

Thinking outside the box

How Alternative Investments can benefit your portfolio

October 2023

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Agenda

Thinking outside the box

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03 The role of alternative investments in multi-asset portfolios

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Thinking outside the box
Introduction



Recap: The original inescapable truths

Last 10 years, next 10 years: 'What got us here isn't going to get us there...'

Economic forces

Subdued DM
productivity growth

Limited **inflationary**
pressure

Low real **interest rates**

Lower **GDP growth**

Disruptive forces

Environmental concerns
increasingly influential

Politics responds to
stagnating median
real incomes

**Govt finances under
pressure** limits room for
manoeuvre

Technology challenges
labour market

Shift from historic economic tailwinds to **headwinds** with **crosswinds** creating further challenges and opportunities

Investment implications

Disruptive forces herald a
regime change

All sources of
diversification must be
considered

**How returns are
achieved** matters

Regime shift

Investing into the new era



Trend 1:

Central banks will prioritise inflation over growth



Trend 2:

Fiscal policy likely to be more active



Trend 3:

A new world order will challenge globalisation



Trend 4:

Labour shortages to drive investment in technology



Trend 5:

Response to climate change is accelerating

Macroeconomic outcomes for investors

1

Higher inflation for longer

- Labour shortages
- Challenge to globalisation
- Greenflation

2

Tighter monetary policy

- Reduced liquidity
- Quantitative tightening
- Need to reduce inflation

3

Increased volatility and populist politics

- High indebtedness and inequality
- Low market tolerance for fiscal largess

4

Reshaped global supply chains and energy policy

- Food and energy security
- Re-shoring, onshoring, protectionism
- Response to climate change

5

More investment in technology

- Labour substitution
- Higher hurdle rate for debt
- Finding solutions for climate change



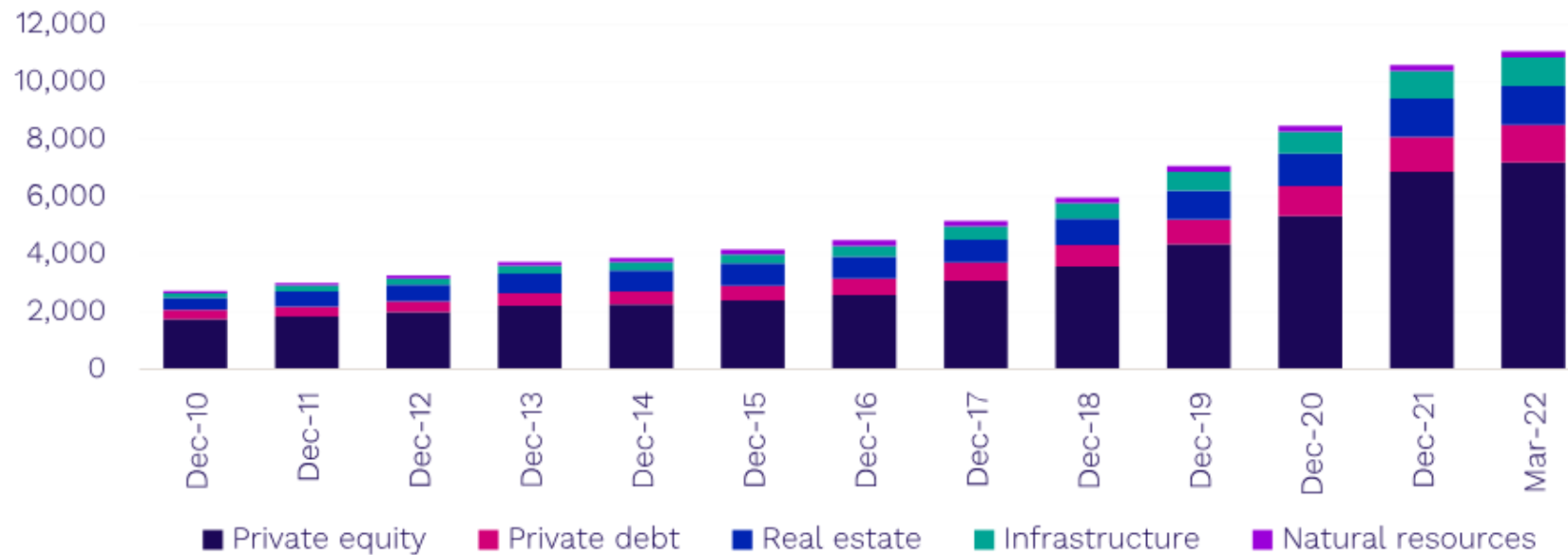
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**What are alternative
investments?**

The alternative investments universe

Significant AUM growth over the past decade

Global assets under management by asset class (\$bn)



The need for higher returns and increased diversification has fuelled significant growth in the alternatives market over the past decade.

What are alternative investments?

Key characteristics

Accessibility

Can have limited access due to their complexity and high minimum investment requirements

Liquidity profile

The liquidity profile differs across the range of alternative assets. Some investments, such as private assets, can be less liquid than traditional investments, meaning that they cannot be easily bought or sold on public markets.

Risk level

Can carry higher risk than traditional investments, due to complexity, lack of transparency and less regulation than traditional investments

Potential return

May offer the potential for higher returns than traditional investments because they often involve investments in less efficient markets or in assets that are not well-covered by traditional investment strategies

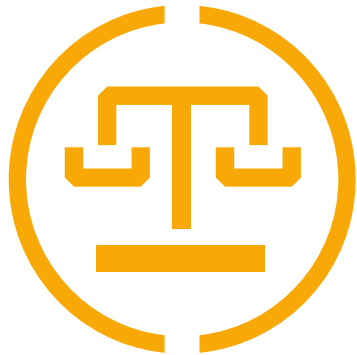
Diversification

May have low correlation with traditional investments which can help to reduce overall portfolio risk and improve risk-adjusted returns.

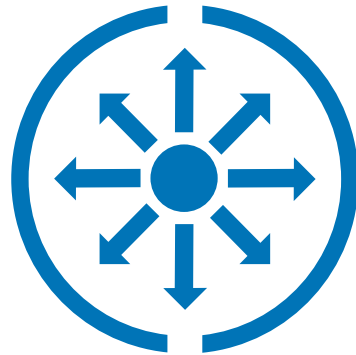
Alternatives are a broad category of investments that are not traditional stocks, bonds, or cash

