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- Spotlight
- ▶ Insights
  - Shares
  - Bonds
  - Multi Asset
  - Systematic Solutions
  - Overlay
  - ESG

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2022 as the ideal environment for liquid alternatives – where do we go from here?

The strongest US inflation in 40 years and the consequently much more restrictive central bank policy made 2022 one of the most difficult years in stock market history. The implications for investors in traditional multi-asset portfolios are enormous. Traditional diversification effects were overturned with significantly rising inflation and, correspondingly, more restrictive central banks. For mixed portfolios of equities and government bonds in the US, it was the most difficult year since 1931 in terms of the classic 60/40 portfolio. For long periods, only commodities, energy sector equities and the US dollar provided support among the classic investment themes.

Many alternative strategies[1], on the other hand, offered a real diversification effect. They benefitted from pronounced macroeconomic trends in traditional asset classes and higher volatility. Individual strategies achieved significant gains and were thus convincing both relative to conventional investments and in absolute terms. However, the more attractive interest rate level in the bond segment, coupled with higher risk premiums, now makes it necessary to reconsider defensive alternative strategies as bond substitutes. The diversification aspect of the multi-asset portfolio should become even more important. In our view, managed futures, long volatility and global macro strategies are particularly suitable for this purpose. We provide an outlook for these and other individual strategies for the investment year 2023.

Alternative strategies offered added value compared to traditional investments in 2022

The bulk of alternative strategies outperformed traditional asset classes in 2022, delivering clear added value

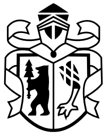
Fig. 1 shows that in 2022, all the alternative strategies presented generated added value compared with traditional investments (viewed in US dollars). Five of the seven strategies even achieved an absolutely positive performance by the end of November.

Fig. 1: Alternative strategies significantly outperformed conventional asset classes in 2022 (total return in USD, %)

	Since the beginning of the year (YTD)	12-month periods of the last 5 years				
	31/12/2021 - 30/11/2022	30/11/21 30/11/22	30/11/20 30/11/21	30/11/19 30/11/20	30/11/18 30/11/19	30/11/17 30/11/18
HFRI Institutional Macro	10.5	11.3	8.0	-0.8	9.6	-1.7
HFRI Trend Following Direction	10.4	11.4	10.6	-1.1	7.5	-5.2
HFRI Relative Value Volatility	5.1	5.2	5.0	-4.2	-1.2	-0.9
HFRI ED Merger Arbitrage	1.6	2.3	13.5	2.9	5.3	4.3
HFRI EH Equity Market Neutral	0.6	1.8	7.5	-1.2	2.3	-0.8
HFRI RV - Convertible Arbitrage	-2.7	-2.4	10.5	11.3	6.7	-0.8
HFRI Credit	-2.7	-2.5	10.3	3.7	3.4	2.1
MSCI World	-14.5	-10.9	21.8	14.5	14.5	0.1
ICE BofA Global Broad Market Index	-17.1	-17.3	-3.9	8.1	8.6	-2.8

Source: Bloomberg, 11/30/2017 - 11/30/2022, Total Return in USD (%). Indices: HFRINM Index, HFRIMTF Index, HFRIVOL Index, HFRIMAI Index, HFRIEMNI Index, HFRICAI Index, HFRICRDT Index, NDDUWI Index, GBMI Index.
EUR hedged returns from a EUR investor's perspective would have been about 2.5% lower in 2022.
HFRI indices offer the longest possible availability of data on alternative strategies. The so-called survivorship bias can lead to an overestimation of the historical performance and general characteristics of an index.

[1] See "Liquid alternatives are a useful addition in the low interest rate environment – we look at their classification and implementation in a multi-asset context", Berenberg Markets Focus, 30 September 2021.



Global macro strategies and trend-following strategies stood out, both achieving double-digit gains. Thanks to their flexibility, they benefitted from the long-lasting trend of rising interest rates, the sell-off in equities and the continuous appreciation of the US dollar through October. In addition to their directional positioning, relative value trades on the yield curves were also able to generate added value.

