Q3 2022

ALLOCATOR'S ANGLE

A Quarterly Newsletter from *IOR*isk Aware

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SUMMARY IN BRIEF

- In last quarter's Allocator's Angle, we presented evidence that cross-asset correlations were breaking down – meaning that traditional diversification techniques may not afford the intended benefits. We suggested a defensive position against this backdrop.
- Given that commonly used diversification techniques tend to fail precisely when they are needed most, such as during market disruptions, we study what types of investments might offer diversifying returns during turbulent times[1]. Our study reveals that some Macro and CTA strategies may offer meaningful diversification during periods of volatility, when other assets trade in lockstep.
- As we entered 2022, there was considerable evidence to suggest the Value factor was poised for a period of outperformance vs. the Growth factor. The Value factor may be in the early innings of a multi-year run, but after a blockbuster start to 2022, we no longer see a uniquely compelling entry point for allocators considering a rotation into Value-oriented funds.

[1] Defined as our proprietary turbulence indicator registering a reading greater than 10%.

CIO OUTLOOK

SUMMARY

Allocators who are looking to weather turbulent times may consider adding Macro and/or CTA strategies to their portfolio because of their unique ability to capitalize on economic uncertainty. In addition, we find that Value may still perform well, but the uniquely attractive entry point we noted in Q1 2022 may have passed.

As allocators, we're constantly trying to root out human biases and emotions that may infiltrate our investment processes. Among the most pernicious behaviors we see is the tendency to grow frustrated with strategies when their style is out of favor and in some cases this frustration may boil over precisely when a strategy is about to come into favor. To overcome such biases, we prefer data-driven approaches that help reduce subjectivity, which can interfere with rational investment decisions.

In this edition of ***Allocator's Angle***, we share observations on several strategies that have only recently come back in favor. Specifically, using a data-driven approach we share several observations that suggest Macro and CTA strategies may offer unique benefits during periods of elevated turbulence. We also share observations on the Growth and Value factors and find that while Value may still be attractive, the entry point appears less compelling than we noted in our Q1 2022 ***Allocator's Angle***. The resurgence of these strategies serves as a reminder that institutional allocators are in this for the long haul, and yesterday's laggards may become today's darlings.

Once again, if you're an allocator facing a problem that may benefit from a data-driven approach, we'd love to hear from you. Please drop us a line and we may discuss it in a future edition of ***Allocator's Angle.***

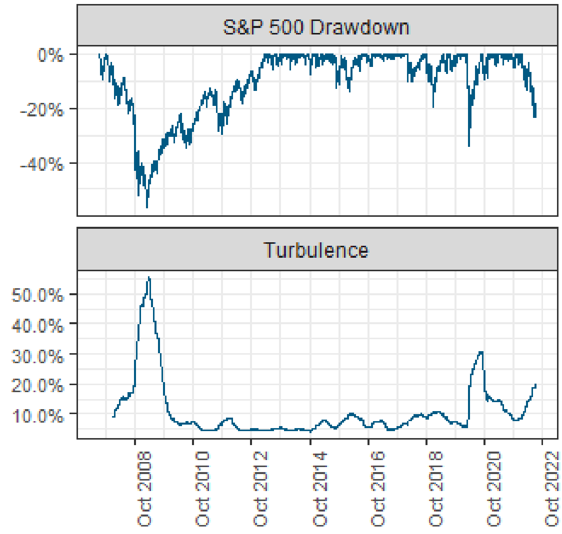
BRACING FOR TURBULENCE

In last quarter's Allocator's Angle we cited that our proprietary Turbulence Indicator, a quantitative tool that measures cross-asset correlations, alerted us to be wary of a market environment during which diversification may no longer afford the intended benefits. We noted that this indicator had risen to a level that is consistent with elevated portfolio volatility.

This observation prompted us to suggest that allocators may wish to move into a more defensive position, including temporarily increasing cash exposure to the upper range of policy targets to dampen portfolio volatility.

Importantly however, turbulent environments are not simply "risk off"; **Exhibit 1** below plots our measure of Financial Turbulence (bottom panel) vs. historical S&P drawdowns (top panel). The chart suggests that turbulence tends to rise during market crises but remains elevated after eye of the storm has passed and risk assets begin to recover. Having an increased cash exposure may be helpful during the drawdown phase, but too much cash may be a material drag when risk assets recover.