The different types of alternative investments

Each have their own unique characteristics and risks



Private equity



Hedge funds



Real Assets



**Specialised
Property**



Commodities

Private equity

Investing in companies that are not publicly traded on stock exchanges

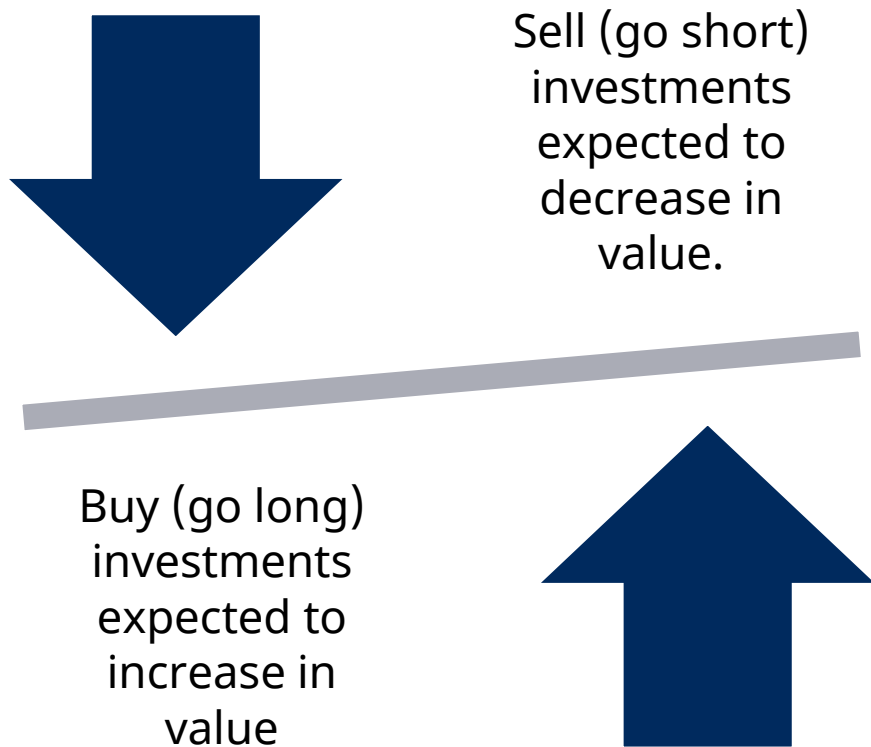
Example lifecycle of a private equity fund



Hedge funds

A diverse group of strategies

What is a Long/Short Equity strategy?



Proportion of active hedge funds by strategy



Source: Preqin Pro. Data as at December 2022
*ARP: Alternative risk premia

Real Assets

Assets that have intrinsic value due to their substance and unique properties

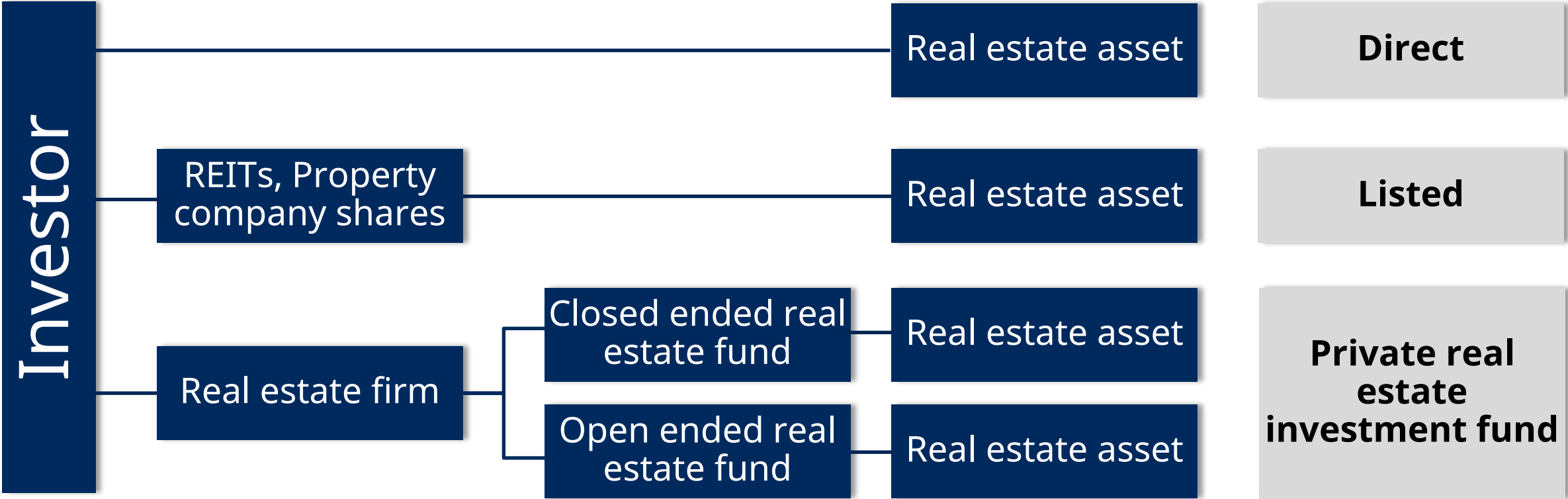


Source: Schroder Investment Solutions 2023

Specialised Property

From residential housing to commercial real estate

Route to market



Source: Schroder Investment Solutions, Prequin 2023

Commodities

Physical goods, such as gold, oil, and agricultural products

Commodity investments can take the form of

- Ownership of the physical commodity
- Securities of commodity producing firms
- Forward or futures contracts
- Exchange traded fund (ETFs)



**Agriculture/
Farmland**



Energy



**Metals &
Mining**




Timberland



Water

Source: Preqin Pro.



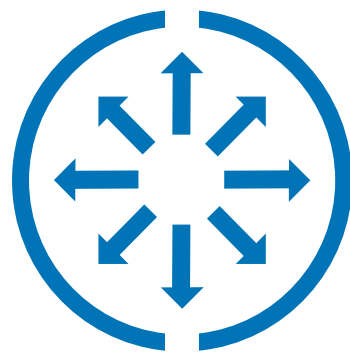
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The role of alternative
investments in multi-asset
portfolios

Why invest in alternatives?

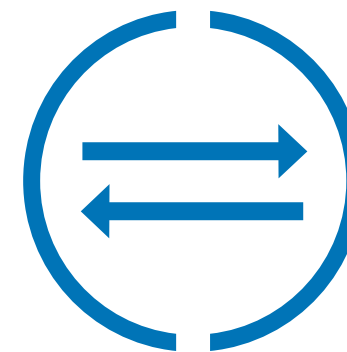
Part of the strategic asset allocation and portfolio construction toolkit



