Atchison

November 2024

Alternatives: Defining Alternatives and Portfolio Construction

Illuminating
the way forward

In today's complex investment landscape, Australian financial advisers are increasingly turning to alternatives as a vital strategy to diversify portfolios, manage risks, and unlock unique return drivers. These strategies build resilience in portfolios by addressing the limitations of traditional equity and bond allocations.

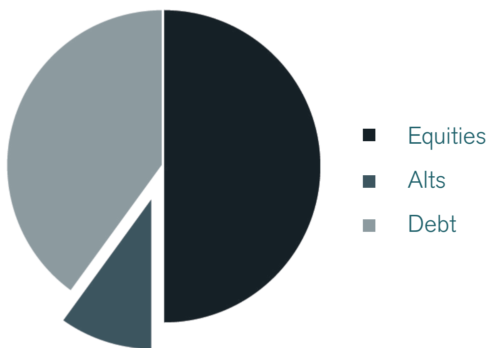
Atchison, as a leading asset consultancy, has developed this whitepaper to share expertise in crafting tailored portfolio solutions for advisers. By incorporating alternative investments, advisers can access opportunities such as illiquidity premiums, differentiated return profiles, and strategies less dependent on market direction.

These investments play a critical role in addressing challenges like portfolio resilience, downside protection, and the need for uncorrelated performance.

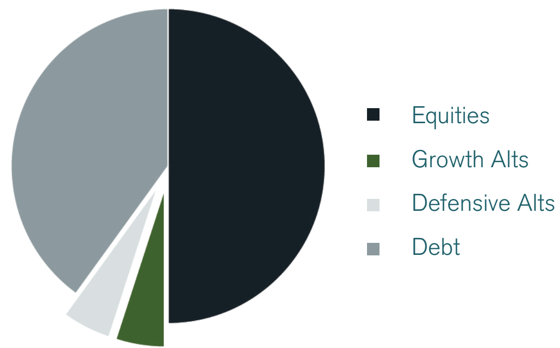
In this whitepaper, Atchison outlines a clear framework to define alternatives, explain their role in portfolio construction, and guide advisers through effective allocation strategies — such as specific alternatives allocations or integrating them within traditional asset classes.

By exploring these strategies, Atchison aims to empower advisers with the tools and insights necessary to enhance client outcomes and adapt to the evolving dynamics of modern portfolio management.

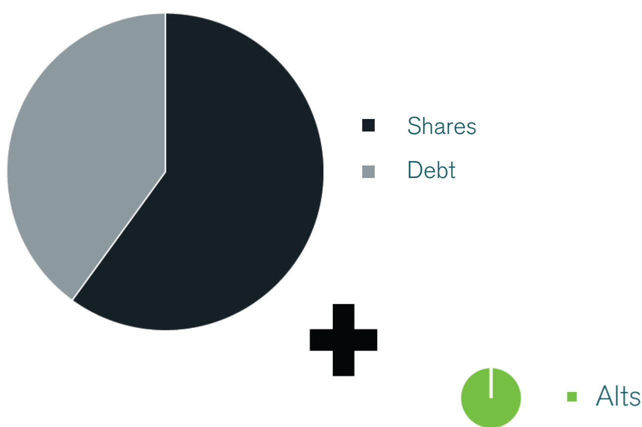
Option 1.
Carve-out a Specific Alts Allocation



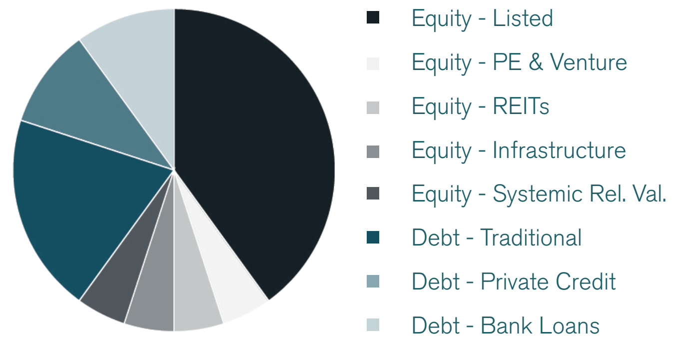
Option 2.
Carve-out Growth + Defe



Option 3.
Side-pocket Allocation



Option 4.
Allocate within Traditional Classes



Alternative
(Oxford Dictionary)

Different from the **usual** or **traditional** way in which something is done alternative therapy/treatments an alternative lifestyle.

