Transcript

Better conversations. Better outcomes.

Episode 1.3 – Alternative investments: exploring the opportunities

Lowell Yura - What liquid alternatives can do is make the ride a bit smoother and help advisors diminish the likelihood of clients making poor investment decisions due to market volatility. So anything that we can do as an industry to help smooth the ride for clients and keep them in their seats is a good thing. Liquid alts can do a great job diminishing poor behavior by making the ride a lot smoother than if you didn't have them in your portfolio.

Ben Jones - Welcome to Better Conversations, Better Outcomes, presented by BMO Global Asset Management. I'm Ben Jones.

Matt Smith - And I'm Matt Smith. In each episode, we'll explore topics relevant to today's trusted advisors, interviewing experts and investigating the world of wealth advising from every angle. We'll also provide actionable ideas designed to improve outcomes for advisors and their clients.

Ben Jones - To learn more, visit us at bmogam.com/betterconversations. Thanks for joining us.

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Ben Jones - Welcome to episode three of Better Conversations. Better Outcomes. The category of alternative investments includes a wide variety of investments that typically don't fit into traditional asset classes, such as stocks, bonds, and cash. It can be an important part of a client's portfolio, but it can be different to understand and communicate to clients. In this episode, we talk about the value of adding alternatives to your clients' portfolios, what to consider when adding them, and how to understand the wide range of characteristics and the types of risks that these investments might hold. Matt Smith sat down with Lowell Yura, head of Multi-Asset Solutions at BMO Global Asset Management in Chicago.

Matt Smith - The listeners are sure this is an authentic interview in Chicago.

Lowell Yura - Yes.

Matt Smith - With the authentic street noise behind us. My goodness. Why don't you introduce yourself and just give us a very brief background of your career?

Lowell Yura - Sure. Lowell Yura. I'm the head of Multi-Asset Solutions here at BMO Global Asset Management. Got about 25 years of experience. Spent a lot of time, prior to joining BMO, with large institutional investors including sovereign wealth funds, central banks, and in large public funds and corporate funds, as well as working with private client entities. The evolution of the multi-asset world has changed rapidly over that time period, and the role of liquid alts is something that all multi-asset teams, including ours here at BMO, are spending a lot more time thinking about.

Matt Smith - Before we go further, I want to take a moment to remind the listeners that we're having a drawing to show appreciation to our early adopters of the show. We cover all the details on how to enter at the end of this episode. If you've already given us a review on iTunes or Google Play, thank you for your review.

Ben Jones - Lowell explains what the alternative investment category is from a high-level view and what case can be made for adding them to a client's portfolio. But first, he describes what he and his team does.

Lowell Yura - Yeah, so we're responsible for managing the firm's multi-asset strategies, and there are two main types of strategies that we are focused on. One is traditional balanced portfolios of different levels of risk, and the others are target-date funds. So very traditional strategies that clients don't expect to have a lot of surprises in.

Matt Smith - So you make some liquid alts. Let's even take a step back from that to the alternative investment category. Can you just give our listeners a brief description of what alternatives are relative to traditional investments?

Lowell Yura - Yeah, it's an interesting term. Alternative to what? I think, simple terms, the best way to think about alternatives is it's something that's alternative to stocks and bonds. Most investors have traditionally relied on stocks and bonds to generate returns. And alternatives are simply the “everything else” basket. It's very simple that they are driven by different factors. For example, the equity markets are driven by the business cycle, right? If the business cycle and the economy is going well, we would expect equities to be doing well. Likewise, if the business cycle is doing well, you'd expect interest rates to go up, and perhaps bonds not doing as well. And in periods of crisis, you'd expect bonds to do well as interest rates fall. It's not always the case, but that's typically what's driving portfolios. The interesting thing is that, even in a 60/40 portfolio, what you find is that equities drives about 90% or more of the risk in those types of portfolios. And so you've got a portfolio that's very heavily dependent on the business cycle and whether it's growing or not. Alternatives introduce other risks into the portfolio, or other exposures into the portfolio that are not necessarily driven by the business cycle. It's as simple as that. Setting expectations about why you own these managers, you own them because you want less reliance on the business cycle in this portfolio. Number two, you believe returns are going to be lower, and we certainly believe returns are going to be lower because bond yields are so low. You're getting less out of bonds. It's the same with any portfolio decision that you would ever make. It's either going to increase returns at the same level of risk or generate similar returns with less risk. So we're looking for portfolio efficiency. And quite simply, what you're looking for is some type of exposure that you either don't have enough of in your portfolio, or you don't have it all. And if you can't answer those two questions, what exposure am I looking to replace in this portfolio that I don't have enough of or I don't have at all, then you shouldn't add that type of strategy. And liquid alts, in general, have a lot of exposures that are underrepresented in client portfolios today.