Provide other avenues of growth or income



Enhance portfolio diversification



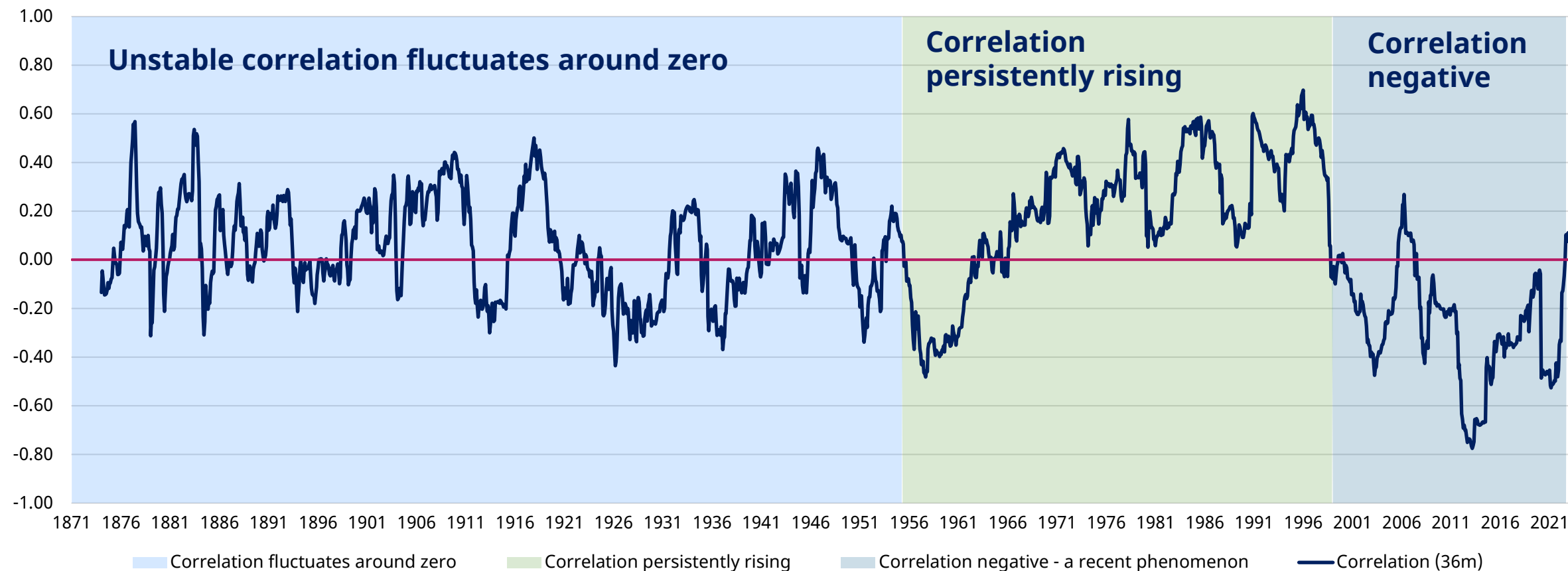
Protection against an unexpected rise in inflation

For illustrative purposes only and should not be viewed as a recommendation to buy or sell.
Source: Schroders

The new regime's impact on correlation and diversification

Negative equity-bond correlation has only been around since 2000s

Equity/Bond correlation

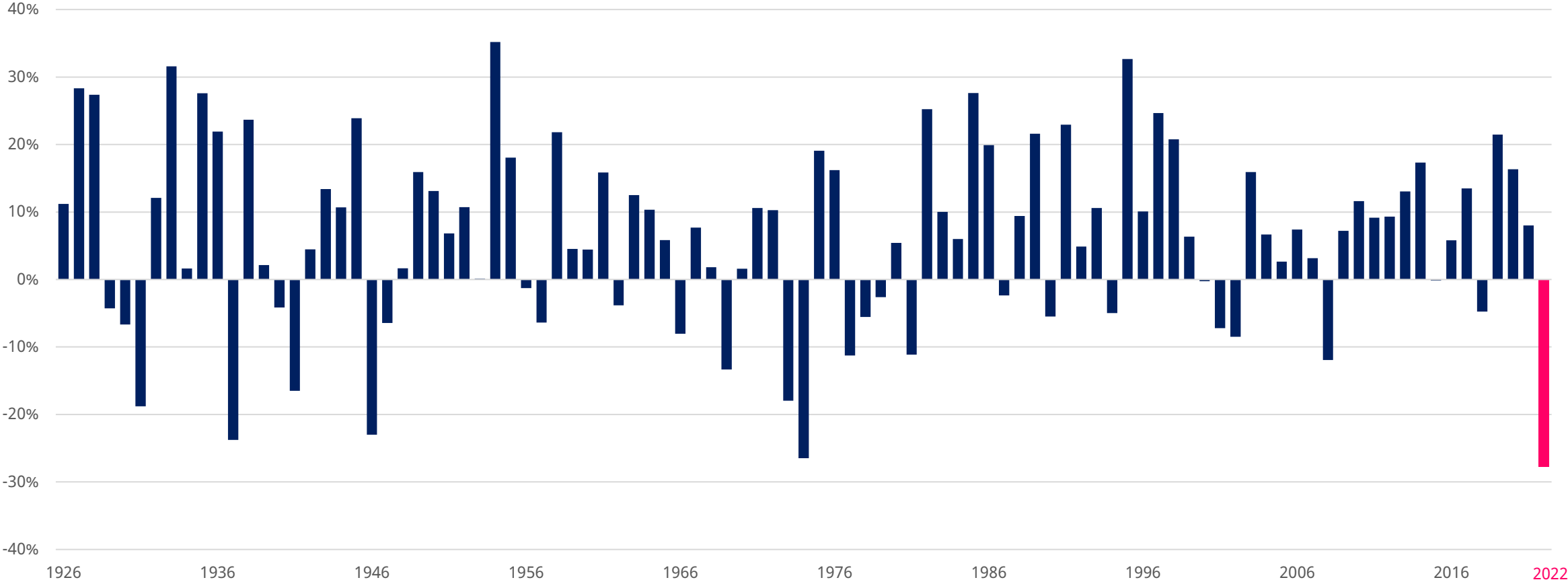


Source: Schroders, Robert Shiller Dataset, Refinitiv DataStream, 30 December 2022. (Bottom) Data from 31 December 1969 to 30 December 2022. US Equities refer to S&P 500 and US Government Bonds refer to US 10-year Treasury Bonds. Calculation assumes monthly rebalancing to target 60/40 asset allocation.

No place to hide in traditional asset classes

Global equities and bonds – worst combined six month performance in over 30 years

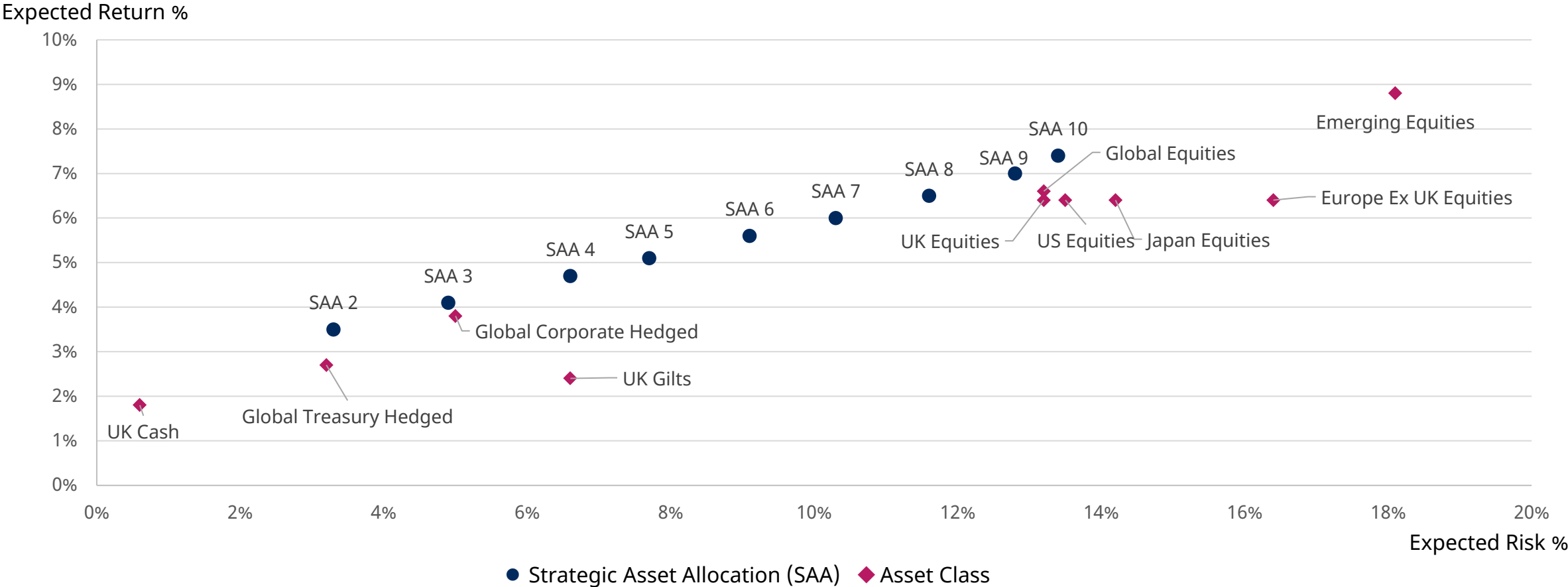
Past performance is not a guide to future performance and may not be repeated.