Exhibit 1: Choppy Waters Remain



Source: Bloomberg, Investment Office Resources calculations as of 30 June 2022

This prompted us to ask, what other assets may help institutional allocators navigate turbulent times? Said differently, what assets can help sidestep significant losses and compound returns at a higher capital base when market conditions normalize?

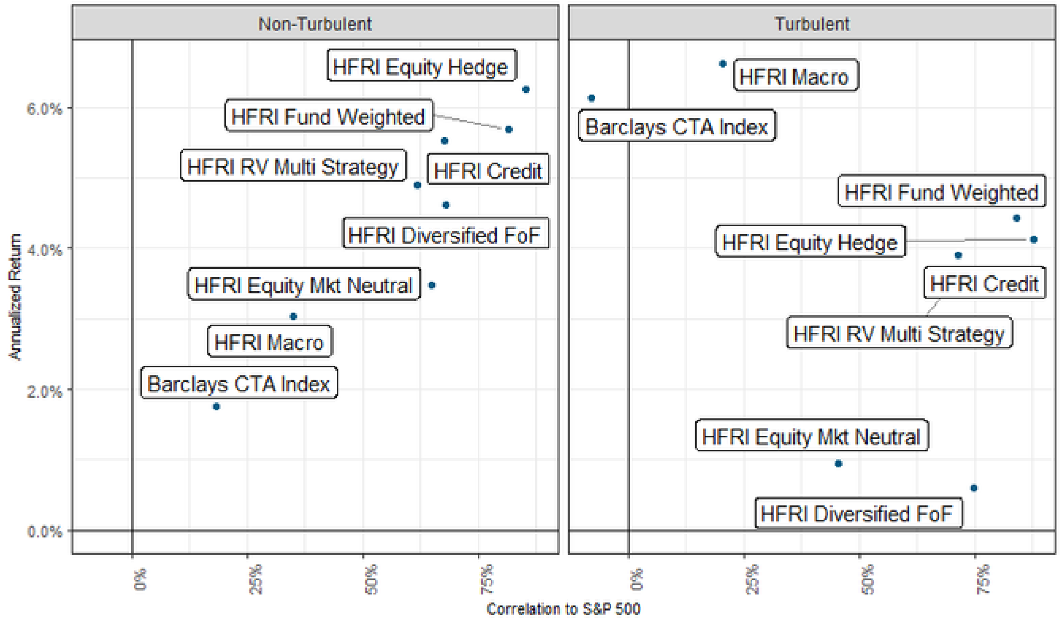
The most obvious answer to this question is hedge funds, which hold the promise of excess returns with low correlation to traditional asset classes. While we view hedge funds with a healthy dose of skepticism, we observe some hedged strategies may afford investors the benefits of diversification when it's needed most.

Exhibit 2 plots the annualized return of a diverse set of hedge fund strategies vs. their correlation to the S&P 500, a crude proxy for the dominant risk in most institutional portfolios.[2] We show this analysis during both turbulent and non-turbulent times. This chart yields several notable insights:

1. During non-turbulent times, returns appear strongly linked to the direction of the S&P 500. This suggests that allocators should study their managers closely to determine if the manager is delivering true alpha versus simply benefiting from beta.
2. Many strategies such as Credit, Equity Market Neutral, RV Multi-Strategy, Diversified Fund of Funds, and Equity Hedge, should not be relied upon as diversifiers; however, Macro and CTA managers exhibit low correlation to equities, and positive returns during periods of elevated financial turbulence. This suggests they may play a valuable role when other assets struggle to provide adequate portfolio protection.

In the sections below we explore these points in greater detail by analyzing how various hedge fund strategies may impact portfolio risk and return.

Exhibit 2: Are Hedge Funds True Diversifiers?



