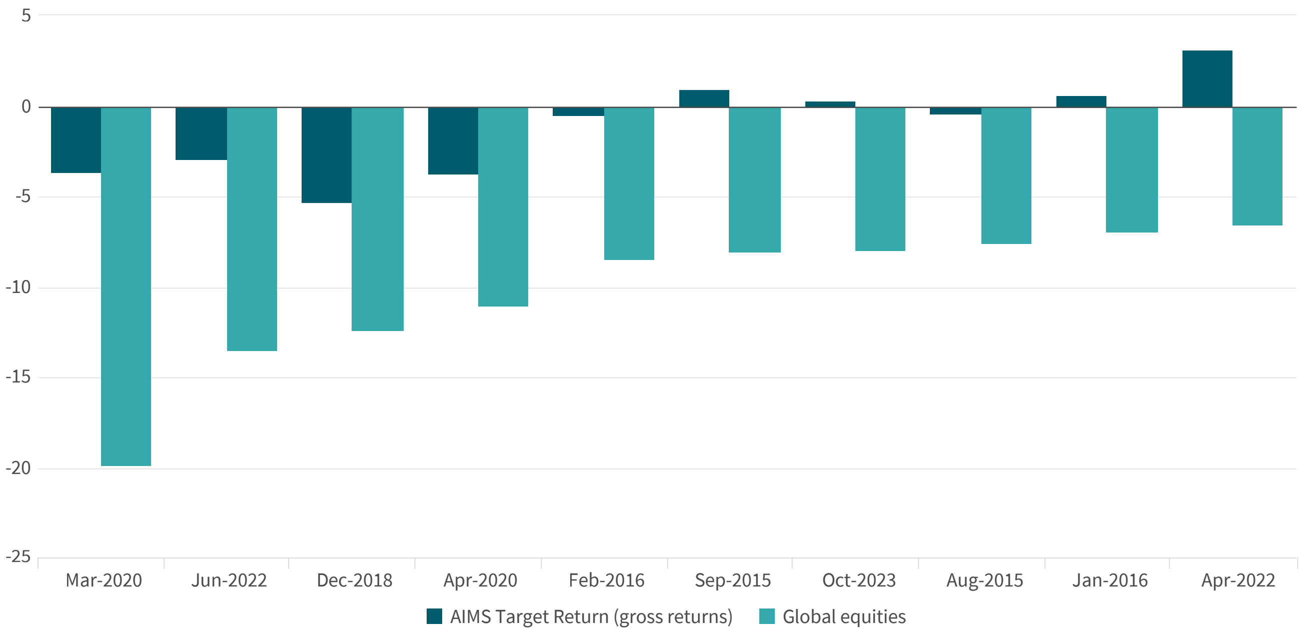
Note: Global equities represented by MSCI All-Country World Index, local currency.

Source: Aviva investors, Bloomberg. Data as of October 31, 2023.

3. Focus on capital preservation

Another measure of portfolio resilience is an ability to preserve capital through periods of market volatility. Figure 7 illustrates the performance of AIMS TR during the ten worst rolling three-month periods of equity declines since the fund's launch; AIMS fared relatively well during these periods, mitigating drawdowns and even generating positive returns during some periods.

Figure 7. **Performance of AIMS TR during ten worst rolling three-month equity declines (per cent)**



