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# PROTECTING WEALTH:

## TRADITIONAL VS. ALTERNATIVE SOLUTIONS

**Clients and advisors have so many choices in today's environment, spanning global markets and asset classes with investments varying dramatically across the liquidity, volatility and strategy spectrum. Call it the "Paradox of Choice" – too many investors are left taking a reactionary approach to portfolio management, given the overwhelming level of available alternatives.**

Ultimately, portfolios have just two primary components: investments designed to generate returns, and those meant to minimize risk. Stated differently: capital appreciation and wealth preservation. These components have traditionally been equities and fixed income, and each asset has been relatively uncorrelated to the other over time, providing some level of diversification. Plus, when market volatility spikes, this historical "stock/bond" relationship often becomes negatively correlated, resulting in even greater portfolio diversification — precisely when it has been needed the most. For example, the two worst years of performance for equities over the past two decades were 2002 and 2008, with the S&P 500 Index declining by -22% and -37%, respectively; these years provided two of the best returns for investors in Treasury Bonds, with gains of +15% and +20%, respectively.[1]

With so much focus (and concern) recently regarding the outlook for equity returns, the risk of investor complacency regarding their "low risk" bond allocation might be the more insidious cause of future disappointment, especially in what looks to be a structurally challenging environment for fixed income markets on the horizon. In fact, while many equity indices continue to hit all-time highs, the difficulties impacting traditional bonds have already surfaced, for reasons that appear to be long-term in nature.

Since the 10-year Treasury Bond yield bottomed in the Summer of 2016, a few important developments have commenced, with others seeming more likely as we look ahead. Specifically:

- **The Federal Reserve** announced the end of its Quantitative Easing program, with the goal of normalizing its balance sheet
- **The yield curve** has flattened, with the spread of 2-year vs. 10-year bonds decreasing from roughly 1.0% to less than 0.3%[2]
- **The Treasury Department** predicted that the U.S. government's borrowing needs in the second half of 2018 will jump to the most since the financial crisis a decade ago[3]
- **U.S. government debt** exceeded $20 trillion, more than double the level prior to 2008[4]
- **The BofA ML US High Yield Master II** Option-Adjusted Spread fell from 890bps to 340bps[5]
- **The Fed** raised interest rates 6 times, with future rate hikes expected

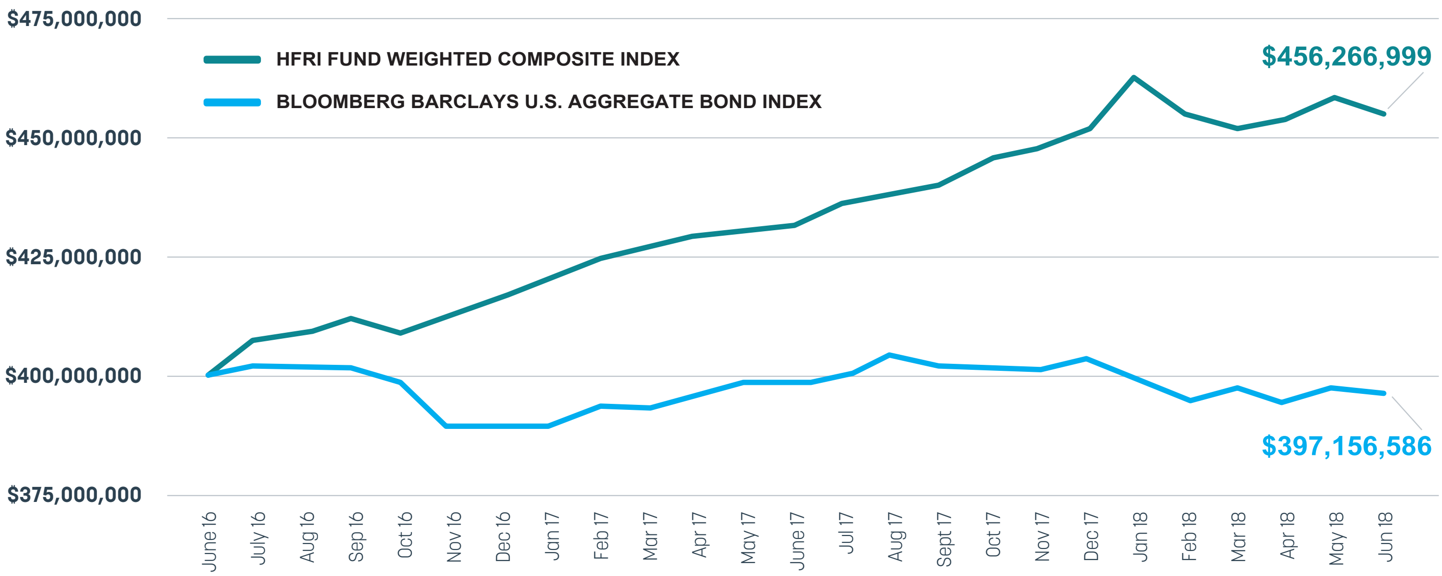
The outlook for fixed income is impacted by many of these factors in terms of market liquidity, potentially deteriorating fundamentals and technicals, interest rates, credit spreads, and overall return expectations. While these factors don't seem as scary as sharp declines in equity markets — and might feel like "tomorrow" problems, in some respect — these challenges have had an adverse impact on client portfolios for the past couple of years.

Take, for example, an Advisor with $1 billion in client assets, invested with a traditional 60% equity and 40% bond allocation. How has the fixed income portion of the portfolio performed over the past 2 years, as compared to a sample hedge fund investment?

Not too well, it turns out:

## COMPARATIVE PERFORMANCE: BONDS VS. HEDGE FUNDS

FOR THE PERIOD JULY 2016 – JUNE 2018




Source: Evestment , For Illustrative Purposes Only

The $400 million invested in fixed income, as referenced by the Bloomberg Barclays U.S. Aggregate Bond Index shown in the above table would have lost nearly $3 million (down roughly 1% cumulatively). Over that same 2-year period hedge funds, as measured by the HFRI Fund Weighted Composite Index gained just over 14%, which would have resulted in a portfolio gain of $56 million. Interestingly, both indices generated these returns with a realized volatility of less than 3%.

Clearly, hedge funds have not kept up with equity markets over the past decade; and if the next 10 years mirror the past 10, that may be the case going forward. Putting equity market return assumptions and the desire for capital appreciation aside, advisors must be increasingly cognizant of the wealth preservation portion of their clients' portfolios. If the factors that have negatively impacted fixed income markets are indeed persistent and structural in nature, then identifying alternative solutions to protecting client wealth remains mission critical, with select hedge fund and alternative credit strategies well-positioned to serve that purpose.

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END NOTES

[1] Source: http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html

[2] Federal Reserve Bank of St. Louis, 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity [T10Y2Y], retrieved from FRED,
Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/T10Y2Y, August 23, 2018.

[3] https://www.bloomberg.com/news/articles/2018-07-30/treasury-raises-borrowing-outlook-with-2h-hitting-769-billion, August 23, 2018.

[4] https://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo5.htm

[5] https://fred.stlouisfed.org/series/BAMLH0A0HYM2

[6] The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 1,500 single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in US Dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds..The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

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