Source: Bloomberg, Investment Office Resources calculations as of 30 June 2022

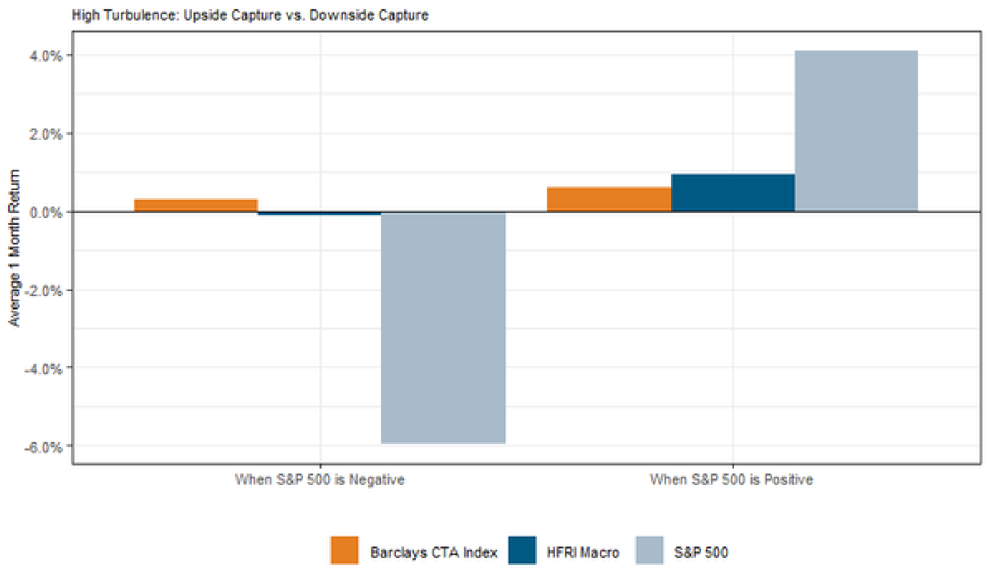
[2] We recognize there may be survivorship bias embedded in these indices, but that bias should be consistent across all hedge fund strategies.

A PRACTITIONER'S GUIDE TO RISK MITIGATION

As noted above, defensive assets such as cash play an important role in avoiding significant losses during turbulent times, but if taken too far or left in place too long, investors may forego upside when conditions improve. A balanced portfolio should, therefore, include line items with positive skew, managers that can protect capital during adverse market conditions and compound returns when conditions improve. **Exhibit 2 suggests Macro & CTA strategies fit this description, thus making them valuable components in institutional portfolios.**

Exhibit 3 further illustrates this point; it plots the upside/downside capture of Macro and CTA strategies vs. the S&P 500 when turbulence is high. The chart suggests Macro and CTA strategies generate modest returns when the S&P is positive but avoid significant losses when the S&P is negative. There is some intuition for why this may be the case. Macro/CTA strategies operate across multiple asset classes and have the flexibility to go long and short. This latitude enables managers to find shelters during periods of stress while other managers have a narrower playbook. **As a result, Macro and CTA strategies appear to act as diversifiers precisely when it's needed most.**

