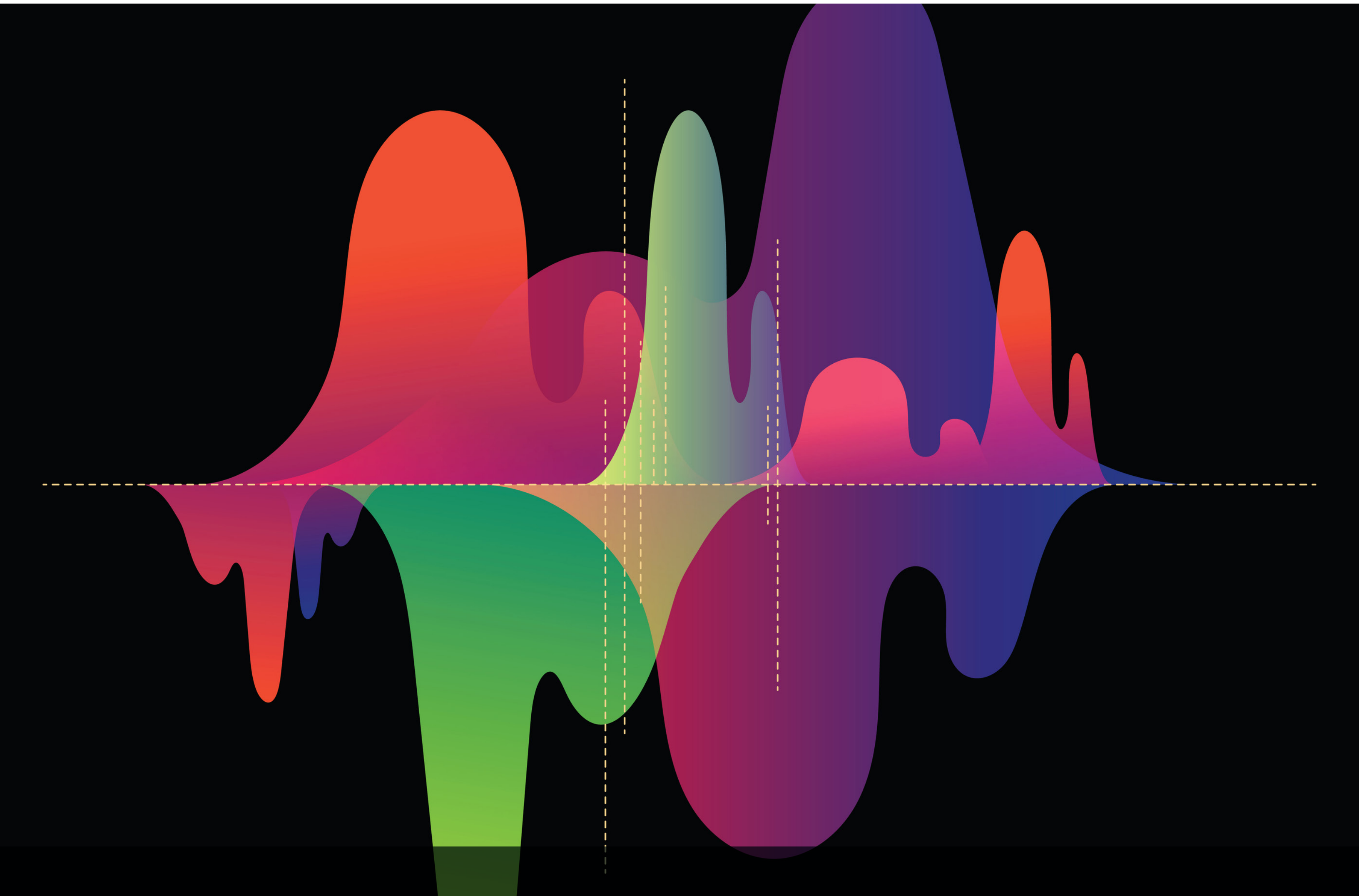
iCapital



CYCLICAL TRENDS AND STRUCTURAL ALPHA - ENHANCING RETURNS IN CLIENT PORTFOLIOS

"Indexing, or passive management has become increasingly popular in recent years. If and when economic or company fundamentals turn unfavorable, the large, blue-chip, high-multiple growth stocks will return to more 'normal' valuation levels. This will mean a decline in stock prices – in some cases a substantial decline." Source: MarketWatch, January 2000

