ALTERNATIVES IN A MULTI-ASSET PORTFOLIO

AMP Capital has exposure to a diversified mix of alternative investment strategies ("alternatives").

This guide seeks to provide a broad overview of the different types of alternatives, from defining what they are to understanding their role in multi-asset diversified portfolios. We also highlight some of the alternative managers we invest with and the process by which we select managers in this space.

INVESTING IN ALTERNATIVES

Investing in alternatives offers both compelling portfolio advantages as well as significant challenges. We believe that alternatives can deliver attractive risk-adjusted returns on a stand-alone basis while also bringing diversification benefits to an overall multi-asset portfolio. Alternative strategies access a broader investment universe outside of traditional asset classes, such as equities and bonds.

However, along with the benefits, there are also challenges to investing in alternatives. Some of these challenges include higher fees relative to traditional investments, less liquidity, and resourcing for the level of due diligence required. At AMP Capital, our Alternatives Team partners with some of the highest quality firms in the world to research and manage market leading strategies. We also have the added benefit of a strong governance framework to ensure that the highest standards in due diligence are met, while our scale helps us to gain the most favourable pricing possible.

DEFINING ALTERNATIVES

The definition of alternative assets and strategies across the industry is very broad with the term meaning different things to almost all investors. Typically, alternative assets include anything that does not fall into the traditional fixed income listed equity buckets. For example, alternative assets may include infrastructure, property, agriculture, and private equity. Alternative assets can also be opportunistic investments that span across asset classes or investments which are expected to offer some diversification features to equities and fixed income. It may also be assets classes that are new.

Alternative strategies, on the other hand, may include hedge funds and their sub-strategies as well as absolute return strategies. We define absolute return strategies as long / short investments that aim to deliver consistent returns above cash which are not measured against a benchmark. The focus of this guide will be on a sub-component of alternative strategies, specifically hedge funds and absolute return strategies.

Table 1: Alternative assets and alternative strategies

Alternative assets	Alternative strategies
• Currency • Commodities • Agriculture • Real estate • Infrastructure • Real assets • Private equity	• Hedge funds o Equity long-short o Event driven o Relative value o Global macro o Managed futures o Multi-strategy • Absolute return

ROLE OF ALTERNATIVES IN MULTI-ASSET PORTFOLIOS

Alternative strategies are attractive investments as they are expected to deliver excess returns above a traditional investment benchmark (alpha) as well as provide diversification benefits multi-asset portfolios. When done well, we believe that alternative strategies can help multi-asset portfolios achieve their target returns with lower overall volatility and lower exposure to risk of extreme losses.

Investors typically invest in alternatives for the following reasons:

1. As another source of returns that is not reliant on traditional asset classes (e.g. agriculture)
2. To provide diversification away from market risk (beta) towards strategies which are more reliant on investment skill (alpha) (e.g. hedge funds)
3. To reduce a portfolio's overall volatility as these strategies tend to be less volatile than equities and have typically exhibited lower correlations to other growth assets (e.g. absolute return funds)
4. To take advantage of market inefficiencies, illiquidity premiums, and opportunities that are not usually possible with traditional listed equity investments (e.g. private equity)

Alternative strategies utilise a combination of asset classes which have varying degrees of equity correlation. Equity correlation measures how closely the strategy returns move in sync with a traditional equity benchmark - the lower the correlation, the more diversification benefits the strategy is expected to deliver.

Table 2: Defining single and multi-strategy alternative strategies, their equity correlation and return drivers

Single strategy alternative strategies	Equity correlation	Strategy definition and asset classes	Key return drivers
Equity long / short	Variable	Long and short equity securities	Net equity exposure, geographic, sector and security selection
Managed futures	Low / Variable	Long and short equity, fixed income, currency, and commodity futures	Formation of market trends across deep, liquid markets
Global macro	Low / Variable	Long and short positions in equity, interest rates, currencies and commodities	Analysis of macroeconomic fundamentals
Event driven	Variable	Long and short equity and / or credit instruments to exploit mispricing as a result of corporate events	Realisation of value from key corporate events
Relative value	Low	Long and short equity, fixed income, derivatives or other securities on the basis that price discrepancies should normalise	Discrepancies in prices among securities with similar characteristics
Equity market neutral	Low	Long and short equity securities where the net equity market exposure is minimal	Quantitative and/or qualitative techniques to analyse mispricing associated in equity markets

Multi-strategy alternative strategies	Equity correlation	Strategy definition and asset classes	Key return drivers
Multi-manager, multi-strategy (e.g. Fund of hedge funds)	Low / Variable	Investments in a diversified mix of managers employing different alternative strategies	Strategy allocation decisions and manager selection
Alternative beta (e.g. Style risk premia or hedge fund risk premia)	Low / Variable	Factor-based investing aimed to capture alternative risk premia (style risk premia or hedge fund risk premia)	Long-term market inefficiencies created by investor behavioural biases
Opportunistic	Low / Variable	Flexibility to pursue direct and indirect investments across asset classes, geographies and liquidity profiles; typically medium-term opportunities (2-3 year duration)	Taking advantage of market dislocations in timely and efficient manner

In environments where the valuation case for traditional asset classes can be arguably stretched, alternative strategies provide a means for investors to re-allocate away from equity markets, credit and fixed income, but still target growth-like returns. The lower expected correlation these alternative strategies have with other asset classes also provide the added benefit of dampening any market drawdowns.