Macro strategies as well as trend-followers were able to generate positive performance, as in previous crisis phases with long-lasting trends

While pure long volatility strategies profited significantly around the start of the war in Ukraine but lost most of their gains over the course of the year, volatility strategies with a relative value approach profited relatively consistently over the year. Dispersion approaches in equities took advantage of the difference between increased individual stock volatility and index volatility. The large rotation below the index surface, such as the strong underperformance of the technology sector compared to value segments, helped.

Merger arbitrage strategies found themselves in difficult waters for long periods due to the prevailing risk-off environment. Merger spreads widened and M&A activity generally declined. Nevertheless, defensive strategies achieved slight gains, outperforming traditional markets. The latter also applies to market-neutral L/S equity strategies, which almost eliminate market risk. The high dispersion at the single stock level offered a corresponding range of opportunities, especially to macro-oriented managers with flexibility in terms of sector and style orientation.

Market neutral strategies can take advantage of short opportunities and benefit from hedging in a difficult environment

Alternative credit strategies could not escape the historically high interest rate and spread volatility. Although they performed better on average than long-only credit strategies, they were negative in absolute terms. Convertible arbitrage strategies were closer to zero than traditional asset classes but were also weighed down by valuation corrections despite hedging in credit, interest rate and equity markets. In addition, a large proportion of convertible bonds are issued by the technology sector, which was under pressure in 2022 due to high valuations and the sharp rise in interest rates.

The bottom line is that all the alternative strategies listed in Fig. 1 had advantages over traditional asset classes in 2022, and thus complementing them in a multi-asset context would have been beneficial.

Alternative strategies also achieved historically positive results in phases of rising interest rates

Looking at the broad HFRI Fund of Fund Index since 1990 during periods of rising interest rates, the picture is quite clear. In each of the time windows of rising 10-year US Treasury bond yields shown in Fig. 2, a diversified hedge fund portfolio performed positively and outperformed the broad global government bond market – by about 29.2ppt at its peak (Oct 98 - Dec 99) and by about 2.3ppt at its lowest (Oct 93 - Nov 94). Looking at the length and, more importantly, the magnitude and speed of the inflation-driven yield movement this year, it seems unsurprising that the excess yield has now grown to around 33.1ppt since August 2020. The obviously low correlation with bonds makes it clear, especially in the difficult phases shown, that the integration of alternative strategies in a multi-asset context can make sense.

In periods of rising interest rates, diversified portfolios of alternative strategies have historically generated positive returns

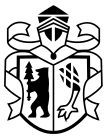
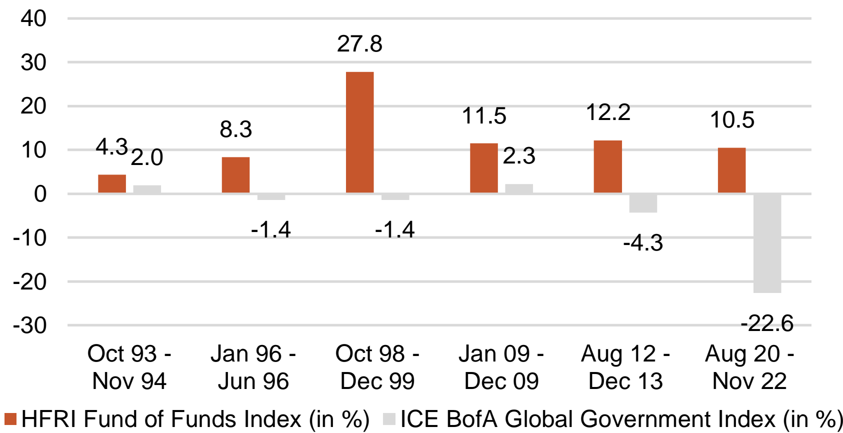


