MACKENZIE Investments

Accessible Alternatives™

Liquid alternative strategies

Part 3: How much to invest and how to fund?

How much to invest and how to fund?

For investors seeking to enhance an existing model portfolio with a liquid alternative strategy, the appropriate amount to allocate will be a function of:

- Correlation, volatility and expected return, relative to what it is being combined with,
- How much an investor is willing to let this new investment influence the return stream of their total portfolio going forward.

Knowing how much an investor would be willing to let their new enhanced total portfolio underperform the original model portfolio in the short term, in the pursuit of better outcomes (for example: higher returns with similar risk, similar returns with less risk, or a higher rate of income with similar risk and total return) over a longer time horizon, will be very helpful when it comes to sizing the alternatives position ideally.

The appropriate amount of any liquid alternative fund to own will be a function of its volatility, correlation and expected return relative to what it is being combined with, and how much an investor is willing to let it influence their total portfolio, once given an allocation. Important considerations when deciding how to fund the allocation include the stand-alone risk characteristics of the fund in question, how it behaves relative to other asset classes and how it will be expected to impact total portfolio equity risk from a strategic and dynamic perspective.

Tracking error is a useful measure that can help investors with this question of appropriate position sizing.

- Tracking error is the standard deviation of the excess returns of a portfolio versus its benchmark (estimated, back tested or realized). It is a measure of how much you expect your return to differ (plus or minus) from those of a benchmark in normal circumstances.
- A new model portfolio's relative performance to an original model portfolio is expected to be within plus or minus two standard deviations (two tracking errors) 95% of the time and within plus or minus three standard deviations (three tracking errors) 99% of the time, on a rolling 12-month basis, assuming that returns are normally distributed.
- As a rough first approximation, multiplying the tracking error of the new model portfolio, relative to the original portfolio by minus three, provides an estimate of what kind of relative underperformance one should expect to see over a rolling 12-month basis, in the worst 1% of cases, assuming a normal distribution of excess returns.
- While certainly not a perfect measure, it does provide some guidance over the relative performance risk a new strategy brings to a portfolio with a given allocation.
- This method works relatively well for strategies with close to normal distributions, it is less reliable for strategies that exhibit more skewed return distributions.

Generally, the more differently a fund behaves relative to a model portfolio or benchmark, the higher the tracking error it will bring, and the smaller a position is required to have a meaningful impact.

How to fund?

When thinking about what to sell in order to fund an allocation to a liquid alternative, it can be helpful to consider the following:

How risky is the alternative fund in question and how does it correlate with the original portfolio, traditional stocks and traditional bonds?

If the alternative fund in question is as, or less risky than the model portfolio it's being added to, then funding the allocation proportionately from equity and fixed income should not add incremental risk to the portfolio. If a proposed alternative fund is riskier on a stand-alone basis than the existing model portfolio with a medium-high positive correlation with equities, it may be appropriate to have the position more than proportionately funded from equities if total portfolio risk is to remain at a similar level. If a proposed alternative fund is designed to offset equity risk or has prominent traditional fixed income features, it may be appropriate to have the position more than proportionately funded from fixed income.

Important risk considerations

When it comes to alternative strategies, standard deviation and correlation can be insufficient when it comes to forming a clear picture of the risk inherent in them. That is due to the "non-normal" or "skewed" nature of some of their return distributions. Short-volatility and put option writing are examples of strategies that may appear to generate attractive, low volatility return streams over short and medium time periods, but these can be subject to large and sudden drawdowns that might appear to come out of nowhere. For that reason, it pays to investigate the potential causes and severity of any rare but painful left tail events that could impact the liquid alternative under consideration. If these rare events tend to occur during periods of equity market stress, standard correlation and volatility statistics alone may also overstate the diversification benefits of the strategy in question. For these reasons, measures such as maximum drawdown, value at risk and conditional correlation and beta statistics (the condition being large equity market sell offs) can help investors form a clearer picture of the risk characteristics of such strategies.

How will an allocation to a proposed liquid alternative fund impact the total portfolio's strategic and dynamic range of asset class exposures?

The amount of equity market risk that the new investment adds, both now and potentially in the future, is a critical consideration. Equity market exposure is the primary driver of risk and return in most portfolios, so thinking about how a given liquid alternative fund could impact a portfolio's exposure to equity market risk can be informative when thinking about how to fund the position.

Relative return strategies are often measured against benchmarks that include exposure to long only indices. These tend to come with strategic asset class exposures, and the makeup of those benchmarks often provide an indication of how much net equity exposure to expect on average.

Absolute return strategies typically use cash benchmarks and are generally not required to take on significant strategic equity exposure. Their equity exposures are likely to be low on average but variable, with the possibility of negative exposure in some cases.

Market neutral strategies are generally mandated to maintain zero net equity market exposure.

Alternative strategies are in their infancy in the Canadian retail market but have been staples in the portfolios of large institutional investors for decades. The range of value propositions, portfolio structures, and risk characteristics that are possible within the liquid alternative universe is greater than the sum of possibilities in the non-alternative universe. As such, they present a good opportunity for model portfolio enhancement and customization, but do generally require a higher level of due diligence and care in portfolio construction.