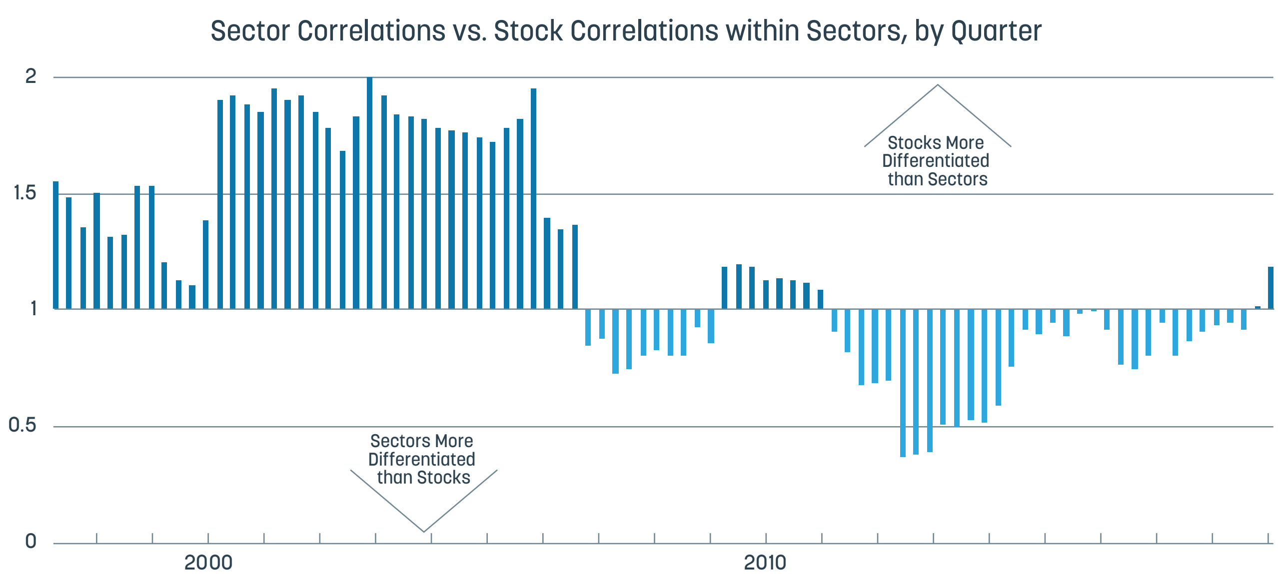
Market participants would be forgiven for assuming the above observation was recent, given the numerous articles on the rise of passive investing, the apparent demise of active management and the dominant performance of the S&P 500 Index. However, this excerpt was taken from an article written almost twenty years ago that proved prophetic. Shortly after it was published back in early 2000, the S&P 500 suffered through a lost decade of performance, with a cumulative return of negative 40% into early 2009.

Cyclical trends are easy to explain with the benefit of hindsight, and the recent cycle of passive fund flows into large-cap equities will someday provide similarly interesting context. Over the past year the S&P 500 Index has outperformed the Russell2000 by nearly 13%, with large caps producing a positive 4% return as small caps declined by 9% through May 31st. The last time U.S. equities had that level of dispersion with positive large-cap and negative small-cap performance was back in 1999, just a few months prior to the above-referenced article, and less than a year before the equity peak in March 2000.

Experienced advisors understand the impact that cyclical trends can have on client portfolios, and the top-performing funds typically rebalance ahead of any sort of trend reversal to lock-in gains and limit future downside volatility. We have been in a long-term trend of large-cap, U.S.-oriented passive strategies outperforming all other types of funds across the global and market capitalization spectrum for over ten years. Yet, as the following chart reflects, this decade-long trend may have already begun its reversal. According to BofA Merrill Lynch, the movement of individual stock prices had a wider outcome dispersion than equity sectors over the past 2 quarters, reflecting a reversal as compared to past 7-8 years (when sector movement was the dominant driver of market activity). Pick the right sector, sit back and reap the benefits. Today, the importance of individual security selection within and across sectors both long and short has surpassed the impact of sector-level allocation decisions, benefiting active management.

Clearly, cyclical trends can last for quite a while, often trying investors' patience in maintaining the requisite level of portfolio diversification. In today's market, it is easy for investors to feel comfortable with an "overweight" position in the S&P 500 Index, given its outperformance and the perceived diversification of owning 500 stocks in a single investment. Few investors appreciate the fact that just 1% of its holdings, e.g. the 5 largest constituent companies (Microsoft, Apple, Amazon, Google and Facebook) comprise over 15% of the Index and have an average correlation of 65% to each other over the trailing 12 months. The lack of portfolio diversification from holding highly correlated assets typically becomes a problem only after trends reverse.