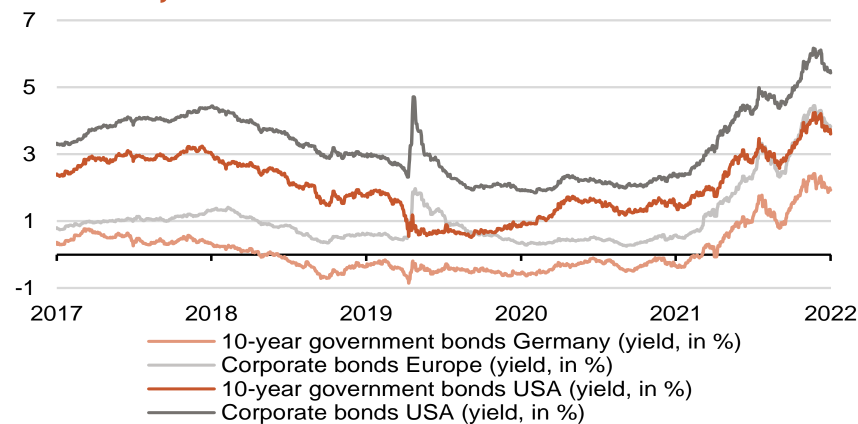
Fig. 2: Alternative strategies generated positive returns in phases of rising interest rates, unlike bonds as a rule (total return in USD, %)



Source: Bloomberg, 12/31/1989 - 11/30/2022, Total Return of HFRIFOF Index and LEGATRUU Index in USD
HFRI indices provide the longest possible availability of data on alternative strategies. The so-called survivorship bias can lead to an overestimation of the historical performance and the general characteristics of an index.

Higher interest rates and risk premiums currently offer alternatives again...
After the sharp rise in interest rates this year, however, yields on government bonds with first-class credit ratings are currently trading well above the average of the past five years again (Fig. 3). Corporate bonds have also become more attractive this year due to the widening of risk premiums.

Fig. 3: Government and corporate bond yields (investment grade) over the last five years



Period: 11/30/2017 - 11/30/2022, Indices: GDBR10 Index, USGG10YR Index, ER00 Index, C0A0 Index
Source: Bloomberg, own calculation

At first glance, there are once again opportunities on the interest rate side

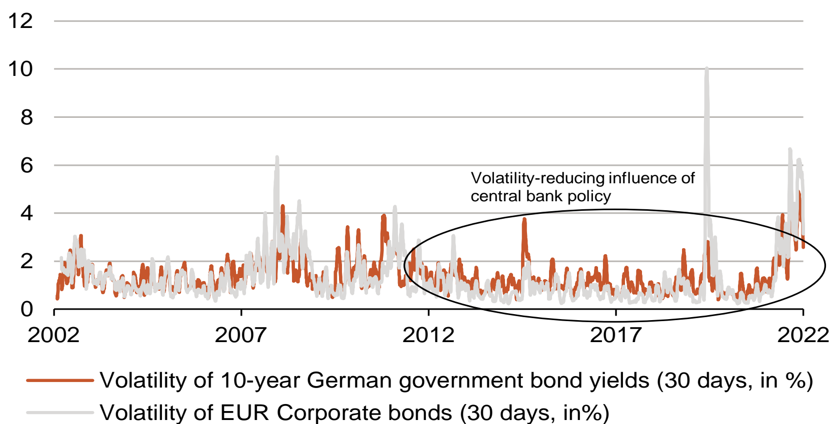
In mid-October 2022, the risk premium of high-quality corporate bonds over maturity-equivalent government securities in Europe was around 230 basis points, close to the level at the height of the COVID-19 pandemic in March 2020 (243 basis points). Accordingly, at least at first glance, there are more opportunities to replace very defensive alternative strategies with high-credit-quality government or corporate bonds, or to reduce the tactical allocation of alternative strategies somewhat in favour of bonds. We have successively taken this path during Q4 2022.

