Alternative to What?

Considering the Role of Alternative Investment Strategies in a Portfolio

By Janus' Portfolio Construction Services Team

The PCS team performs customized analyses on advisor portfolios, providing differentiated, data-driven diagnostics. From a diverse universe of hundreds of models emerge trends, themes and potential opportunities in portfolio construction that we believe will be interesting and beneficial to any investor.

Diversification? Growth? Protection or upside? Compelling benefits, in an assortment of categories

Liquid alternatives have seen steady adoption since the financial crisis. With a proliferation of funds across categories, these strategies have provided access to benefits that were previously available to only a small cadre of investors: diversified sources of returns, alternate tools for wealth protection, and new means for lowering overall volatility.

While such benefits are compelling, our conversations with advisors have unearthed yet another dimension of the alternatives equation: the broad variety of strategies now available can also create confusion and actually *muddle* an understanding of their role in investor portfolios. Furthermore, because these funds tend to be costlier than traditional asset classes, investors may be paying a high premium for unintended or redundant exposures.

41%
Of advisor models include alternatives

12%
The average allocation to liquid alternatives in advisor models that include alternatives

Source: Janus Portfolio Diagnostics

Alternative Impact: Proceed with attention

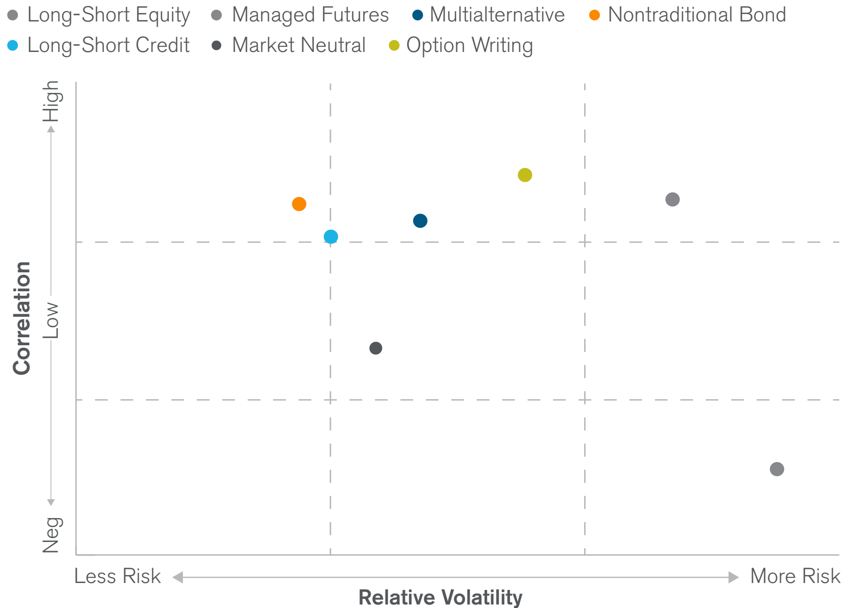
When our clients use alternatives, we continue to ask them: Are they included in the portfolio to diversify your equities, your fixed income or both? The truth is, all alternative strategies have some fundamental connection to traditional asset classes, and very few are likely to generate extreme returns or offer guaranteed wealth protection. Moreover, the flexibility that these investments enjoy may cause their exposures to change over time, requiring more extensive oversight and due diligence. **Conducting a realistic assessment and implementing a liquid alts strategy with clarity of objectives can make their benefits well worth the effort and cost.**

In evaluating traditional equity or fixed income options, we tend to focus on return potential and overall risk level. In the case of alternatives, it's important to think about the relative behavior of a strategy, i.e., how it interacts with other assets within a portfolio.

This is the basis for the newly introduced Morningstar Alternative Style Box, which reports the characteristics of liquid alt strategies relative to global equities. On one axis, the style box shows the correlation of a strategy's returns to the MSCI All Country World Index (MSCI ACWI) and on the other, relative volatility, using the ratio of the strategy's standard deviation of returns to that of the MSCI ACWI.