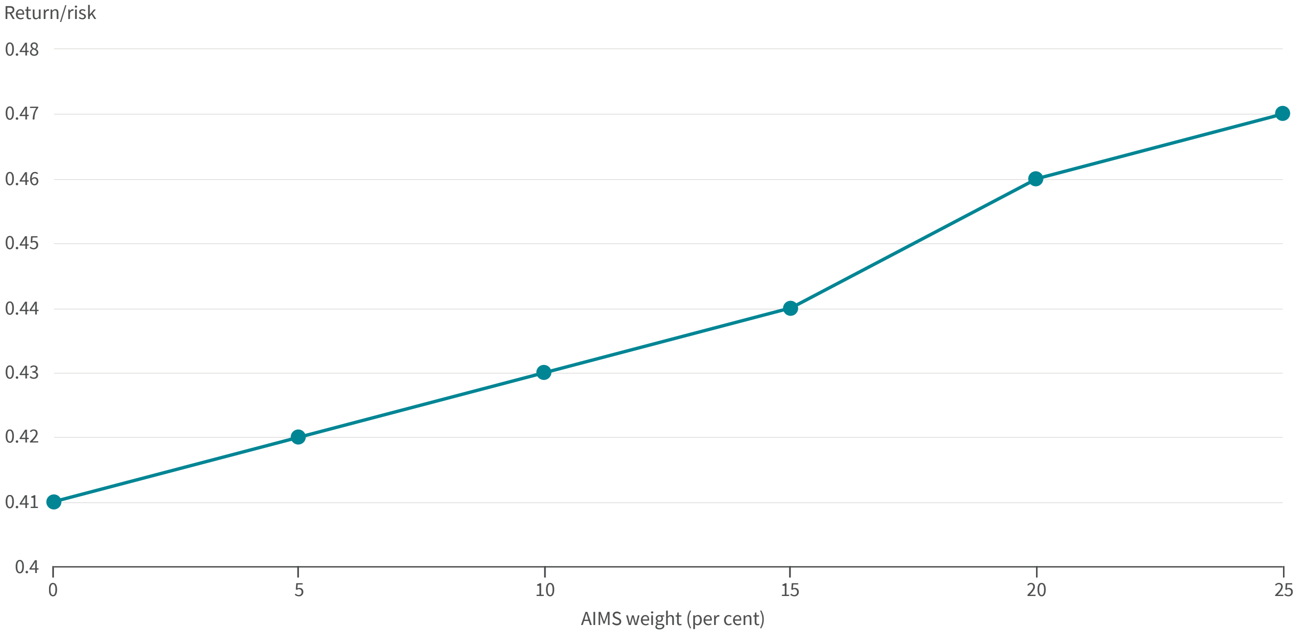
Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested.

Performance contribution is shown gross of all fees. Inception date July 1, 2014. Global equities represented by the MSCI All Country World Index (local currency). Ten worst rolling three-month equity declines since fund inception as measured by the preceding three-months to date shown on x-axis.

Source: Aviva Investors. Data as of October 31, 2023.

In our view, these characteristics mean the inclusion of AIMS TR in a multi-asset portfolio can improve risk-adjusted performance. Figure 8 illustrates the improvement in the Sharpe ratio as incremental amounts of AIMS TR are added to a 60/40 equity/bond portfolio over a three-year period. It shows that by allocating 20 per cent to AIMS TR, overall portfolio volatility is reduced by 1.5 percentage points for a similar return.

Figure 8. **The benefits of holding AIMS TR within a 60/40 equity/bond multi-asset portfolio**



	100 per cent (60/40 equity/bond portfolio)	80 per cent (60/40 equity/bond) + 20 per cent (AIMS TR portfolio)
Annualised return (per cent)	4.4	4.2
Annualised volatility (per cent)	10.7	9.2
Sharpe ration	0.41	0.46

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Note: Equities represented by MSCI World Index (USD unhedged). Bonds represented by Bloomberg Barclays Global Aggregate Total Return Index (USD unhedged). Annualised return and volatility calculated using daily returns over three years.

Source: Aviva investors, Bloomberg. Data as of October 31, 2023.

Key takeaways

- While inflation has fallen a long way from last year's peak, it remains a concern. In this higher-for-longer interest rate environment, we believe investors can expect continued market volatility and uncertainty. This underscores the importance of constructing portfolios that offer genuine diversification to withstand periods of volatility.
- The diversification implications cannot be overstated. Resilient portfolios now require an ability to source other return drivers and implementation techniques capable of performing during periods of rising rates and equity market volatility.
- In our view, AIMS TR, through its dynamic multi-strategy approach and targeted implementation methods, could benefit investors as a core component of a diversified alternatives allocation, seeking to provide resilience to an investor's overall portfolio in a liquid and cost-effective manner. Key takeaways

1. Jennie Byun, et al., "Inflation and the correlation conundrum: Why it's time to look at liquid alternatives in a new light", Aviva Investors, October 2022.
2. Please refer to https://www.avivainvestors.com/ for information on specific fund performance.
3. Jennie Byun, et al., "Inflation and the correlation conundrum: Why it's time to look at liquid alternatives in a new light", Aviva Investors, October 2022.

Key risks

Investment risk and currency risk

The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Investors may not get back the original amount invested.

Derivatives risk

Investments can be made in derivatives, which can be complex and highly volatile. Derivatives may not perform as expected, meaning significant losses may be incurred.

Illiquid securities risk

Some investments could be hard to value or to sell at a desired time, or at a price considered to be fair (especially in large quantities). As a result their prices can be volatile.

Sustainability risk

The level of sustainability risk may fluctuate depending on which investment opportunities the investment manager identifies. This means that the fund is exposed to sustainability risk which may impact the value of investments over the long term.

Important Information

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