Source: ICE Data indices, Refinitiv. Data to 31 December 2022

An allocation to alternatives can improve risk adjusted returns

Optimising portfolios



Expected results are shown for illustrative purposes only, there is no guarantee that such a result will be achieved. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

Note: SAA2-SAA10 represents the Schroder Strategic Asset Allocation for portfolios 2-10.

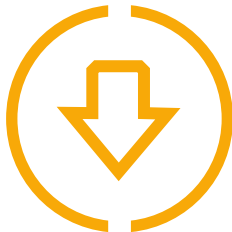
Source: Schroder SMART Model (SMART – Schroders Multi-Asset Risk Team) as at 17 April 2023. For illustrative purposes only and should not be viewed as a recommendation to buy or sell.

What could a good mix of alternatives look like?

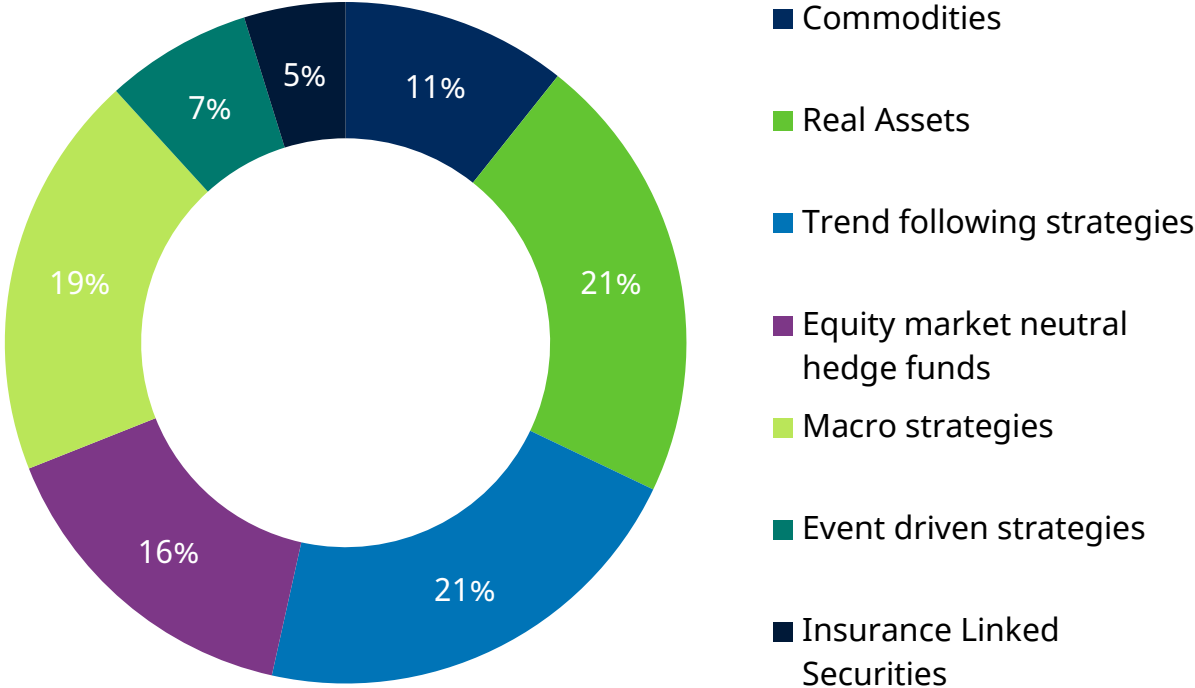
Diversified basket of assets lowly correlated to Global Equity and Bonds



Return enhancers



Risk diversifiers



Protection via uncorrelated strategies to balance out traditional Equity/Bond allocations

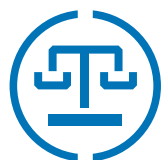
For illustrative purposes only and should not be viewed as a recommendation to buy or sell.

The need for true alternatives

Uncorrelated strategies can add alpha and diversification

Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested. The return may increase or decrease as a result of currency fluctuations.

