Episode 38

Solidifying liquid alternatives

In a market environment where it feels as if nothing is working, liquid alternatives offer valuable opportunities.

[00:00:05] Beth Anne Byrne:
I think it's arguably solidified the need for at least a 20% alternative allocation, you know, going into the future, your 40 is broken and now your 40 is breaking your 60.

[00:00:24] Kara O'Halloran:
Welcome back to FireSide a podcast from FS Investments. My name is Kara O'Halloran, and I'm a Director on the Investment Research team. Here it is, mid-July, meaning we just wrapped up the first half of 2022. And what a six months it's been. Traditional markets have been on a relatively unrelenting decline for much of the year, racking up a number of worst ever stats. The S&P 500 was down almost 20% as of June 30th. It's the worst start to a year since 1962. Fixed income has suffered as well. The Barclays Agg is down over 10%, more than tripling its worst annual decline on record, and the 60/40 portfolio lost over 16%, its worst start to a year in history.

[00:01:05] Kara O'Halloran:
There's been this narrative throughout markets that nothing works this year, but there are some things that have shown their worth lately, specifically liquid alternatives. So on today's episode, we are pulling back the curtain a little bit and talking about why liquid alts have worked this year, when really not much else has. Why investors are turning to liquid alternatives now, and more importantly, why it's not too late to consider these diversifying assets. To walk through all of this I am joined by Beth Anne Byrne, the Liquid Alternatives Investment Specialist here at FS Investments. Beth Anne, thanks for joining.

[00:01:38] Beth Anne Byrne:
Thanks Kara. It's an honor to be here as always.

[00:01:41] Kara O'Halloran:
So I just ran through how challenging markets have been this year. And really, I feel like that list doesn't even cover it. It's just been this unrelenting volatility. But a lot of liquid alternatives, or more specifically, I really wanna talk about how multi-strategy liquid alts are doing really well this year. So I think we're all kind of wondering how? Right? So at a, a really high level to start, can you just walk us through why you're seeing these funds have success this year?

[00:02:09] Beth Anne Byrne:
Of course. I mean, a well-constructed, and that's a very, very important distinction to make, multi-strategy liquid alt fund, really at the end of the day, is relying on broad based balanced return contribution. And more importantly, particularly given the market backdrop right now, not on beta, anybody who's invested in a poorly constricted liquid alt right now knows what it feels like given the market backdrop. The real beauty, in my opinion, is that portfolios are constructed in a way that there are multiple engines of return and as the market evolves, so do

these return drivers. There is not one position that is solely driving return and that really gives you this consistency in return attribution.

[00:02:57] Beth Anne Byrne:
And this is regardless of the macro backdrop. So if you get the macro backdrop right, it's a bonus. But at the end of the day, funds that are properly constructed and express views this way, with diversifying properties, do not and should not have to get the macro call a hundred percent correct to deliver. In a year like this, that has arguably been near impossible to get that macro view a 100% correct, these products are delivering when others are failing.

[00:03:27] Kara O'Halloran:
Yeah, I wanna emphasize one point you made about the, you know, the pain people are feeling when they had these liquid alts in their portfolios that were really relying on market beta.

[00:03:38] Kara O'Halloran:
It's that old, is it the Warren buffet quote, that's "you only learn who's swimming naked when the tide goes out", and I think a lot of liquid alternative investors, unfortunately right now, are finding that these funds were not as well constructed as they had anticipated. So I actually looked into this in the... If you look at the multi-strategy Morningstar category in 2021, there were 30 funds that made up the top 25% in terms of returns. In year-to-date 2022, only 10 of those funds have remained in the top 25%.

[00:04:15] Beth Anne Byrne:
That unsurprisingly is not shocking to me.

[00:04:18] Kara O'Halloran:
Yeah. Yeah.

[00:04:18] Beth Anne Byrne:
You know, I'm clearly very aware of the universe and what has been incredible is how many funds have been able to what I'll refer to as hide behind beta. And now in 2022, the beta trade has arguably run its course.

[00:04:32] Kara O'Halloran:
Yeah.

[00:04:32] Beth Anne Byrne:
And those funds that have really leaned into consistent, uncorrelated return are shining through.

[00:04:38] Kara O'Halloran:
Yeah.

[00:04:39] Beth Anne Byrne:
Those 10 funds, I think you just said.

[00:04:40] Kara O'Halloran:
Yeah, exactly. Exactly. okay. So, so I wanna go back to the macro narrative. We do talk about macro a lot on this podcast because it's really been such a, a macro different market environment this year.

