The Case for Alternatives

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At present, the markets are presenting us with conflicting narratives: On the one hand, the dramatic recovery in risk assets from the March lows suggests that the worst is behind us and that the economy should continue to repair itself from here. Yet, on the other hand, the persistence of low interest rates, elevated credit spreads, and a surge in gold suggest that risks remain elevated in the markets. Given the extreme uncertainty, we aren't in a position to predict one outcome over another. However, we will assert that both bond and equity markets can't be correct simultaneously and we expect to see continued volatility, as the world seeks to find a new equilibrium.

In terms of portfolio positioning, we are increasingly concerned about the prospects of a classic '60/40' portfolio (i.e. 60% equities and 40% 'safe' fixed income), given the risks we are seeing today. Simply relying on traditional asset classes (long equities and fixed income) can be limiting in general, but especially today, when equity valuations might not be reflecting the risk of extreme uncertainty, given the current confluence of a global pandemic, U.S. presidential elections, international trade concerns, and abounding geopolitical risks. Meanwhile, the unprecedented amount of stimulus that governments and central banks have released into the economy introduces significant inflationary risk. With only two tools in the toolbox – traditional, long equities and fixed income – investors are between a rock and a hard place; with interest rates as low as they are, bonds are unlikely to protect investors if markets move back lower and, in the event that inflation materializes or the Federal Reserve raises rates, investors holding long-term bonds could experience painful losses at a time when equities may already be stretched from a valuation perspective.

Cidel's longstanding philosophy is that one should use various complementary, uncorrelated asset classes with positive, long-term expected returns in order to create a robust portfolio that can perform across the market cycle. Hence, we have been a long-time proponent of including alternatives in a portfolio, the importance of which is especially heightened today.

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The Strategic Case: The Cidel Alternative Strategy Funds are a strong solution to the challenges mentioned above. On the equity side, the **Long/Short Equity (CAS L/S) Fund** acts as an equity complement, providing better risk-adjusted returns by delivering equity-like returns over a cycle with relatively lower volatility / better downside protection through active stock selection and relatively modest market exposure (i.e. reduced beta). On the fixed income side, the **Relative Value (CAS RV) Fund** offers a low volatility, uncorrelated, absolute return, capital defensive approach – an 'all weather strategy' with the ability to perform across different market environments. The addition of these strategies into a portfolio allows us to mitigate some of the risks associated with the traditional '60/40' model and better fortifies a portfolio for more uncertain times.

The Tactical Case: While the environment is especially uncertain for traditional equities and fixed income, we are actually very excited about the current environment for CAS L/S and RV. We would summarize the current crisis-driven opportunity set as 'The 4 D's':

1. **Dislocation:** Dislocation occurs when markets decline broadly, without sufficient distinction between the quality of the various underlying businesses and their related securities (equities, bonds, derivatives, etc.). Opportunistic, fundamentally-oriented, active investors can exploit these mis-pricings by buying securities at a material discount to their intrinsic value.

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2. **Dispersion:** Dispersion refers to the market differentiation between the 'winners' and 'losers'. The 'winners' will likely be the securities of companies and countries that are less economically sensitive and have better balance sheets. The 'losers' will likely be those facing more persistent financial strain. While traditional, passive strategies will be exposed to both, active long/short and relative value strategies can profit from the spreads created by this aforementioned dispersion.

3. **Dysfunction:** A market crisis breeds various forms of dysfunction such as a) lower levels of liquidity which can greatly impact merger situations, ETFs, closed end funds, and SPACs causing deviations from their NAV, and b) changing relationships between related securities (i.e. bonds -v- equities, equities -v- options, bonds -v- CDS, etc.). Relative Value managers can profit from the spreads and arbitrage opportunities that result from these crisis-driven market dysfunctions.

4. **Distress:** The economic shock that comes from a crisis can create existential problems for certain companies and countries. Amidst a crisis, default rates rise, forcing companies to either liquidate or restructure. Active managers in the alternatives space can benefit from these scenarios initially on the short side, but also in the aftermath by purchasing heavily discounted bonds and taking control of the assets in the restructuring process.

Given the above, the current opportunity set is very attractive, especially relative to a passive, long only approach. With an eye to this tactical opportunity, we have also created a new fund, specifically designed to benefit from the current and future climate in the credit market that has resulted from the steepest economic contraction since the Great Depression. The Cidel Credit Opportunities Fund will offer investors a diversified portfolio of successful, active managers who are focused on credit markets and employ a variety of strategies to exploit the current opportunity set.

Market uncertainty is at unprecedented levels at a time when real rates are negative and equity markets have roared back a long way from the recent lows. It is hard to argue that equity valuations are cheap at current levels and, when you analyze stocks there are a lot of relative value opportunities that an active investor, with the ability to go long and short, can exploit. A passive index tracking strategy cannot access these opportunities. While the past decade, pre-COVID, can be characterized by a 'tide that lifted all boats' as economic growth, low rates, and relative calm allowed risk assets to broadly appreciate, we are now less likely to see this kind of clear trend until uncertainty abates. This is where fundamentally oriented, long/short active managers can thrive, given an environment that we expect to be characterized by greater dispersion. The performance spread created by this dispersion can be of great benefit to the hedge funds in the CAS portfolios, as these managers all have the deep expertise and skill to identify idiosyncratic opportunity via detailed fundamental analysis. Hence, as opposed to owning broad indices that have exposure to both the 'good' and the 'bad', well positioned to capture this new bifurcated opportunity set that is likely to unfold in a more choppy and trendless market environment.

Conclusion

Crises can breed opportunity for active managers with the ability to invest long and short. Therefore, we are particularly excited about the opportunity set on a go-forward basis for hedge funds. As such, we believe that hedge funds remain an important allocation within a true multi-asset class portfolio – and arguably an even more important role today as we navigate markets with a heightened level of uncertainty.

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*Cidel is an operating name of Cidel Asset Management Inc.