Our definition of Alternatives



Less than half the beta of the equity market



Low volatility

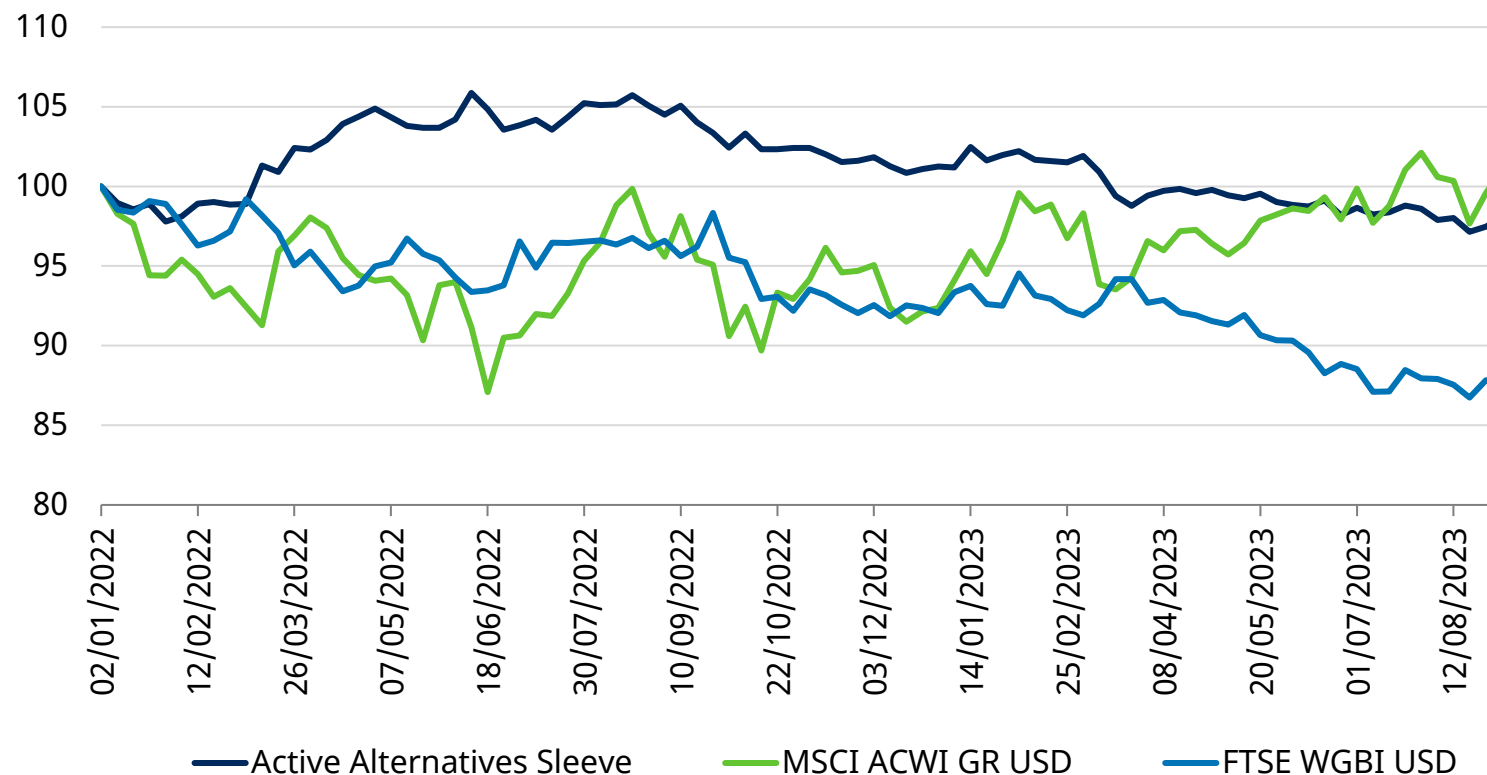


Downside protection



Not market dependent

Performance relative to bonds and equity



Source: Morningstar. Data as at 31 August 2023.

Calculated based on model portfolio returns net of costs. Cumulative returns apply to all periods. Model portfolio returns may vary from individual investor returns due to timings and cash flows.

Assessing the role through risk measurements

Understanding risk relative to the potential reward

Expected return	Consider historical performance and the economic and market conditions that may impact the investment.
Volatility	The degree of variation in the value of an investment over time. Ratios such as standard deviation, Sharpe ratios and Sortino ratios can be used to assess risk-adjusted performance.
Correlation	The degree to which alternative investments move in relation to each other and other asset classes. The correlation coefficient is a number that ranges from -1 to 1.
Beta	Evaluates performance relative to a benchmark or other traditional asset classes. A beta greater than 1 indicates higher volatility than the market, while a beta less than 1 indicates lower volatility than the market.
Drawdown	A measure of the peak-to-trough decline in the value of an investment over a certain period of time and during times of market stress.

Assessing alternative investment fund managers

A repeatable investment process

Manager selection approach

- **Asset manager**
- **People**
- **Resource**
- **Investment philosophy/process**
- **Risk management**
- **Performance**
- **Cost**

Due diligence process



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Case studies



Diversification – Real Assets

Low correlations to traditional asset classes as well as each other

	FTSE All-Share	UK Gilts	Property	Private equity	Infrastructure	Music Royalties	Shipping	Aircraft Leasing	Renewables
FTSE All-Share		0.21	0.11	0.36	0.19	0.05	0.10	0.02	0.03
UK Gilts			-0.07	-0.04	-0.02	0.00	0.04	0.00	0.02
Property				0.12	0.11	0.12	0.00	0.10	0.04
Private equity					0.15	0.00	0.14	-0.01	0.01
Infrastructure						0.05	0.00	0.14	-0.01
Music Royalties							0.00	0.15	0.06
Shipping								0.00	-0.25
Aircraft Leasing									0.01
Renewables									

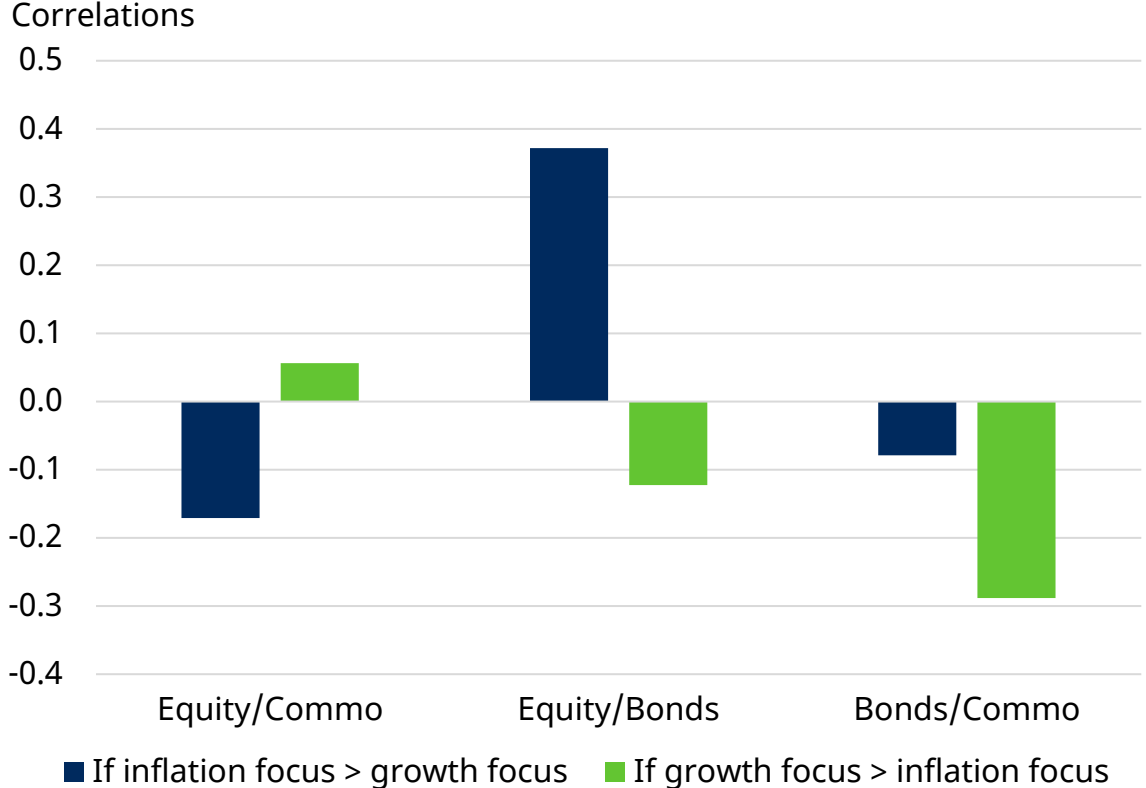
For illustrative purposes only and should not be viewed as a recommendation to buy or sell.

Source: Jefferies, Cazenove Capital. Data shows correlations for different sub-sector real asset investment trusts over the last 10 years. Correlations calculated based on a simple average weighting average of all investment trusts with a full 10 years of data and which are going concerns as at the current date. Shipping and Music cover the time that they have been in existence. Data as at 12 April 2023.