Matt Smith - So what would be some typical asset types that you would find in the alternative investment category?

Lowell Yura - If you take the highest level of alternatives, you could include things like commodities and other real assets like infrastructure. Real estate to some extent. So those are alternative and some of them do have a lot of exposure to the business cycle, but less so. Then there is the entire other segment of the market, which we think is actually more interesting. And that is some of the more hedge fund like strategies. Why are those interesting? Those are strategies that are reliant more on manager's skill than traditional equity and bond strategies. So the successes of those strategies are based on inefficiencies that managers have found in the market that they've been able to take advantage of. It's that skill that is less reliant on the direction of markets that we're after.

Matt Smith - You mention the term liquid alternatives. Some of those investment types or those asset types, that you mentioned in the alternative category, are by nature either illiquid or hard to value on a frequent basis. What is different about a liquid alternative vehicle than other types of alternatives?

Lowell Yura - The liquid alternative space, because it's regulated by the SEC and the 40 Act, you're required to price these on a daily basis and strike a NAV. And they're invested in mostly liquid instruments where you tend to see some illiquid instruments within these portfolios is in the credit space. It's no different for high-yield bond fund. We would argue that those are the same types of risks that are in a portion of the liquid alternative space. But it's really limited to that space. The vast majority of liquid alts operate in our equities and whether you're long or short equities doesn't really matter. The liquidity is still there. All of this, you can use 2008 as the evidence of there is liquidity there. None of these things that I'm going to talk about had any problems during the 2008 crisis. The only thing that had problems were the credit markets, and that's not unique to liquid alts. It's just issues with the credit market, whether it's traditional long-only core bonds that have a lot of corporate bond exposure, or high-yield. Those would have the similar types of risk. So when you think about the portfolios that we're talking about, these liquid alternative portfolios, 90% of these portfolios are made up of the same instruments that you will see in traditional long-only equities, traditional long-only bond portfolios, and other types of mutual funds that have proven to be very resilient to liquidity issues. We don't want to minimize the risk when it comes to credit, but that also applies to long-only fixed income portfolios.

Ben Jones - Now that we have a broad overview of what's included in the alternatives category, and specifically liquid alternatives, let's dive into the best way to allocate to alternatives.

Lowell Yura - We think the best way to allocate to liquid alts, particularly the hedge fund like liquid alt strategies, is to have some breadth, just like you would with equities. You want large cap managers, you want small cap managers, you want US, you want non-US. You want hedge fund like strategies that operate in different parts of the market. And you also want different types of strategies. So you want, for example, a handful of long/short equity managers. But ideally, you want them operating in different parts of the market, some in the US, some outside the US, some in large and some in small. You want that breadth. And then you want other types of markets where these managers are operating in. So for example, macro is very important because macro is something that you often get less exposure to in a traditional stock/bond portfolio. So here you're looking for managers that can take advantage of central bank policy, deviations, and do that really across all markets, fixed income, equities, as well as FX. And a lot of times, you don't have that type of breadth in the traditional part of your portfolio. And then things like option managers or volatility managers can take advantages of inefficiencies in the options market. Very simply, here's an example, people will pay a premia for downside protection. It's just like buying insurance. There is a certain amount of premia that can be gained by selling downside protection to the market in a risk-controlled framework and collecting that premium. Selling volatility is a strategy that is proven over time, within a risk-controlled framework, to be something that provides some return that is less dependent on the direction on markets. Those types of strategies are helpful in two different ways. One is they provide some exposures that you wouldn't otherwise get. For example, volatility as an exposure you wouldn't otherwise get in a portfolio. Volatility, credit, currencies. And then you get skill. You get a greater proportion to skill. So we like to see anywhere from half a dozen to a dozen managers in the portfolio. We don't want to over diversify, but we certainly don't want to have just one or two managers because you're missing a broad opportunity set.

