Alternatives may be an answer to challenging investment environments

Walter Davis
Alternatives Investment Strategist
New York

Key takeaways
- Expect lower equity returns, increased volatility and rising interest rates in 2019.
- Alternative investments can help investors weather a more challenging environment.
- Investors need to be proactive and avoid the mistake of adding alternatives reactively.

Following an idyllic 2017, when equity markets were characterised by strong returns and low volatility, we were reminded in 2018 that markets are often volatile and can go down just as easily as up. In 2019, I believe investors should be preparing themselves for lower equity returns, increased volatility and rising interest rates. Given this outlook, investors may want to consider the addition of alternative investments to their portfolios.

In 2019, I believe investors should be preparing themselves for lower equity returns, increased volatility and rising interest rates. Given this outlook, investors may want to consider the addition of alternative investments to their portfolios.

What are alternative investments?
Invesco defines alternatives as investments other than publicly traded, long-only equities and fixed income. Based on this view, investments that have any of the following characteristics would be defined as alternative investments:
- Investments that engage in "shorting" (i.e., seeking to profit from a decline in the value of an asset), such as global macro, market neutral and long/short equity strategies.
- Investments in asset classes other than stocks and bonds, such as commodities, natural resources (i.e. forestry, mining leases), infrastructure, and real estate.
- Investments in illiquid and/or privately traded assets, such as private equity, venture capital and private credit.

Historically, alternative investments were only available for institutional and ultra-high net worth investors, but that is no longer the case. Many alternative investment strategies are currently available to all investors through various investment vehicles.

Alternatives to consider for 2019
Given my outlook for lower equity returns, increased volatility and rising interest rates in 2019, investors may want to consider the following types of alternative strategies, all of which are available as mutual funds:

- **Global macro for opportunistic, long/short investing across global markets.** Global macro funds invest opportunistically on a long and short basis across global equity, fixed income, currency and commodity markets. Because these funds can invest long and short, it is possible for investors to earn profits in both rising and falling market environments. For this reason, global macro funds have the potential to outperform traditional stocks, especially during challenging and volatile periods for equity performance.
- **Market neutral to help preserve principal.** Market neutral funds trade related equities on a long and short basis, such that the funds have close to zero net market exposure. In these funds, the key to generating a positive return is security selection – determining which equities to go long and which to go short. Given the potential for lack of net market exposure, market neutral funds may reduce the impact of market swings, have the potential to generate positive returns in all market environments, and may produce returns that have low correlation to equities and bonds.
- **Long/short equity for potential upside equity market participation coupled with downside risk mitigation.** Long/short equity funds combine both long and short equity positions in a portfolio, while typically being net long to equities. As a result, performance tends to directionally follow the equity market while the short positions seek to cushion performance during periods of stock market decline.
- **Senior loans to play offense in a rising interest rate environment.** Senior loans (also known as bank loans) are made by banks to non-investment grade companies, commonly in relation to leveraged buyouts, mergers and acquisitions. The loans are called "senior" because they are contractually senior to other debt and equity and are typically secured by collateral. Another key aspect of senior loans – the interest rate typically floats with a reset every 30 to 90 days. This means that in a rising rate environment, as long as the rate rises above a predetermined minimum level, the payments from the borrower may increase.

- **Multi-alternatives may offer a one-stop shop investment in alternatives.** Multi-alternative funds generally invest across multiple alternative strategies and/or alternative managers. These typically use a combination of alternative strategies, including taking long and short positions in debt and/or equity, alternative assets and futures, among others. Such funds may provide investors with broad exposure to alternatives via a single fund.

A final word

One final word on alternatives: In my opinion, the most common mistake investors make with alternatives is investing on a reactive basis, seeking out alternatives following a period of outperformance by these assets. For this reason, I encourage investors to work with their financial advisor to research and consider an appropriate allocation to alternatives, especially given the current market environment.

In my opinion, the most common mistake investors make with alternatives is investing on a reactive basis, seeking out alternatives following a period of outperformance by these assets. For this reason, I encourage investors to work with their financial advisor to research and consider an appropriate allocation to alternatives, especially given the current market environment.

Important information

This document has been prepared only for those persons to whom Invesco has provided it. It should not be relied upon by anyone else. Information contained in this document may not have been prepared or tailored for an Australian audience and does not constitute an offer of a financial product in Australia. You may only reproduce, circulate and use this document (or any part of it) with the consent of Invesco.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs. Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

You should note that this information:

- may contain references to dollar amounts which are not Australian dollars;
- may contain financial information which is not prepared in accordance with Australian law or practices;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address Australian tax issues.

Issued in Australia by Invesco Australia Limited (ABN 48 001 693 232), Level 26, 333 Collins Street, Melbourne, Victoria, 3000, Australia which holds an Australian Financial Services Licence number 239916.

The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals. There is no guarantee the outlooks mentioned will come to pass.

Not all strategies mentioned are available in all jurisdictions.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions.

Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

Stocks are related if driven by the same fundamental factors. For example, two stocks from the same industry would be related.

Long/short equity strategies involve taking long positions in stocks that are expected to increase in value while taking short positions in securities that are expected to decrease in value.

Short sales may cause an investor to repurchase a security at a higher price, causing a loss. As there is no limit on how much the price of the security can increase, exposure to potential loss is unlimited.

Market Neutral strategies generally seek to minimize net market exposure to benefit from rising prices on the long side and declining prices on the short side.

Short positions/short selling is the sale of a security not owned by the seller, then buying later.

The belief is that security prices will decline and the price paid to buy it back at will be lower than the price it was sold.

Net market exposure is the percentage difference between a funds long and short exposure.

Correlation is the degree to which two investments have historically moved in relation to each other.

Most senior loans are made to corporations with below-investment grade credit ratings and are subject to significant credit, valuation and liquidity risk. The value of the collateral securing a loan may not be sufficient to cover the amount owed, may be found invalid or may be used to pay other outstanding obligations of the borrower under applicable law. There is also the risk that the collateral may be difficult to liquidate, or that a majority of the collateral may be illiquid.

This does not constitute a recommendation of any investment strategy for a particular investor. Investors should consult a financial professional before making any investment decisions.