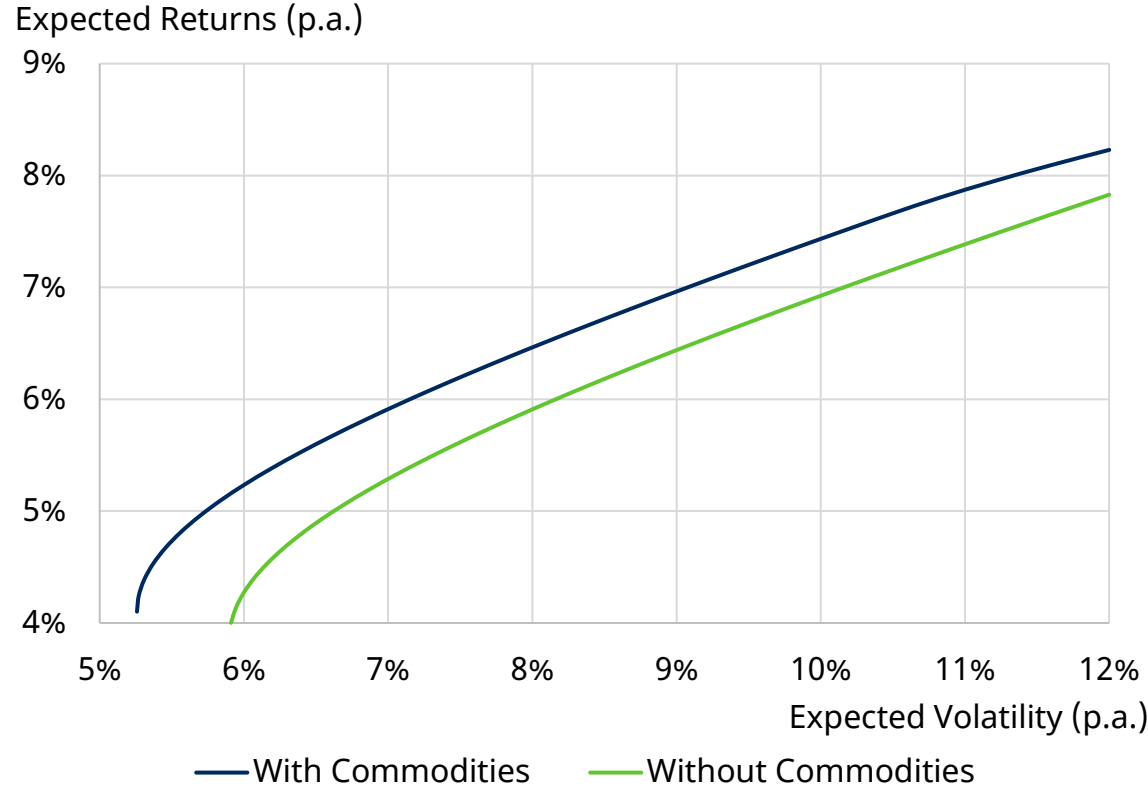
Commodities become more important when inflation is higher

Portfolios with commodities provide better expected risk-adjusted returns

Asset correlations in different regimes



Comparing efficient frontiers

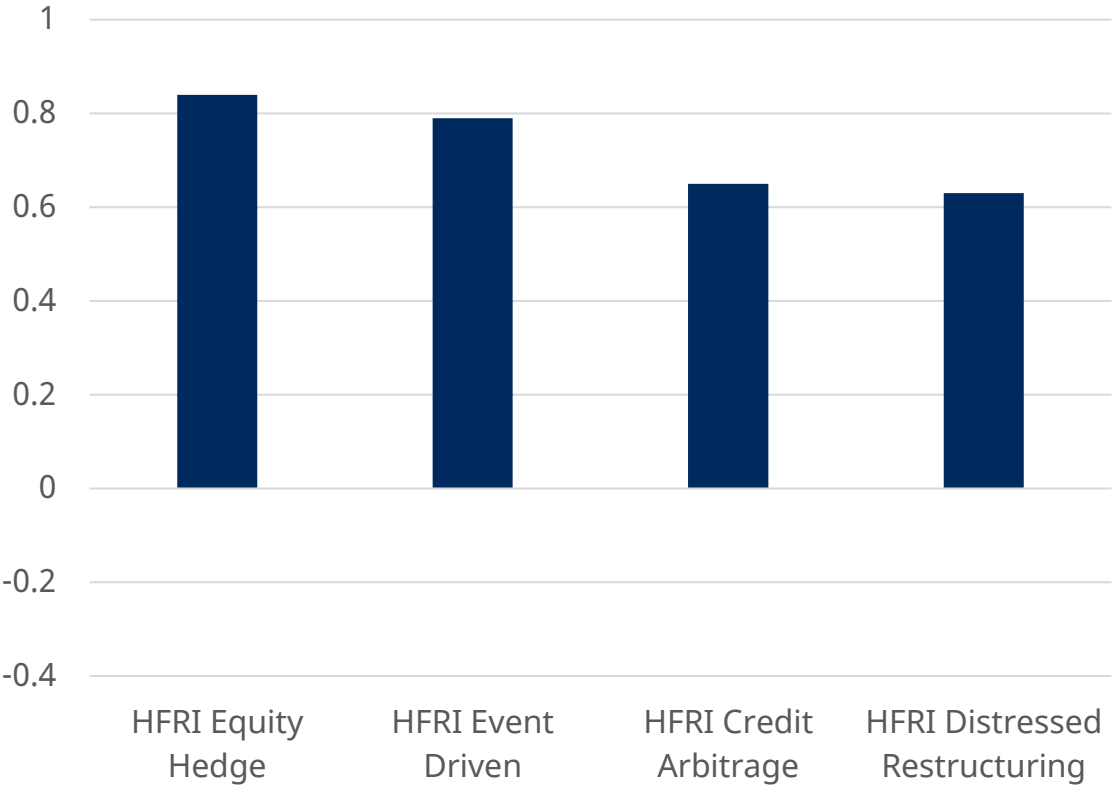


LHS: Source: Schroders, Refinitiv Datastream, Bloomberg, data from 31 December 1969 to 31 March 2023. Equity uses S&P 500 index, Bonds refers to US 10-year treasury bonds and Commodities uses Bloomberg Commodity Total Returns index. The ratio of change in US CPI and US GDP is used to determine whether the market is focusing more on inflation or growth. RHS: Source: Schroders, 30 April 2023. Base portfolios include US Equities and US Government Bonds. Expected returns references Schroders 10-year returns forecast.