...however, inflation and changing market structures continue to demonstrate the need for additional diversification through alternative strategies in the medium term in a multi-asset context

Inflation increases volatility in the individual asset classes

Deglobalisation, demographic changes and the energy transition are expected to lead to a sustained increase in inflation and inflation volatility, which are thus likely to trigger faster monetary policy cycles and shorter and more erratic economic cycles.[2] This should increase the volatility of both equities and bonds. The volatility of corporate earnings is rising, and declining interest coverage ratios are weighing on more highly indebted companies, which is reflected in valuations and price reactions. Particularly evident at present is the clear regime change in bond volatility, which has been depressed by the (ultra) loose central bank policy in the form of low-key interest rates and bond purchase programmes over the past decade (Fig. 4).

Fig. 4: Low interest rate policy and bond purchases by central banks missing as volatility-reducing factors in the future



Period: 10/31/2002-10/31/2022, Realised volatility, Indices: GDBR10 Index and ER00 Index
Source: Bloomberg, own calculation

Changing market structures require diversification aside from bonds and equities

Bond volatility is thus likely to remain at a higher level in the future and negatively affect the volatility of multi-asset portfolios. History also suggests that the correlation between risk assets and government bonds tends to be in positive territory when inflation is higher, which is negatively affecting multi-asset portfolios. In addition to the volatility aspect, it supports the argument for additional diversification aside from bonds and equities.

Furthermore, the liquidity level should not be lost sight of during crisis phases. The fourth quarter of 2018, March 2020 and phases of this year impressively showed that this can become a problem for corporate bonds. The reason for this is fewer intermediaries and less proprietary trading by banks combined with higher outstanding volumes than in the past.

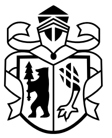
Alternative strategies can therefore still have a justification when it comes to increasing the degree of diversification and reducing the volatility and drawdown vulnerability of portfolios through carefully selected profiles.

Continued positive outlook for alternative strategies

Alternative strategies have evolved and can deliver value even with a higher base rate of return

Alternative strategies have not only proven their worth in the current crisis but have also undergone further development over the past years. More and more UCITS strategies have entered the market that replicate long-term established and successful

[2] See "What comes after the inflation hump? Implications for investors", Berenberg Markets Focus, 3 November 2022.



offshore strategies – usually at more favourable conditions than in the past, with improved fungibility and more investor-friendly access via platforms and corresponding connections to the management of the strategies. The reflationary environment and the associated discontinuation of the expansionary central bank policy open significantly more opportunities for alternative strategies to play to their strengths and generate alpha, both now and in the future. The higher base rate is also an advantage, as risk premiums increase and excess liquidity or collateral can be invested at significantly better conditions, thus increasing expected returns.

Hedging strategies provide diversification, especially in the still uncertain market environment

Fig. 5 shows our preferences regarding individual strategies for 2023. The allocation of hedging strategies continues to appear sensible, particularly in view of the geopolitical risks that still exist and the overall fragile market situation, which is strongly influenced by inflation and central bank policy. Strategies with long volatility profiles offer protection in extreme events, but also benefit from increased individual stock volatility in the case of dispersion approaches. In addition, hedges have recently become cheaper again due to lower volatility. However, it is still important not to disregard the "insurance costs" arising from such strategies and to therefore diversify across different approaches if necessary.

Fig. 5: Our preference for 2023 for alternative strategies

	Strategy	Preference
Hedging Strategies	Long Volatility	+
	Managed Futures (Trend Follower)	+
Diversifying Strategies	L/S Equity (Market Neutral)	o
	Event Driven (Merger Arbitrage)	o
	Global Macro	+
	Convertible Arbitrage	o
	L/S Credit	-

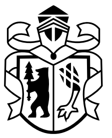
"+" = positive, "o" = neutral, "-" = negative

A characteristic feature of managed futures or trend-following strategies is, on the one hand, the convex profile due to profiting from strongly falling or strongly rising markets and, on the other hand, the inherent multi-asset character due to positioning in different asset classes. Diversification is thus given in relation to the classic investment themes, but also within the approaches, in order to conserve profits that have been made. Both aspects give us the conviction in the long term – particularly after the very positive development this year – that profits made can not only be preserved, but also expanded in a possible scenario of further rising interest rates through short positions. However, it should be borne in mind that the strong trends of 2022 will likely not recur in the same form. Therefore, it also makes sense in this area to diversify across different approaches and to include strategies that focus on shorter trends – so-called "short-term trading strategies" – in allocation considerations.