Alternative Categories Span a Wide Range of Characteristics

Category Average vs. MSCI ACWI (1/1/2014 – 12/31/2016)



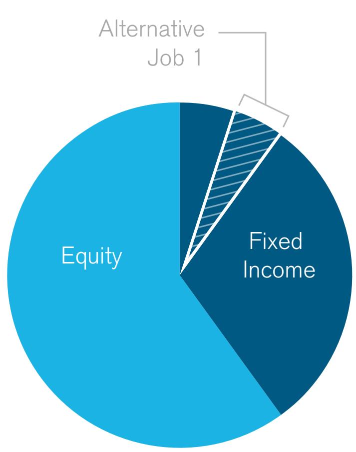
Source: Morningstar

A framework for implementing liquid alts

With this in mind, we thought it would be useful to lay out a framework for determining what specific job an alt should be playing in a portfolio. In suggesting such a framework, we examine key metrics that may be used for determining whether it can successfully perform this role, and from which part of the portfolio the position should be allocated.

Job 1: Diversify fixed income

Many alts are designed to be a source of wealth protection. As with bonds, these strategies aim for low correlation to equities, while maintaining low volatility and moderate returns. They typically seek to provide higher-risk adjusted returns and to protect portfolios from interest rate risk.



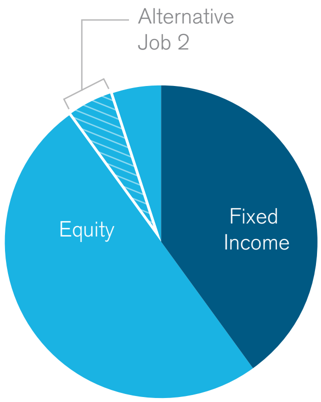
- **Typical Choices:** Long-Short Credit, Nontraditional Bond
- **Potential Effectiveness:** Buffering equity downturns, and for some categories, lowering interest rate exposure.
- **Key Metrics:** Low correlation to fixed income while maintaining low beta and downside capture vs. equities. Low overall volatility. Competitive risk-adjusted returns.
- **Implementation Considerations:** These strategies can be a compelling alternative to fixed income, but may not be as conservative as investment-grade bonds. Investors should also be mindful of how the fixed income diversifier interacts with their equity exposure, as some of these funds may increase equity beta. Consider the additional portfolio risks carefully.

10-Year Category Average Performance (%)

(as of 2/28/17)	Annualized Returns	Sharpe Ratio	Annualized Std Dev	Max Drawdown	Beta	Correlation
Long-Short Credit	3.55	0.64	4.59	-9.26	0.18	0.23
Nontraditional Bond	3.83	0.62	5.75	-17.24	0.36	0.39
Bloomberg Barclays Global Aggregate Bond Index	3.34	0.48	5.89	-10.08	–	–

Job 2: Diversify equity

Alts that have been higher in measures of upside and volatility should be considered in lieu of conventional equities. These strategies target absolute returns and growth that is less correlated to equity beta. Many deploy derivatives to alter the exposure to beta, while others have the ability to short sectors and stocks that are perceived as overvalued.



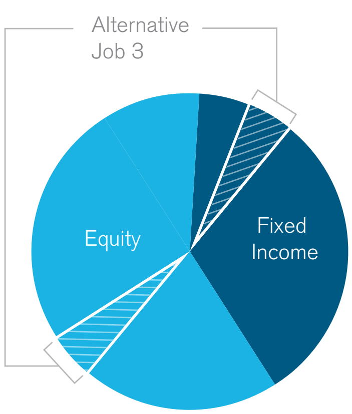
- **Typical Choices:** Long-Short Equity, Option Writing
- **Potential Effectiveness:** Offering upside that's not strictly tied to equity beta
- **Key Metrics:** These funds target absolute return, so moderate to high long-term absolute and risk-adjusted returns, moderate beta
- **Implementation Consideration:** Be wary of strategies that have a persistently high beta to equities, as there are much lower-cost ways to implement such exposure. If you see high beta, look for strong upside, but lower downside capture relative to equities.

10-Year Category Average Performance (%)

(as of 2/28/17)	Annualized Returns	Sharpe Ratio	Annualized Std Dev	Max Drawdown	Beta	Correlation
Long-Short Equity	5.18	0.42	11.83	-29.24	0.95	0.68
Option Writing	4.53	0.39	10.70	-33.00	0.60	0.55
MSCI ACWI Index	4.08	0.28	17.01	-54.92	–	–

Job 3: Dampen overall portfolio volatility

Some alternative options lie between bonds and stocks in their risk/return profile, but offer diversification effects compared to both categories. As such, reducing both fixed and equity allocations can preserve returns while incrementally lowering portfolio volatility.