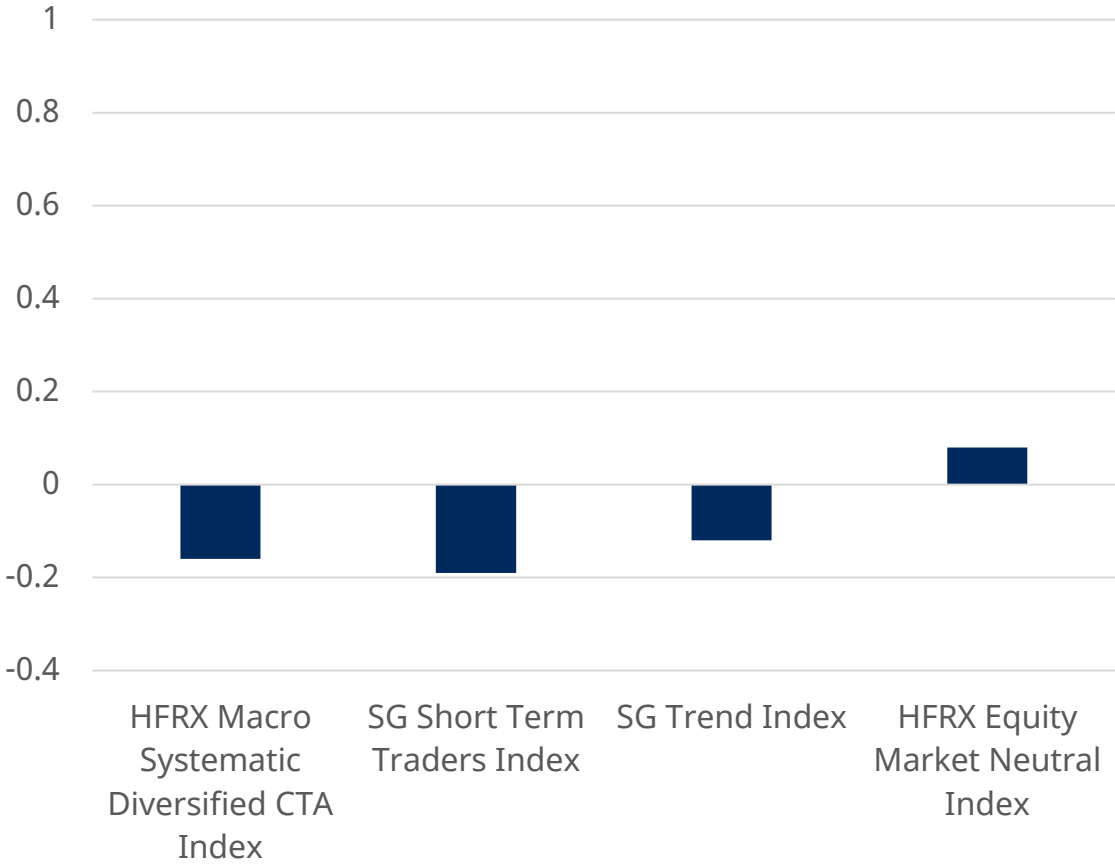
Identifying diversifying strategies within hedge funds

Correlation of hedge fund strategies to Equities (MSCI World Index)

Higher correlation strategies



Lower correlation strategies



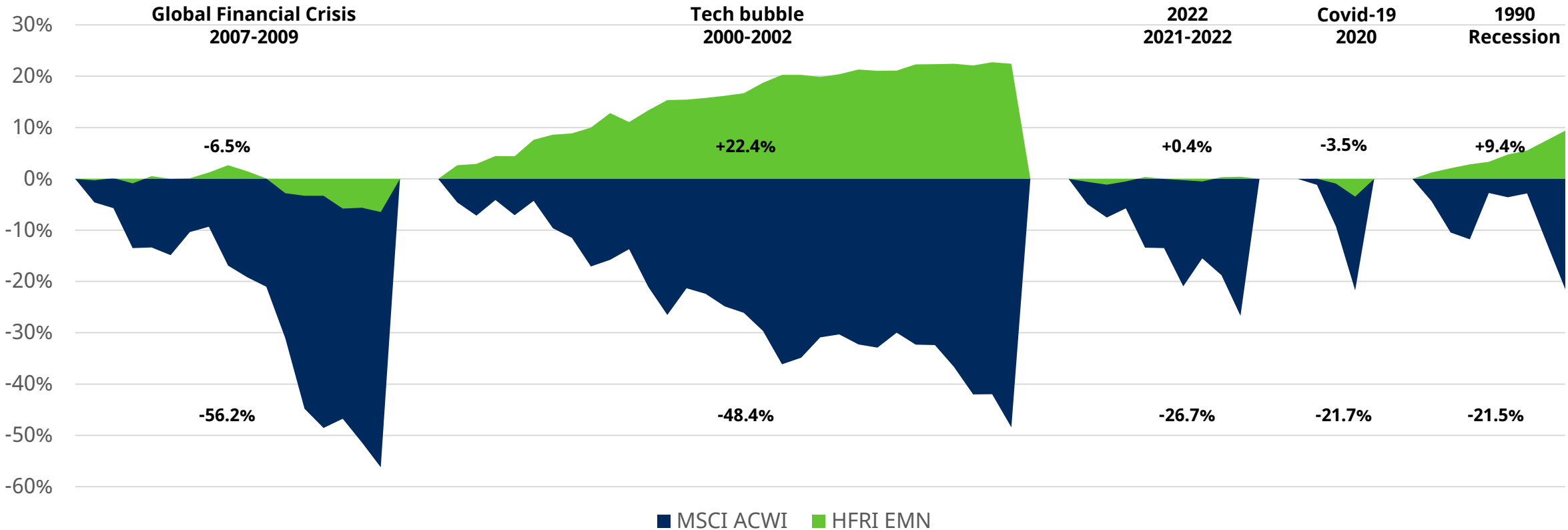
Source: NB Analysis, Societe Generale, HFRI, Bloomberg. Correlation data is calculated using monthly returns from January 2000 to March 2023.