Matt Smith - Are there any specific risks to using multiple managers? One that comes to mind is you have independent managers making decisions in their portfolio. But inadvertently, you could have several of them taking on the same risk and concentrating a risk in something, just inadvertently. How do you manage the special risks that come with using multiple managers?

Lowell Yura - That is the main risk of a multi-manager approach. You want this portfolio to be diversified. You don't want all the managers taking the same bets. Most of that can be taken care of at the portfolio construction level. When you select the managers, you're ideally selecting managers that don't cross over into each other's space. It doesn't happen very often, but you do find certain situations where some of the risks are on the same side. And what you can do, and what we do in our portfolios, is we have a sleeve within our portfolio that allows us to hedge out some of that risk. So very simply, for example, if we expect our equity long/short managers to on aggregate have a market beta of 0.3 and we wake up one day and we look at their portfolios through our risk tools and it’s 0.6, we can short some S&P 500 futures contract very simply to bring that market exposure down to 0.3. And that's a really effective way to do that. The other important thing about fund of funds and liquid alts in general, is you want to think about them in the context of what else you own. And so when we allocate to liquid alts, within our traditional target risk funds or our balanced strategies, we're constantly monitoring the risks that our managers are taking in relationship to the rest of the portfolio, which is the 60/40 portfolio. So for example, if we expect a certain amount of interest rate or equity risk or non-US or US risk coming out of this portfolio and it meaningfully deviates from what we expect, we might take action in the portfolio, or at least be aware of it. When you're monitoring risk, you need to think about it at the overall portfolio inclusive of the rest of your portfolio. And I think that's an important point there is you want monitoring at the single asset class level or the liquid alt level, but you also want it in perspective of the 60/40 level.

Matt Smith - What advice do you have for advisors who understand alternatives, believe that it adds value to their clients' portfolios? Do you have any advice for the advisor on how they would talk to their clients about using alternatives in a portfolio?

Lowell Yura - Yeah, I think that's the hardest job here. And I think, number one, is upfront setting expectations with investors is absolutely critical. The reason for that is something we talked about before. A lot of the sources of return are based on skill and not market exposures, and that's what you want. But what comes with that is performance that can deviate very wildly from the market. If the markets are going up a lot, you need to set that expectation that that's not why you own liquid alternatives. Likewise, if the markets are trending sideways, you need to explain what you'd expect from this manager. A lot of the success of the liquid alternative program comes from picking the right manager because you want to pick the right managers to deliver that skill. Just like with traditional long-only managers, liquid alt managers will go through periods of underperformance and outperformance. And you need to manage those expectations in periods of underperformance so that you have investors holding on throughout the cycle and benefiting from the liquid alternatives. And I think that's why the fund of funds approach makes a lot of sense, because the volatility around single manager performance is diminished and will help alleviate some of the concerns about periods of underperformance. Going back to what I said earlier, setting expectations about why you own these managers, you own them because you want less reliance on the business cycle in this portfolio. Number two, you believe returns are going to be lower, and we certainly believe returns are going to be lower because bond yields are so low. You're getting less out of bonds. It's the same with any portfolio decision that you would ever make. It's either going to increase returns at the same level of risk or generate similar returns with less risk. So we're looking for portfolio efficiency. Quite simply, what you're looking for is some type of exposure that you either don't have enough of in your portfolio, or you don't have it all. And if you can't answer those two questions, what exposure am I looking to replace in this portfolio that I don't have enough of or I don't at all, then you shouldn't add that type of strategy. And liquid alts, in general, have a lot of exposures that are underrepresented in client portfolios today.