Stock Picker's Market:
Individual share prices moved more independently of one another than equity sectors in the first quarter



Source: BofA Merrill Lynch US Equity & US Quant Strategy analysis of FactSet data

Aside from assessing and managing these cyclical trends, advisors must also identify areas of the market that provide structural inefficiencies in order to extract alpha. Alpha can be defined in a variety of ways, and beyond a standard statistical definition[1]; "anything that's not beta" and "how managers earn their fees" are pretty accurate descriptions. At its core, alpha can be considered as a measure of differentiation vs. other securities, other money managers, or even other financial advisors. We all strive to provide clients with multiple sources of alpha in their portfolios across changing market conditions.

For some advisors, this differentiation can be accessed through investing with emerging hedge funds. The "alpha" in this approach can take different forms, including:

ALIGNMENT OF INTEREST: Let's assume that a $200 million fund and a $2 billion fund both charge a 1.5% management fee, that equates to $3 million or $30 million in revenue, respectively. Both funds have roughly similar fixed costs of salaries, office space, legal, compliance, technology, etc., after which the "residual" amount is likely to be dramatically different between the two funds, even with the larger fund presumably carrying a higher overhead. This makes the incentive fee far more important to the smaller fund's management, increasing their motivation to generate returns. For newer funds, without a lengthy track record the impact of a drawdown is far more detrimental, so downside risk management is even more critical. And, while larger GPs may have more aggregate dollars invested in their funds, emerging fund managers typically have the majority of their liquid net worth invested alongside their investors, creating additional alignment with limited partners.

DEEP DOMAIN EXPERTISE: Not all funds are created equal. Globally diverse multi-strategy approaches, activist engagement in complex, process-driven situations with multi-national conglomerates and sophisticated quantitative strategies require significant scale to be successful. However, certain strategies with a dedicated focus on a specific market niche provide smaller funds the ability to dynamically allocate capital as liquidity increases and market conditions shift over time. For example, technology and healthcare provide a continuous source of "winners and losers", creating a terrific backdrop for active long-short investing. International exposure provides similar outperformance opportunities for managers running comparatively small pools of capital, as markets outside the U.S. are typically not as deep or liquid (or efficient).

REDUCED COMPETITION: One of the primary concerns for investors relates to the "crowding effect", with too many dollars flowing into fewer securities. As successful funds grow in size, they typically move up the capitalization spectrum. These stocks are more likely to move in tandem, driven by flows and macroeconomic drivers more than company-specific factors. Conversely, securities that don't typically trade in passive ETFs are far more likely to be impacted - positively and negatively - by company-specific events. This backdrop lends itself to actively managed long/short investing, with smaller funds able to express conviction in these less correlated securities in the form of larger position sizes, without the corresponding illiquidity risk that can adversely impact larger funds.

INVESTOR T.L.C.: Many early-stage funds have delivered high-quality, differentiated performance over time, and are able to provide investors with more Transparency, better Liquidity and lower Cost when compared to their larger peers. Transparency in terms of timely access to people and information; liquidity of their positions and terms offered to investors; and potentially lower management and/or performance fees paid by their LPs.

Today, the importance of individual security selection within sectors has surpassed the impact of sector-level allocation decisions, benefiting active management.

Cyclical trends in public equities: active vs. passive, large-cap vs. small-cap, U.S. vs. international, etc., provide opportunities for advisors to improve client portfolios through tactical asset allocation. Accessing areas of the market that are less structurally efficient also offers the potential for higher returns and lower volatility. In public equities certain newer, smaller funds with an ability to dynamically shift exposures long and short can provide a valuable source of outperformance. Investing in funds that are suitably liquid, appropriately sized, structurally differentiated, with lower costs, greater transparency and deep domain experience can make a significantly positive impact in portfolios, especially as certain long-term trends show signs of fatigue.

Joseph Burns
iCapital Managing Director,
Head of Hedge Fund Due Diligence

END NOTES

[1] "The measure of the performance of a portfolio after adjusting for risk. Alpha is calculated by comparing the volatility of the portfolio and comparing it to some benchmark. The alpha is the excess return of the portfolio over the benchmark." Source: https://financial-dictionary.thefreedictionary.com/Alpha