Exhibit 3: Improving Portfolio Skew



Source: Bloomberg, Investment Office Resources calculations as of 30 June 2022

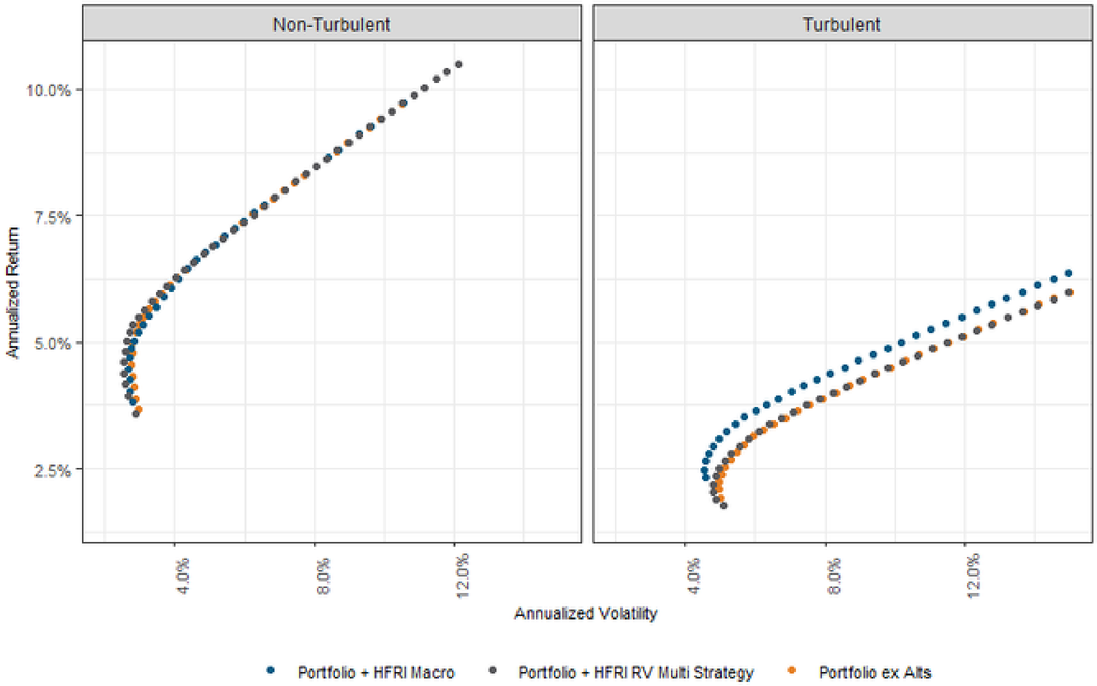
INCREASING PORTFOLIO EFFICIENCY

Macro and CTA strategies express positive skew that affords allocators unique portfolio construction benefits; namely, they may improve risk adjusted during periods of elevated Turbulence while other hedge funds struggle. To illustrate this point, we create two efficient frontiers that compare the impact of adding Macro vs. Relative Value hedge funds to a portfolio of equities, bonds, and commodities. The efficient frontier is calculated using the following parameters:

1. The portfolio is comprised of:
   a. Growth (S&P 500)
   b. Income (Bloomberg US Aggregate Bond Index)
   c. Real Assets (Bloomberg Commodities Index)
   d. Alternatives (HFRI Macro Index OR HFRI RV Multi-Strategy Index)
2. Return, Volatility and Correlation assumptions are based on historical monthly returns during non-turbulent and turbulent times respectively.
3. The Alternatives segment is capped at a 10% weight.

The results of this analysis are shown below in **Exhibit 4**. Notably, the chart shows that risk adjusted returns are significantly worse when turbulence high, thus suggesting that risk-averse investors should be keenly aware of how their portfolio is constructed for such environments. While neither group of hedge funds offers a meaningful improvement during non-turbulent times, we find the addition of Macro hedge funds leads to a significant outward shift in the efficient frontier during turbulent times. This implies that allocators should consider utilizing these strategies to improve the overall efficiency of their portfolio, particularly during turbulent times.

Exhibit 4: Diversification When It's Needed Most



Source: Bloomberg, Investment Office Resources calculations as of 30 June 2022

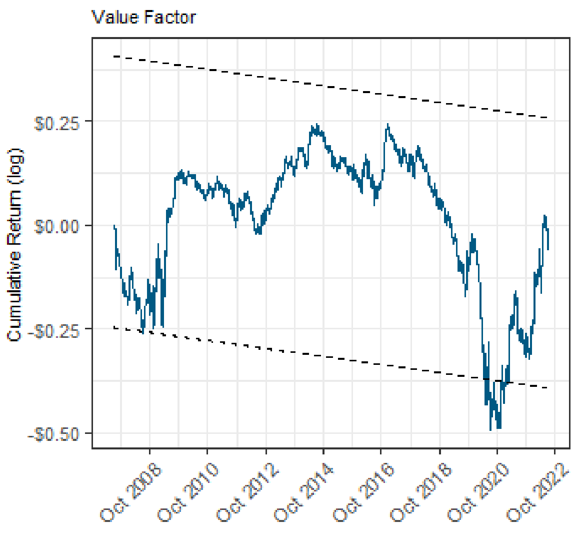
Importantly, we would not encourage allocators to blindly invest in any Macro or CTA manager. Our goal was merely to illustrate that those investors looking for diversifying returns may have better luck parsing through the universe of managers employing a Macro and/or CTA strategy.

UPDATE ON GROWTH VS. VALUE

After years of frustration, Value-oriented strategies are finally starting to shine as Growth oriented strategies face headwinds from rising interest rates. The resurgence of Value-oriented strategies was preceded by the Value factor breaching the lower 2 standard deviation band, and the Growth factor simultaneously breaching the upper 2 standard deviation band of their respective long-term trends. This observation gave us reason to believe the probability of a reversal was elevated, and the persistent outperformance of Growth may be exhausted.