- Alternative therapy/treatments
- An alternative lifestyle

Defining the meaning of ‘alternative’ from a portfolio construction viewpoint

A definition of ‘alternative’ investments is not self-evident.

Unlike ‘shares’, ‘property ’or ‘cash’ as asset-class categories, ‘alternatives’ is in effect the absence of a description of what it is: it is the investments left over once you have bucketed items into the ‘traditional’ asset-class categories.

Therefore, to define what ‘alternative’ investments are, we must first define what “normal/traditional” investments are for a given investor strategy – this will be **Step One**.

We will expand on that caveat ‘for a given investor strategy’ below.

Step Two is identifying what role we seek prospective alternative opportunities to play within the portfolio; what success and failure looks like for the investments, and if that is a compelling proposition.

Step Three is finalising the portfolio construction and ongoing risk management framework we use; that is, how Atchison brings this all together within a portfolio solution and manages it on an ongoing basis.

Step One.
Defining what 'traditional investments' are

The simplest test example is to only have two 'traditional' asset classes:

- Listed Equities; and
- Debt

Both asset classes are then ascribed benchmarks to generally reflect the investible universe of the asset classes. This can look like:

- Listed Equities = 50% S&P/ASX200 + 50% MSCI All Country
- Debt = 50% Bloomberg Comp Bond + 50% Barclay Global Agg

Forecasts are then specified, and portfolio optimisation analysis provides a basis for strategic target portfolio allocation weights.

Think about tracking error and return characteristics tolerance

Active decisions within each defined asset class incur tracking-error risk. This can involve biasing an equity portfolio through the use of a small-cap index exchange-traded fund (ETF) or allocating to active stock-picking managers within your strategy. Investors do this in the expectation of enhanced return or risk outcomes relative to matching the specified allocations of the asset class benchmark.

As one considers the use of more 'alternative' return profiles within a given asset class, one must judge at what point the return profile and/or tracking error outcome assumptions of the top-down asset allocation analysis have been compromised.

The 'for a given investor' caveat

It may be the case that issues such as the time horizon or liquidity profile of different investors will impact how much latitude is used to include differentiated strategies with 'traditional' asset class definitions.

For example, a church endowment with a high tolerance of illiquidity may choose not to care about the relative liquidity profile of listed versus private equity investments – bucketing private equity within its equities allocation, not alternatives.

Step Two.
Defining what we want from alternative investments

Common Alpha Objectives:

- Access advantage (deal flow, opaque markets)
- Skill advantage independent of market direction
- Illiquidity premium
- Durable return profiles with strong risk-adjusted ratios

Common Risk Objectives:

- Rebuilding portfolio resilience through downside protection, in light of bond/equity correlation
- Portfolio revaluation differentiated from traditional market direction
- Differentiated factors driving underlying investments relative to traditional assets

Lack of Natural Benchmark

AAlternatives have one major disadvantage – there is no natural 'beta' benchmark against which performance returns and characteristics can be judged.

Traditional asset classes have indices or ETFs that are good representations of their return profile. This provides two key advantages:

1. Clarity in defining the relevant inputs of top-down asset allocation forecasts or return and risk characteristics, and
2. The ability to create performance benchmarks that reflect the relative opportunity cost an investor makes by engaging in active management decisions.

For alternatives, instead, proxy benchmarks may be applied, such as 'secured overnight financing rate (SOFR) + x % per annum' or 'official cash rate + y% per annum' may be applied. The investor may also set target absolute return and volatility budgets.

However, over the short and medium term, such benchmarks do not reflect the realities of the specific investment opportunity.

Generally speaking, this leaves investors needing to take a leap of faith between the benchmark used (and the resultant risk/return expectations) and the reality of the underlying investment strategies used.

Step Three.
What Portfolio Construction Framework do you need?

Below are the most common portfolio construction options used globally by investors, presented as a decision matrix.