Table 3: Correlation of hedge funds versus traditional asset classes

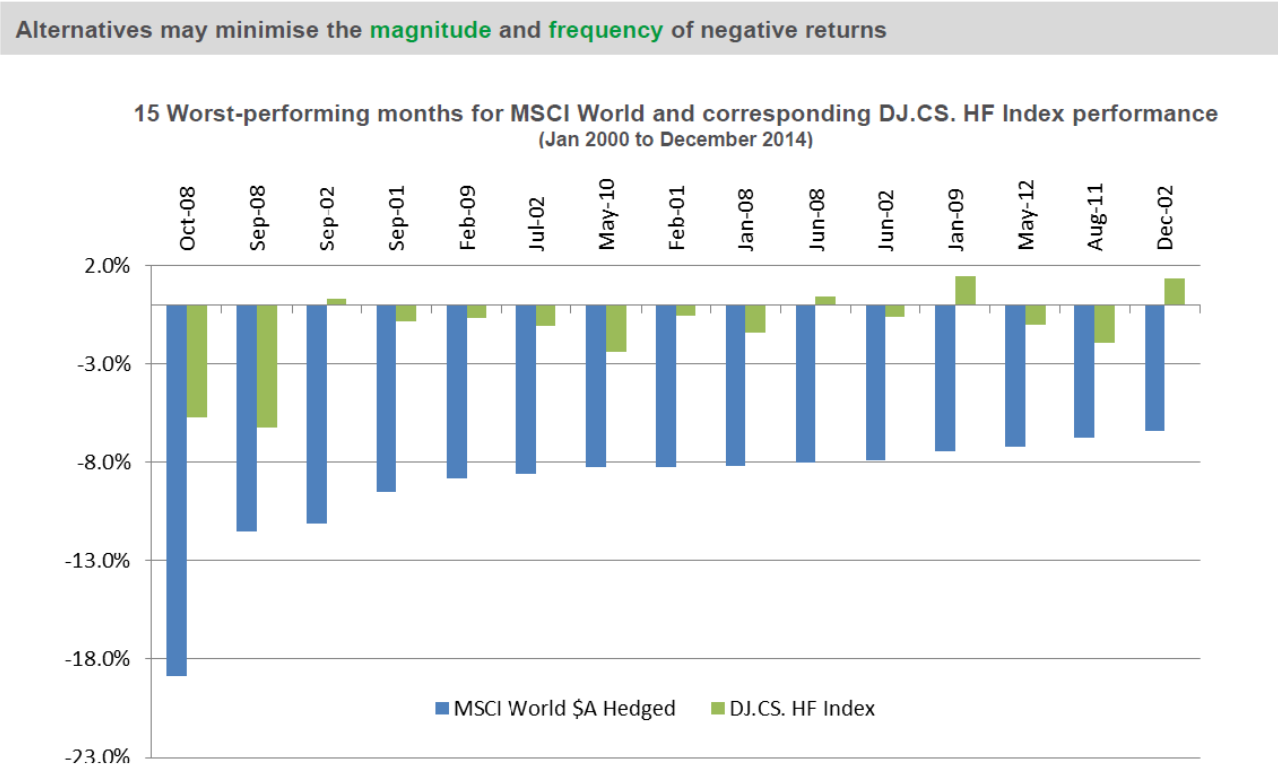
	HFRXGL	*SPX*	*MSCI World*	*Barclays Agg.*	*GSCI*	*NAREIT*
US equities (SPX)	0.55					
Global equities (MSCI World)	0.63	0.97				
Aggregate bonds (Barclays Agg.)	0.26	0.16	0.29			
Commodities (GSCI)	0.49	0.29	0.38	0.24		
Real estate (NAREIT)	0.56	0.74	0.8	0.45	0.3	
Cash (3M Libor)	-0.18	-0.07	-0.13	-0.31	0.02	-0.11

Source: AMP Capital as at August 2015

One could argue that another way to reduce a portfolio's risk levels is to sell equities in favour of a higher weighting to bonds or cash. While this is possible for more conservative portfolios, which have lower investment objectives, we believe that there are a few drawbacks to this approach. Firstly, investing in bonds can introduce interest rate risk and secondly, bonds offer probably the lowest returns of any asset class over a medium-term horizon. Moreover, de-risking portfolios into cash can only be a tactical move as doing so reduces a portfolio's ability to meet its long-term return objectives. As such, diversifying a portfolio away from equities or other growth assets into alternative strategies helps to maintain the total portfolio's long-term expected return, while reducing market risk (or beta) and potential drawdown during periods where returns are expected to be volatile.

To illustrate the potential for alternative strategies to reduce a portfolio's overall volatility, Chart 1 compares the Dow Jones Credit Suisse Hedge Fund Index with the MSCI World Index during periods of market stress between 2000 and 2014. What we see is that while investors should not expect these strategies to produce a positive return in all market environments, they should expect to see alternative strategies helping mitigate the impact of drawdowns. For the 15 worst performing months for global equities between 2000 and 2014, hedge funds, as represented by the Dow Jones Credit Suisse Hedge Fund Index, sustained less severe losses and even generated positive returns in a few of those months.

Chart 1: Performance of hedge funds against global equities during market stress



Source: Blackrock as at December 2014. Past performance is not a reliable indication of future performance.

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