Effective downside protection in equity market sell offs

Equity Market Neutral strategy

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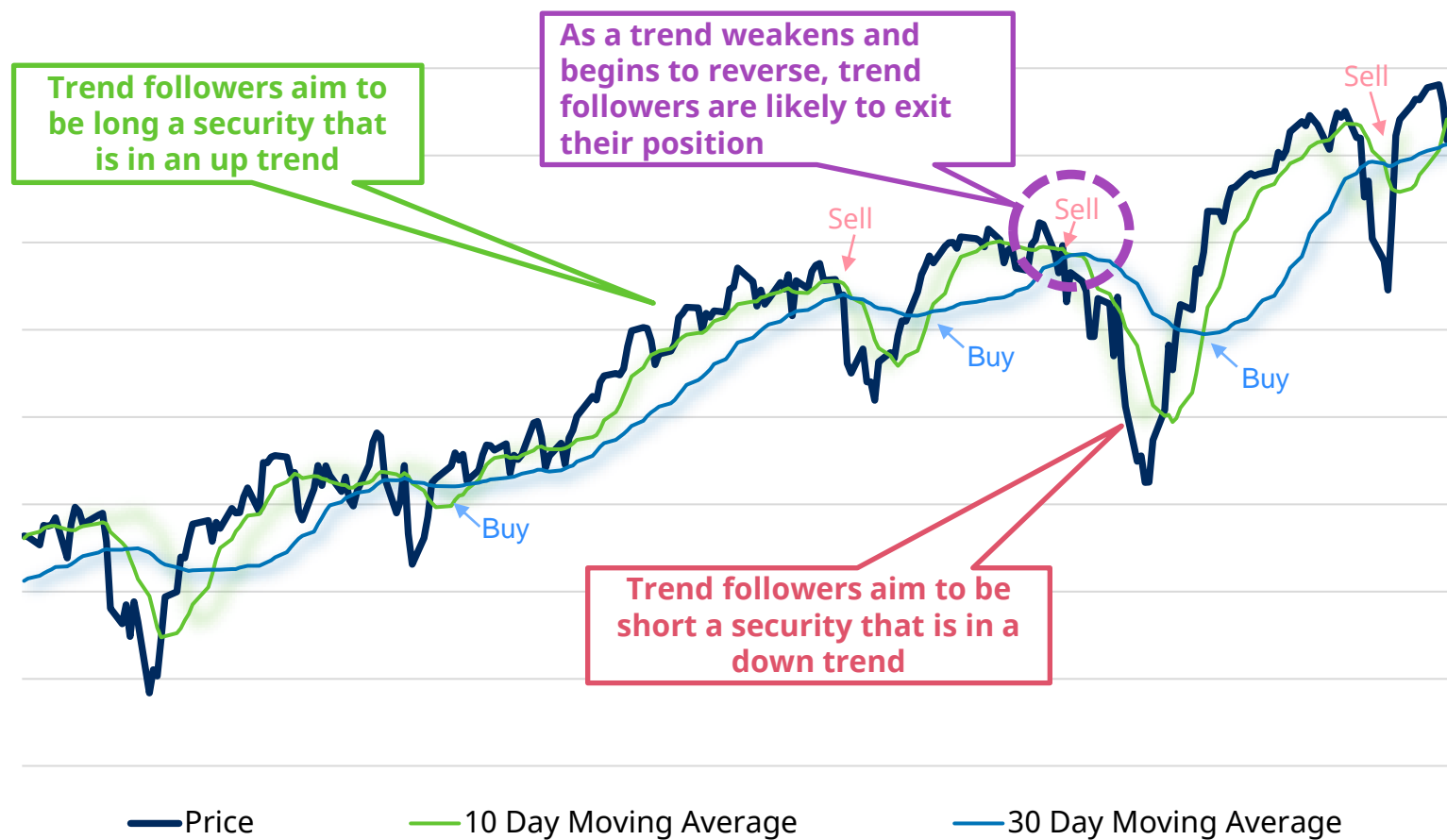
Five largest equity market drawdowns since 1990 (Cumulative returns)



Source: Bloomberg, Refinitiv, Schroders as at 31 May 2023. Drawdowns are calculated by identifying the largest differences between the highest and lowest value of MSCI ACWI price index. Monthly returns within this periods are compounded for the calculation of the magnitude of drawdowns.

What is trend following?

Trend followers aim to capture and ride market trends



Trend followers aim to be long a security that is in an up trend

As a trend weakens and begins to reverse, trend followers are likely to exit their position

Trend followers aim to be short a security that is in a down trend



The '**moving average cross over**' is a popular trend indicator. When asset prices cross over their moving averages, it may generate a trading signal for trend following strategies.



Trend followers differ according to the **speed** at which they **identify trends** and their ability to manage risk on sharp trend reversals.

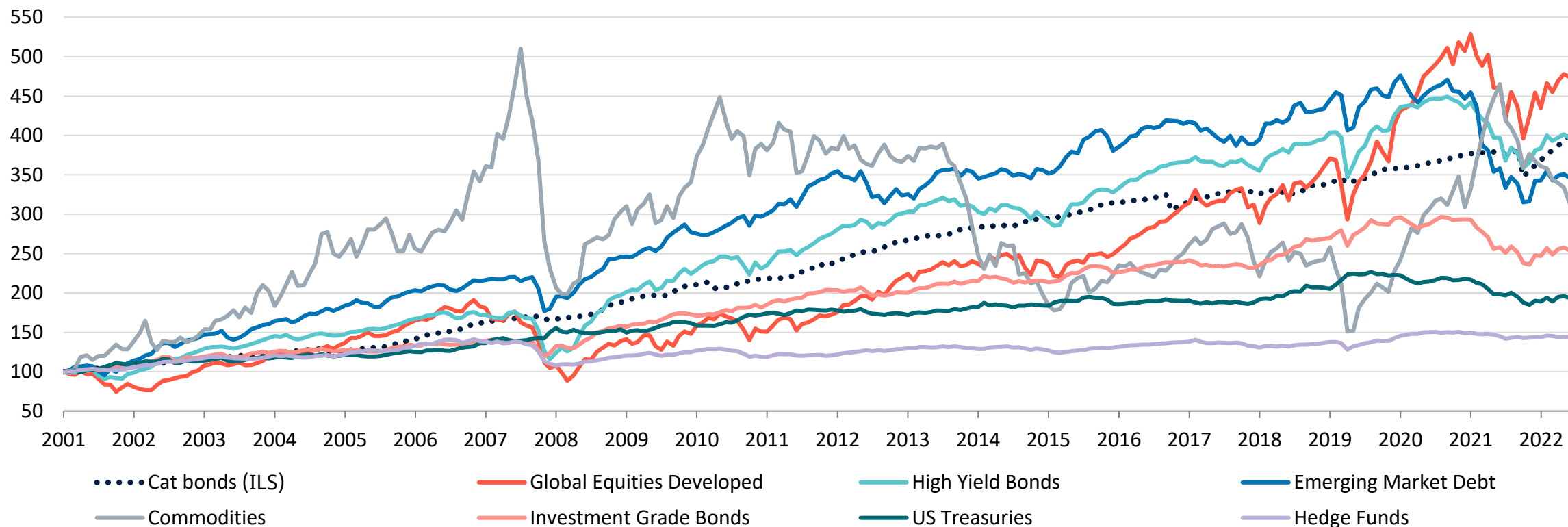


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Source: Systematica Investments, SPX Index from Bloomberg. For illustrative purposes only.

Insurance-Linked Securities benefits persist

Low correlation of ILS to all major financial assets

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Source: Schroders Capital, Bloomberg, monthly returns from 31 January 2002 to 31 May 2023 in USD. Cat bonds: Swiss Re Global Cat Bond TR Index, Global Equities Developed: MSCI World, High yield bonds: BofA Merrill Lynch Global High Yield Index, Emerging Markets Debt: JP Morgan EMBI+, Commodities: S&P GSCI, Investment grade bonds: Bloomberg US Corporate Bond Index, US Treasuries: BofA Merrill Lynch US Treasury, Hedge Funds: HFRX Equally Weighted Index. Any reference to sectors/countries/stocks/securities are for illustrative purposes only and not a recommendation to buy or sell any financial instrument/securities or adopt any investment strategy. The Fund invests in insurance-linked instruments which are particularly exposed to sudden substantial or total loss due to, natural and/or man-made catastrophes. Diversification cannot ensure profits or protect against loss of principal.

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Summary



How Alternative Investments can benefit your portfolio

Thinking outside the box

1

A strategic allocation

- Including alternative investments in portfolio can enhance diversification and balance the potential benefits and risk of investing in a new regime.

2

Define the objective

- Alternative investments can serve different purposes and defining the objective is critical for risk management and portfolio construction.

3

Due diligence

- Alternative investments can be complex and involve unique risks that are not present in traditional asset classes.
- Robust due diligence supports making informed investment decisions.

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Source: Schroders

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