[00:04:51] Kara O'Halloran:
Right. So really more than in recent memory, I feel, obviously at the beginning of the year, we started with inflation and we started then talking about the fed and the Fed's hiking cycle. And you know what that was going to do to markets and all the challenges that that brings. And then of course, recession, fears have really escalated quickly very recently. And that's kind of been the name of the game right now, but we're still kind of ping ponging on a daily basis. Are we concerned about inflation? Are we concerned about growth? obviously we are concerned about all of it. um, but markets just kind of keep ping ponging back and forth in this kind of tug of war.

[00:05:24] Kara O'Halloran:
And to your point, it does seem impossible to get the macro call completely correct this year. obviously we do not have a crystal ball. So this concept of being able to take a macro view and lean into it a little bit, but almost still, be able to be right. Even if you're wrong, it sounds pretty good right about now.

[00:05:42] Kara O'Halloran:
Right. so I wanna bring this concept to life a little bit. and I think some examples would be helpful. So, you know, a key tenant that we talk about with alternatives is really being able to express views, but in a different way, or through differentiated exposures, other than what you might get in, in a traditional long only fund.

[00:06:00] Kara O'Halloran:
So I wanna walk through some of those macro narratives that I just talked about, and then how you are seeing, or how, you know, these different kinds of exposures that you have seen implemented that are working. So let's start with inflation.

[00:06:14] Beth Anne Byrne:
Great. I mean, that's an awesome place to start. The first half of 2022 was all about inflation and then the way that that can influence other sources of risk throughout the market.

[00:06:25] Beth Anne Byrne:
So being able to thread that theme through a portfolio and invest in beneficiaries, you know, is a great place to start. Obviously there are the traditional ways to do that with inflation in mind, right? Commodities, real assets. And these aren't incorrect expressions at all, and they certainly have a place within a portfolio, but there are other ways to do this as you alluded in a market like this to take advantage of that view, but instead of explicitly lean into it, More or less thread that theme throughout the, the portfolio in a more of a market neutral fashion, if that tends to make a bit of sense.

[00:07:03] Kara O'Halloran:
Yeah. Well, I think that market neutrality is, and I know you'll, we'll get into an example in a second, but that market neutrality is so important cause you don't have to take a directional view on markets right now. And I don't think, you know, with, with all of this volatility, I think that's a, a pretty tall order.

[00:07:17] Beth Anne Byrne:
Exactly, but there are ways to do it. And the first example that comes to mind for me is in investing in something like a value factor, a valuable factor at the end of the day is just going long, "quote un-quote" cheap stocks and short quote unquote expensive stock. When inflation

rises often with an in conjunction with rates rising, it leads to what we call multiple compression or changes in equity valuation.

[00:07:44] Beth Anne Byrne:
And those tend to be less severe in your high value stocks and more severe in your low value stocks. Just think about growth stocks this year and the volatility and a pain associated with them because it's hard for people to figure out what the proper valuation is given the discounting assumed with rates.

[00:08:03] Beth Anne Byrne:
So. It's an easy way. I shouldn't use the word easy. Nothing in this market is easy. It's a way to express a view on inflation, but do so in a market neutral way that doesn't rely on beta.

[00:08:16] Kara O'Halloran:
So let's talk about the fed hiking and then some of the interest rate impacts that we've seen. Obviously we've seen, long term rates, actually.

[00:08:24] Kara O'Halloran:
We've really seen interest rates across the curve, really move up this year. But beyond that, we've seen a ton of interest rate volatility. There is, I know this is an audio medium, so, you know, forgive me listeners. But if you look at a chart of the daily changes in the two-year treasury, It looks like a pretty scary EKG not one that any of us would wanna get. So how are you playing or the fed hiking and then some of these interest rate impacts.

[00:08:48] Beth Anne Byrne:
Yeah. And, and to come back to the chart, the easiest way to see this visually is the move index, right. which is tracking interest rate volatility. So the good thing about liquid alternatives and, you know, I just ran through an example of a market neutral expression.

[00:09:04] Beth Anne Byrne:
Here's another example where you really don't have to get the market direction. Correct. You just have to get the fact that the market is moving correct. So, as you alluded, given this ping ponging narrative between inflation and recession, people are not sure if rates are going up down or sideways and it's creating a lot of volatility for that asset class.