- **Typical Choices:** Managed futures, Market Neutral, Multialternative
- **Allocated from:** Fixed income *and* equities
- **Potential Effectiveness:** Preserving the level of portfolio returns while lowering overall volatility.
- **Key Metrics:** Low beta and correlation to both equities and fixed income. Competitive risk-adjusted return and long-term returns in line with overall portfolio profile.
- **Implementation Consideration:** Be particularly mindful of equity beta, so that lower-risk fixed income is not unintentionally replaced with higher-than-desired equity exposure.

10-Year Category Average Performance (%)

(as of 2/28/17)	Annualized Returns	Sharpe Ratio	Annualized Std Dev	Max Drawdown	Beta	Correlation
Multialternative	2.05	0.18	9.00	-31.78	0.85	0.82
Market Neutral	1.44	0.25	4.67	-13.89	0.19	0.35
50% MSCI ACWI/ 50% BBgBarc Global Agg	4.57	0.48	8.82	-29.92	–	–

Managed Futures Since Category Inception (8/30/2006): Return: 3.86, Sharpe Ratio: 0.08, Std Dev: 11.58, Max Drawdown: -32.06, Beta: 0.06, Correlation 0.03

38%

Models in which alternative allocation includes a Multialternative fund

Source: Janus Portfolio Diagnostics

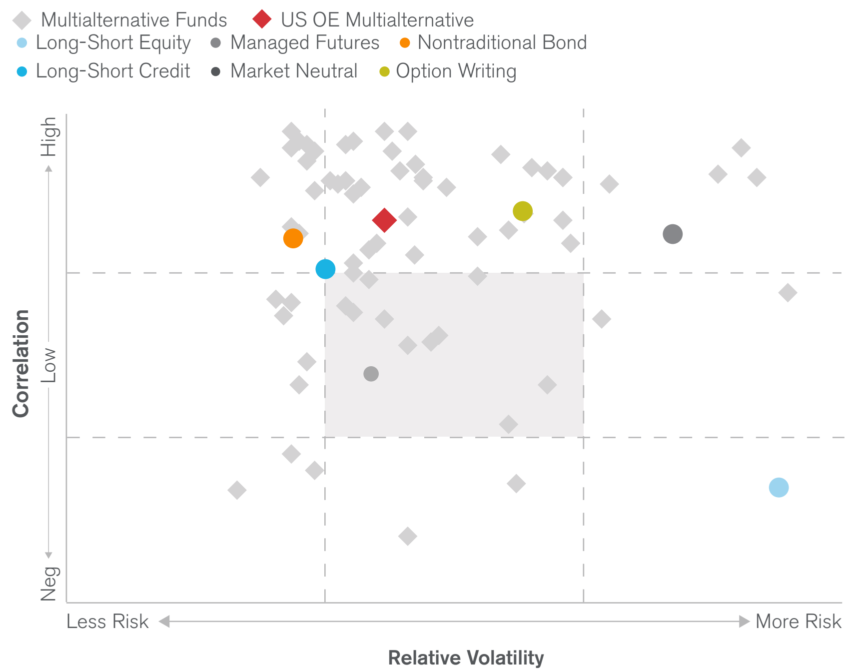
Most Popular: Multialternatives

Multialternative strategies are by far the most widely used alternative category, accounting for almost a third of all asset flows to alternatives between 2007 and 2016.[1] In fact, of those models holding alternatives that we have analyzed, 38% of the positions belong in the Morningstar Multialternative category.

Because of their prominence, it is worth emphasizing that they are especially diverse in their characteristics. As illustrated below, the category does little to define the type of fund and many are closer in volatility and correlation to the median of other alternative categories. Thus, such one-stop-shopping solutions need to be carefully evaluated on an individual basis and a determination made as to what benefits might be expected vs. whether a more specialized fund offering similar exposure might be more sensible. **The ideal Multialternative may fall in the middle of the style box, striking a balance between low correlation and moderate volatility.**

Multialternative Funds Come in Many Different Stripes

Multiaternative Funds and Alternative Category Averages vs. MSCI ACWI (1/1/2014 – 12/31/2016)



Source: Morningstar

Everything in its Place: Integrating alts in your portfolio

Many investors mistakenly look to alternatives for short-term, on-demand outcomes. Remembering the headline-grabbing early days of hedge funds, some have a lingering expectation that alternative investments can or should provide off-the-charts returns or magically uncorrelated growth.