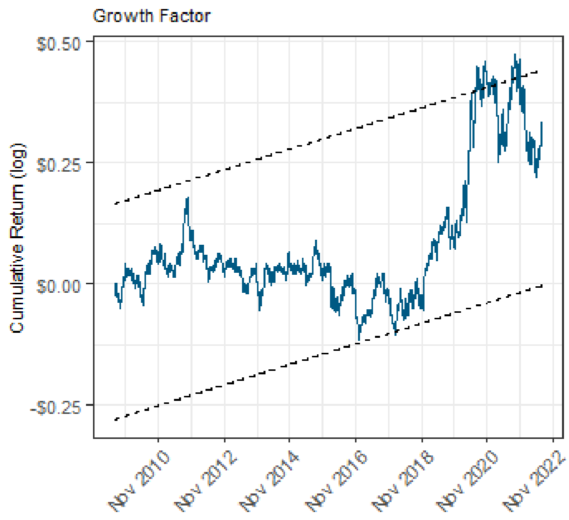
Now, after months of Value's outperformance, we no longer see a uniquely compelling entry point for allocators considering a rotation into Value-oriented strategies. At the time of writing this, the Value factor has risen 22.9% YTD, while the Growth factor has fallen -5.6%. This reversion has pushed the Value and Growth factors away from their respective 2 standard deviation bands, indicating the rubber-band is not as stretched as it once was. While there may still be room for further reversion in these two factors, the current setup is not as provocative as it was in 1H 2022.

Exhibit 5: Value's Blockbuster Start to 2022

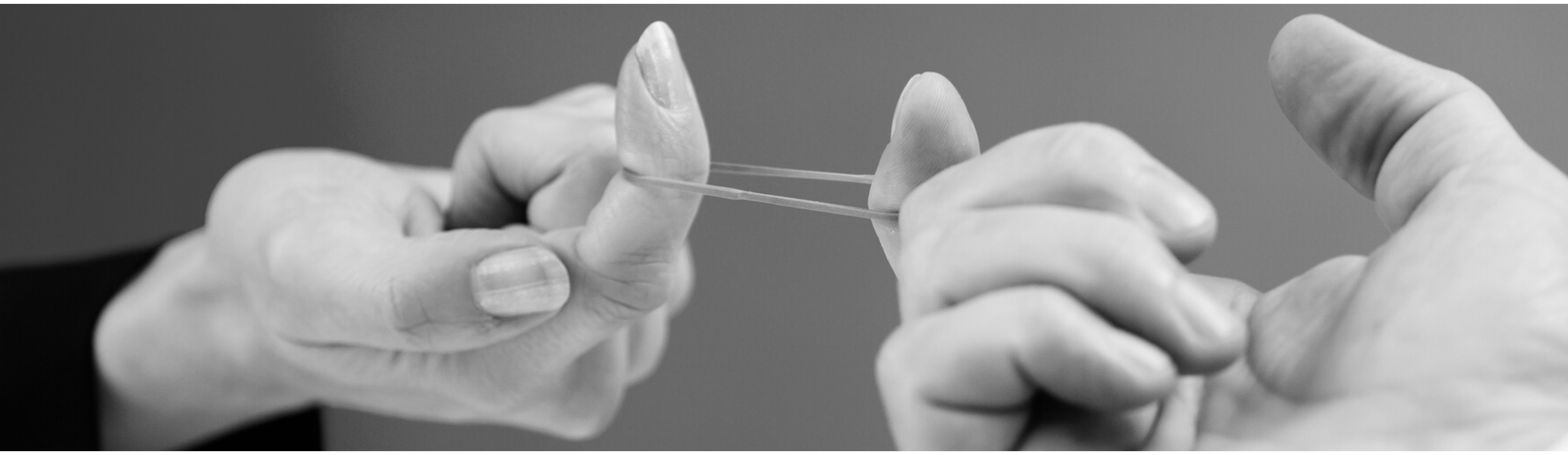


Source: Bloomberg, Investment Office Resources calculations as of 30 June 2022

Exhibit 6: Growth Under Pressure



Source: Bloomberg, Investment Office Resources calculations as of 30 June 2022



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