[00:09:25] Beth Anne Byrne:
Unbelievably, there's a way to access hedges within the rates market that do not require you to pay premium, right? So you are getting long or you are investing in a hedge that doesn't require you to have an initial payment outlaid just based on a structural dislocation in the market. At the end of the day, what does that mean?

[00:09:47] Beth Anne Byrne:
It means that you're able to get a non-beta reliant exposure. I E something that is market neutral. That's going to pay when the market is volatile, which it certainly has been and should be going forward.

[00:10:00] Kara O'Halloran:
So you're not just shorting treasuries?

[00:10:03] Beth Anne Byrne:
No. And that obviously [00:10:05] worked until it didn't .

[00:10:06] Kara O'Halloran:
Yep, exactly.

[00:10:07] Kara O'Halloran:
So, all right. So we talked about a few of the macro narratives, but you know, you also, talked about how you don't have to get the macro narrative fully, correct. but how are you putting all of these pieces together? How do you see kind of the best way to construct, a portfolio?

[00:10:23] Beth Anne Byrne:
Awesome. I mean, I've admittedly spent a lot of time talking about the macro awareness and the macro backdrop that liquid alternatives can usually utilize in constructing portfolios.

[00:10:34] Beth Anne Byrne:
Maybe it's because I'm in your presence. but at the end of the day, When you're taking a step back when constructing a portfolio, you need to make sure you both have these macro aware strategies and then more importantly, uncorrelated strategies that are complimentary in nature. So they're giving you again that balance, sorry to keep using the same words, balance and broad-based return contribution. There are strategies that out there that are more structural, more persistent in nature. Meaning that the theme is there for many, many, many years, and some of them decades. one such example I can think of that's pretty tangible for most folks is equity dispersion.

[00:11:15] Beth Anne Byrne:
Equity dispersion really means you're benefiting from the extreme movements in single stocks versus what is going on at the S and P 500 index level. So simply put there's company winners and there's company losers. Not all stocks are trading together.

[00:11:31] Kara O'Halloran:
Which is crazy, even in a market where it almost feels like they are right. Like the S&P 500 is down a lot more than it's up these days, but we're still seeing those individual company, you know, the individual stock performance that's way out, you know, outsized versus the index.

[00:11:48] Beth Anne Byrne:
Exactly. But this phenomenon, if you actually think back to it became particularly pronounced after COVID right. If you think about COVID. Implications that are still present today, two plus years on, right. We're still getting tested to be traveled. People are working from home. You know, there's a lot of supply [00:12:05] chain disruptions, particularly in the medical field. So though it feels like this year, everything's moving in one direction.

[00:12:11] Beth Anne Byrne:
If you actually look at what's going underneath the hood, there's a lot of differentiation between individual names.

[00:12:18] Kara O'Halloran:
Like my favorite COVID. my favorite COVID stock story is when did you see this? When, The wrong zoom, when, when people bought the wrong zoom, I think it was like some other, yeah, the wrong ticker. I think I, I don't know what the actual zoom ticker is, but I think literally this ticker might have been zoom and it was some like very small company, not the zoom video software that we were all like became so reliant on and it just went to the moon. It was anyway,

that was an aside, but that was my favorite, uh, an example of some dispersion in the market. I think induced by COVID

[00:12:47] Beth Anne Byrne:
No, and, and clearly we're trying to still understand. You know, complications that COVID is creating at a macro level. And more importantly, at a company level. As I alluded working from home inflation, rising energy costs, all of these are creating problems at the individual company Le level, and more importantly for the analysts that forecast them.

[00:13:09] Beth Anne Byrne:
Right? So you're getting all of these earning calls that companies surprising to the upside, to the downside they're matching expectations when the market wasn't pricing that. So at the end of the day, this has been a consistent uncorrolated return. You do not care if zoom or Peloton is going up or down or fake zoom, you just care that the market and the individual companies are moving more than the, the index level.

[00:13:38] Beth Anne Byrne:
And what's great about this and other strategies that I'd kind of bucket into this category. Not only are they uncorrelated they're often negatively correlated and tend to be defensive in nature. Right? So they're balancing out some of these more macro aware strategies. So when the macro view is changing, evolving, these strategies are still there.

[00:13:59] Beth Anne Byrne:
They're always on providing a ballast to other ports of the portfolio.

[00:14:09] Kara O'Halloran:
Okay. So we talked about the individual pieces. We're taking some of our macro aware, and kind of our more balanced, more persistent defensive strategies, combining them into our nice, perfect multi-strategy portfolio.