So what should your alts be doing? **Are they included in the portfolio to diversify your equities, your fixed income or both?** The key is to use the framework above to get a sense for how a fund could affect a larger portfolio. Remember, because alternatives tend to have far more flexibility than most traditional funds, the categories in which they are grouped tend to be more heterogeneous, therefore it is

[1] Source: Morningstar

important to also consider the individual fund's objectives, process, expected returns and price and to conduct periodic and extensive due diligence, to ensure that they are delivering the assets, diversification and result you expect.

Place the right alternative, in the right role, in the right portfolio, and you will be in a good position to benefit from the diversification, growth and/or protection they are meant to provide.

Takeaways:

- The growing popularity of different types of alternatives is leading investors to implement them **without a clear role in a portfolio**.
- **Make sure you are clear on the desired role of an alternative in your portfolio.** Once the role is chosen, it is easier to define metrics and better evaluate the options, increasing the likelihood that a strategy will deliver on expectations.
- Ongoing fund due diligence will **ensure that your portfolio continues to have the intended exposures and results.**

This article is part of regular series of thought leadership from Janus' Portfolio Construction Services Team. For more, visit Janus.com/PortfolioDiagnosticsReport

JANUS CAPITAL Group

Past performance is no guarantee of future results.

Investing involves market risk. Investment return and value will fluctuate, and it is possible to lose money by investing.

The views presented are as of the date published. They are for information purposes only and should not be used or construed as an offer to sell, a solicitation of an offer to buy, or a recommendation for any security or market sector. No forecasts can be guaranteed. The opinions and examples are meant as an illustration of broader themes, are not an indication of trading intent, and are subject to change at any time due to changes in market or economic conditions. There is no guarantee that the information supplied is accurate, complete, or timely, nor are there any warranties with regards to the results obtained from its use. It is not intended to indicate or imply in any manner that any illustration/example mentioned is now or was ever held in any Janus portfolio, or that current or past results are indicative of future profitability or expectations. As with all investments, there are inherent risks to be considered.

Standard Deviation measures historical volatility. Higher standard deviation implies greater volatility. **Sharpe Ratio** measures risk-adjusted performance using excess returns versus the "risk-free" rate and the volatility of those returns. A higher ratio means better return per unit of risk. **Correlation** measures the degree to which two variables move in relation to each other. A value of 1.0 implies movement in parrallel, -1.0 implies movement in opposite directions, and 0.0 implies no relationship. **Beta** is a measure of the volatility of a portfolio in comparison to a benchmark index. Less than one means the portfolio is less volatile than the index, while greater than one indicates more volatility than the index. **MSCI All Country World Index℠** is an unmanaged, free float-adjusted market capitalization weighted index composed of stocks of companies located in countries throughout the world. It is designed to measure equity market performance in global developed and emerging markets. The index includes reinvestment of dividends, net of foreign withholding taxes. **Bloomberg Barclays Global Aggregate Bond Index** is a broad-based measure of the global investment grade fixed-rate debt markets.

Funds that concentrate investments in a single sector will be more susceptible to factors affecting that sector and more volatile than funds that invest in many different sectors. Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

Fixed income securities are subject to interest rate, inflation, credit and default risk. The bond market is volatile. As interest rates rise, bond prices usually fall, and vice versa. The return of principal is not guaranteed, and prices may decline if an issuer fails to make timely payments or its credit strength weakens.

Alternative investments include, but are not limited to, commodities, real estate, currencies, hedging strategies, futures, structured products, and other securities intended to be less correlated to the market. They are typically subject to increased risk and are not suitable for all investors.

FOR MORE INFORMATION CONTACT JANUS CAPITAL GROUP

151 Detroit Street, Denver, CO 80206 I 800.668.0434 | www.janus.com

Janus Distributors LLC

C-0417-8238 4-15-18

144-15-48238 04-17