In the L/S equity strategies, we prefer market-neutral strategies with low beta or approaches that opportunistically manage their net equity risk mainly with a view to risk management due to the ongoing uncertain macroeconomic environment. Due to the rather conservative positioning (reduced gross and net equity risk) and hedging on index level, capital preservation and diversification rather than significantly positive returns are to be expected from the strategies, at least in the short term.

In terms of diversifying strategies, we currently prefer global macro strategies, followed by L/S equity and convertible arbitrage strategies

We currently take a rather neutral view of event-driven and merger arbitrage strategies. Corporate transactions generally allow for almost uncorrelated returns. However, M&A deals are more predictable in a more stable market environment. This is



reflected in the defensive positioning of managers. In addition, the regulatory environment is in part more restrictive, especially in the US. Nevertheless, the environment is creating opportunities due to the pressure on companies to be more efficient, but also due to reduced valuations. Because of rising interest rates, these opportunities are likely to arise primarily in less capital-intensive transactions in the small and mid-cap segment. In our opinion, managers with sufficient flexibility are preferred in these segments.

Global macro strategies are well suited to benefit from the strong macroeconomically-driven environment due to their top-down approach and the numerous opportunities to exploit price fluctuations, trends and mispricings. We expect heightened interest rate and currency volatility to continue in 2023, as inflation and central bank policy are likely to remain key drivers. While directional trades promised corresponding gains this year, relative value positioning is more likely in 2023. Accordingly, we also prefer discretionary over systematic approaches for 2023.

Within the convertible bond segment, the dislocations this year have left some growth and technology-oriented companies with low delta, bringing the bond component and thus more idiosyncratic themes to the forefront on the arbitrage side. The return of liquidity in trading and a resurgent primary market are likely to continue in 2023 through refinancing-driven new issuance, increasing opportunities for volatility-oriented arbitrage managers. Thus, we are now neutral on the segment again.

With fundamentally higher risk premiums for bonds, the dispersion on the rating scale, especially in the high-yield segment but also at sector level, is creating significantly more opportunities for L/S credit strategies than was the case a year ago. In the individual assessment of the attractiveness of the respective strategy profiles, the higher interest rate level and increased risk premiums for conventional bonds must be considered all the more. As a result, we have moved away from very defensive managers in favour of "long only" positions in bonds, which now have significantly more attractive risk/reward profiles again.

Conclusion: As interest rates rise, the diversification effect of alternative strategies comes more to the fore – targeted and careful implementation remains crucial when implementing such strategies

In addition to the potentially longer-term increased bond volatility, the fundamentally changed market structure with shorter cycles, faster and sharper market movements in conventional asset classes create conditions that require diversification in a multi-asset context beyond equities and bonds. The potential for many alternative strategies to provide positive, uncorrelated returns becomes even more important in periods when equities and bonds do not provide the desired diversification effects.

With the allocation of a tail hedge strategy (long volatility), we focus on hedging strategies alongside diversifying commodity allocations in the broad range of our multi-asset strategies. In our retail fund Multi Asset Defensive as well as in total-return-oriented strategies, further hedging elements are used in the form of long volatility and managed futures strategies, which are supplemented by strategies with a diversification effect, including global macro strategies, in line with our preferences. A necessary prerequisite for profiting from the increased volatility in the asset classes is the flexibility to bet on rising and falling prices, as well as a larger toolbox of investment instruments and trading strategies.

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