[00:14:20] Beth Anne Byrne:
Perfect. um, I like that it's

[00:14:23] Kara O'Halloran:
Yeah, it's a perfect portfolio. So now I wanna talk more about the liquid alts universe more broadly. So Beth Anne we work very closely together. we have for a number of years now and. I think you'll remember that when you first came on board or when, when we first came on board, liquid alts were not necessarily like the most in Vogue product?

[00:14:42] Beth Anne Byrne:
No, because we had this epic beta run. Right.

[00:14:45] Kara O'Halloran:
But I remember going to you one day being like, all right, you know, it's really kind of frustrating. We're not getting that much time in the spotlight. People aren't really paying attention to these funds very much. And we really think investors and advisors need to. and you, you told me my favorite thing.

[00:15:00] Kara O'Halloran:
This is the best advice ever. You said, listen, Kara, they're gonna have their house party. They are, it's gonna be great. They're having their party in the house, the main house. It's great.

They're having fun time, but we're gonna throw a rave in the, in the garage. And eventually it's going to get so loud that everyone's going to have to come outside to see what's happening out in the garage.

[00:15:19] Kara O'Halloran:
So finally people are at our party, unfortunately it's because there seems to have been a fire in the main house. So people had to go outside, but people are paying attention, right? Investors are pouring money into liquid alls consistently for the first time in a pretty long time. I think liquid alternative mutual funds and ETFs have seen over 21 billion of inflows year to date.

[00:15:40] Kara O'Halloran:
That's after a record level of inflows in 2021. But that also means there's kind of this narrative, that there could be some element of performance chasing going on. Right. Are people just buying them after they already needed them? it's kind of like buying the car insurance after you already crashed. So what do you say to that?

[00:15:58] Beth Anne Byrne:
As you alluded. I've always been having my party in the grass. It's been a very fun party. We've had fun. It might have been my own for a little while. And now I have, you know, a pretty big following

[00:16:08] Kara O'Halloran:
I've been there with you.

[00:16:10] Beth Anne Byrne:
That's true. but I'd argue the first six months of the year have been great.

[00:16:15] Beth Anne Byrne:
And very few people can say that in the investment side of the equation, as you said, people have migrated to the back of the house, but honestly, in all jokes aside, The objective of what liquid alts are trying to deliver has not, and will not change. Even if the macro backdrop does. Liquid alts in this is a phrase that I tend to lean into a lot is liquid alts look to deliver quality, not just quantity of return.

[00:16:46] Kara O'Halloran:
So what do you mean? What does that mean?

[00:16:49] Beth Anne Byrne:
Thank you. Usually you're looking for call it very high, single mid digit returns, a sub five volatility or standard deviation. Right? So good risk adjusted return with minimal reliance on beta. I know I keep beating that dead horse, but it's critical in this market.

[00:17:08] Beth Anne Byrne:
And then minimal correlation to traditional assets, right? Creating a place for an, a place for the fund or the product within a portfolio. Return consistency is key. So there's no performance high that you're chasing. There's no lower, attractive entry point to wait for these strategies. It's something that really is going to be boring, steady. Consistent.

[00:17:36] Kara O'Halloran:
Don't call them boring. We want people to listen to this podcast. but no, I mean, I think that's a good point, cuz I think that it, it's not like these are buy low sell high investments. It's not like, oh,

the market just got a heck of a lot cheaper. This is a good entry point for one of these products. I mean we think it's kind of always a good entry point. There's always opportunity out there.

[00:17:55] Beth Anne Byrne:
No, it's no, it's quite the opposite. These products are built to be core alternatives, always on always supporting the rest of the portfolio. [00:18:05] So when times are good, great. They're still adding to return, but when times are pretty not great, it's something that you can turn to and point to positive return attribution to the rest of your portfolio and a support.

[00:18:19] Kara O'Halloran:
Yeah. All right. So let's, talk about actually putting these into practice a little bit more. So I know a lot of your time you're actually out talking to advisors, and, and talking to 'em about how to include liquid alternatives in a portfolio. So where do you see most advisors allocating from?

[00:18:35] Beth Anne Byrne:
It's gonna sound a bit corny.

[00:18:37] Kara O'Halloran:
Great.

[00:18:37] Beth Anne Byrne:
But, multi-strategy funds at the end of the day are really a multifaceted solution.

[00:18:45] Kara O'Halloran:
I like that.

[00:18:47] Beth Anne Byrne:
So what do I mean by that? At the end of the day, this is the solution for multiple portfolio pains. First and foremost, as you started this podcast with equities are down, call it 20 plus percent year to date. Investors have had the benefit of a decade plus long beta run.