Matt Smith - What is your opinion for, let's say a typical 60/40 portfolio? 60% equity, 40% bond. If your team were managing that profile, about how much of that 100% would be allocated to alternatives?

Lowell Yura - We like broad alternatives. We like to have 15% of our 60/40 portfolios, moderate risk portfolio and alternatives. 10% in hedge fund or other skill-based strategies, and 5% in other alternative strategies, which would include commodities, infrastructure, and others. So about 15% in alternatives, with 2/3 of that being in the hedge fund like strategies.

Matt Smith - Okay. That gives listeners a good context in terms of scale. Now, if an advisor wants to start using alternatives but wants to go slow, maybe add it to their portfolios gradually, over time, in terms of alternatives, is there a minimum amount below which you would just advise probably not worth taking the time and energy to add it to the portfolio?

Lowell Yura - Particularly with fund of funds strategies, where you've got underlying diversification within the fund, you probably want to think about a 5% allocation to start. It's a good starting point. And it's also important to remind folks that are using these strategies that are fund of funds, is that you're not allocating 5% to one strategy. You're allocating 5% to a basket of strategies. So if there's five strategies in that fund, it's like making five 1% allocations to five different managers. And I think that's an important point is that you're actually more diversified than you might think. You don't want to only think about the diversification of your liquid alts, you want to think about the diversification of returns from a total portfolio construct. And if you've got 15 equity and bond managers in the portfolio, with an average of 5% to 6% allocation to each, why would you want to have such a low allocation to some of these hedge fund or liquid alt type managers? You'd want them to have a meaningful part driving the success of the portfolio.

Ben Jones - Lowell has walked us through how to allocate to liquid alternatives, how much of the portfolio they should take up, the risks involved, and how advisors can manage client expectations with these investments. Hopefully, you feel empowered to start talking to your clients about the possibility of alternatives in their portfolios. Lowell wraps it up with a reminder to look at each of the underlying strategies and to always keep the big picture in mind.

Lowell Yura - One of the things that makes this category difficult for anybody is the wide differences and the heterogeneous nature of this category. Our view is any strategy that is less reliant on the direction of markets to deliver returns should all be viewed as liquid alternatives in the construct. So, make sure that you're spending the time to understand each and every strategy and the environment in which those types of strategies will do well or poor, because you don't want to introduce surprises into the portfolio by expecting strategies that do well in rising equity markets to do well in falling equity markets, because you're likely to be disappointed.

Ben Jones - There were some insightful and actionable tips in today's episode. Thanks again to Lowell for joining the show, and for more of Lowell's thoughts about liquid alternatives and effectively discussing them with your clients, you can access them at BMOGAM.com/betterconversations, or check out the show notes and links from this episode.

Matt Smith - We mentioned earlier we are holding a giveaway to reward our early supporters of Better Conversations, Better Outcomes. To enter the drawing, simply leave a review of our show in iTunes. We'll randomly select three usernames from the reviews and announce the winners during our show on September 26th. If you're unfamiliar with leaving reviews, you can find a quick tutorial in the show notes of this episode with step by step instructions. Don't forget to subscribe after you've left your review and be sure to tune into future episodes, especially September 26th, to see if you are selected.

Ben Jones - Thanks again to everyone behind the scenes who helped make this show possible, Jonah Geil-Neufeld and the Freedom Podcasting team, as well as Pat Bordak, Gail Gibson, and Matt Perry from BMO GAM.

Ben Jones - Thanks for listening to Better Conversations, Better Outcomes. This podcast is presented by BMO Global Asset Management. To learn more about what BMO can do for you, go to bmogam.com/betterconversations.

Matt Smith - We hope you found something of value in today's episode and if you did we encourage you to subscribe to the show and leave us a rating and review on iTunes. Of course, the greatest compliment of all is if you tell your friends and coworkers to tune in. Until next time, I'm Matt Smith.

Ben Jones - And I'm Ben Jones. From all of us at BMO Global Asset Management, hoping you have a productive and wonderful week.

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