[00:19:05] Beth Anne Byrne:
And now it's time to take some money off the table. Arguably, you do need to stay invested. And if you want to do that and have something that's gonna be a ballast versus the rest of your equity portfolio, which is no longer bonds given how they're moving together, these sort of strategies can serve as that hedge, delivering you capital preservation for your equity, allocation, diversification benefits, and an ability to take some money off the table, i.e. de-risk equities. The second and more obvious to me. Is a bond alternative given the profile of these funds, right? Multi-strategy funds tend to have high single, mid digit returns, sub five volatility and low correlation to equities. It's been a very, very natural place for people to use within a portfolio.

[00:19:53] Kara O'Halloran:
Sounds like a bond to me.

[00:19:54] Beth Anne Byrne:
Exactly this bond-like profile is something that alternatively can make it a bond alternative. And what does that mean means you don't have to have a view on your bond allocation [00:20:05] going forward. You actually can take some of that off and have the same characteristics as a bond versus the rest of your portfolio.

[00:20:13] Beth Anne Byrne: And third, I hit on this term earlier, a core alternative. These strategies are constructed at the end of the day to be consistent. And always beyond. What's been interesting in a lot of the conversations I've had in the field is that multi-strategy funds are being used as core alternatives, the anchor, more or less in terms of an alternative asset allocation, there are some really compelling products out there.

[00:20:39] Beth Anne Byrne:
A little bit more narrowly focused, a little bit more nichey. And so you can compliment these two return streams by having something that is multi strategy, broad based. Consistent with something that is a bit more narrow and nuanced. So call it private lending, merger, arm, corporate letting whatever it is, you can have this anchor to then do a little bit more work on these more nuanced niche [00:21:05] opportunities.

[00:21:06] Kara O'Halloran:
You know, we've always brought up, we've always thought about our portfolios or for so long, we've thought about our portfolios in terms of the 60, 40. And we said that ad nauseum. but it worked so well until it didn't. and I I'm really glad you brought up the bond alternative stuff because that's not even, we didn't even touch much on that. You know, the, the failings of traditional fixed income this year, it's obviously one of the biggest risks to a portfolio. Especially given this rise in correlation between stocks and bonds. So, you know, it's almost like we thought about a 60, 40 for so long, and now we're thinking maybe it's a 50, 30, 20, or whatever those numbers end up being. But it's, you know, really this year has just forced us to completely reevaluate portfolio construction as a whole.

[00:21:50] Beth Anne Byrne:
I think it's arguably solidified the need for at least a 20% alternative allocation, you know, going into the future.

[00:21:59] Kara O'Halloran:
Would you say it's solidified liquid alts?

[00:22:02] Beth Anne Byrne:
Man, I like the play on words there.

[00:22:06] Kara O'Halloran:
I think that's our episode title.

[00:22:09] Beth Anne Byrne:
Yes, it has definitely solidified the need for alternatives and liquid alternatives. Generally speaking. I mean, you can't deny. I think the expression. That's out there. Maybe we just use here at FS is that your 40 is broken and now your 40 is breaking your 60. So I'd argue that the 50, 30, 20 is not a concept that's transitory in nature.

[00:22:34] Beth Anne Byrne:
Investors need to take the time and do the work now to make sure that they're prepared to get their portfolios ready for let's call it the next decade, because alternatives are going to be that source of consistent return that the 60 40 is going to fail to deliver.

[00:22:51] Kara O'Halloran:

All right before I throw out more terrible puns. I think we should wrap it up there, but then that was great. thank you so much for coming on. We will have you back on soon to talk more about liquid alts because hopefully our, uh, party in the garage is gonna continue for quite some time.

[00:23:05] Beth Anne Byrne:
I, as I said, I'm always back there. So just waiting for, you know, the crowd to keep growing so that I get a stadium rather than a garage.

[00:23:14] Kara O'Halloran:
Awesome. All right. Well, thanks so much.

[00:23:15] Kara O'Halloran:
When considering the use of liquid alternatives, investors should have clear expectations of its purpose. Certain strategies may be better portfolio diversifiers, while others may provide return enhancement potential. Diversification does not eliminate the risk of experiencing investment losses. Investing in liquid alternatives may involve the use of options or other derivatives which may incur additional risk, including the risk of a complete loss of investment. When building a portfolio that includes liquid alternative investments, financial professionals and their investors should first consider the individual's financial objectives. Past performance is no guarantee of future results.