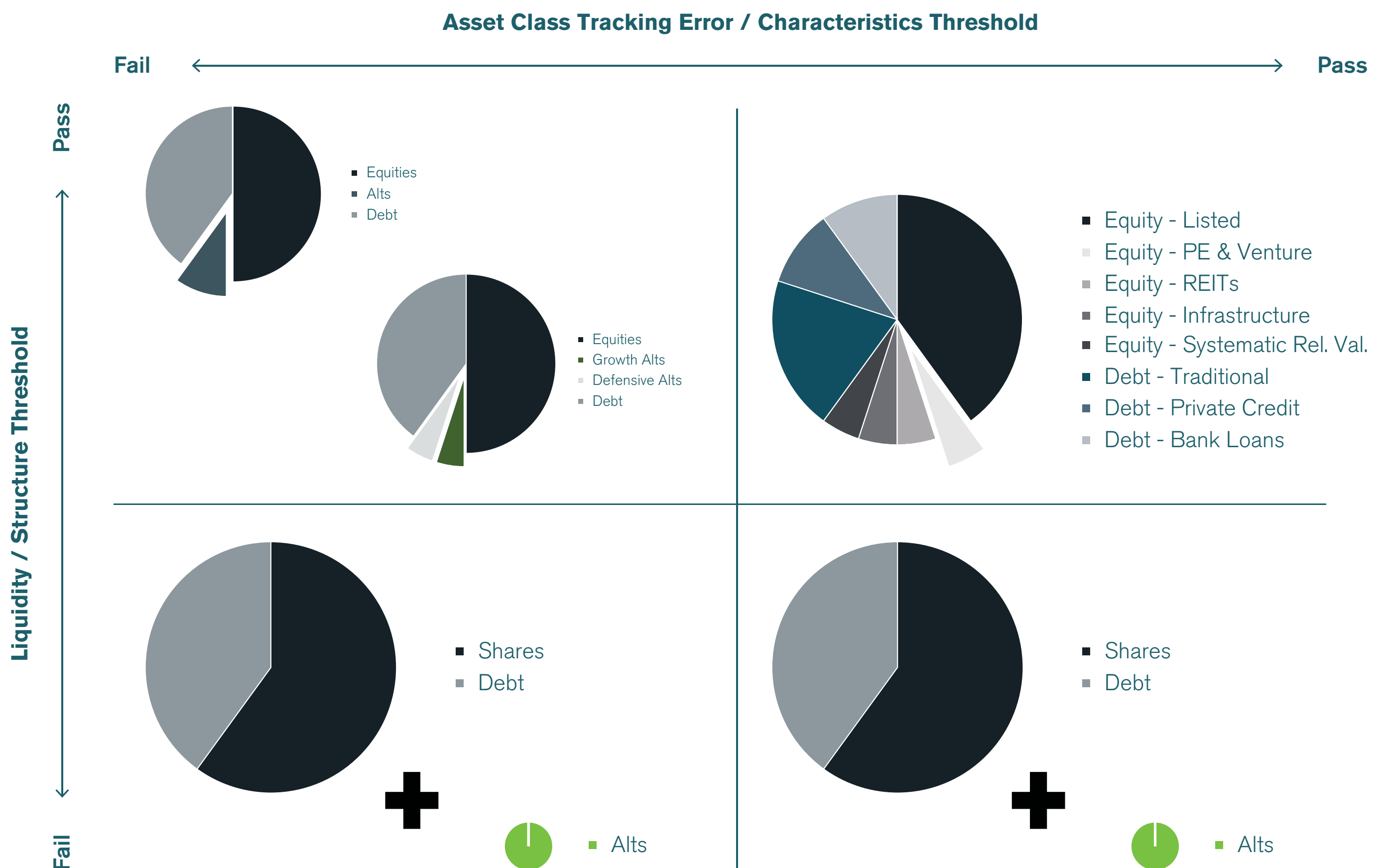
The matrix requires investors to consider their specific situation and whether each prospective new alternative opportunity:

- Meets their threshold (tracking error/factor characteristics) for alignment to an existing traditional asset class, and
- Meets their threshold requirements for liquidity and legal structure to be included within the core investment strategy.

Assessing these questions helps investors navigate how their investment situation aligns to portfolio construction decisions.

These frameworks are not mutually exclusive. At Atchison, we typically customise a blend of the above structures within our client solutions, considering the individual merits of each investment. The following section provides a worked example.

Figure 5. Decision Framework



Worked Example.
Atchison – House View

We identify there are three fundamental ways to allocate investment capital:

1. Equity - ownership of production/business (listed or private equity);
2. Real assets – ownership of physical property, infrastructure, commodities; and
3. Debt – lending to finance 1 or 2 above (sovereign, credit, loans, currency).

In practice, we further split:

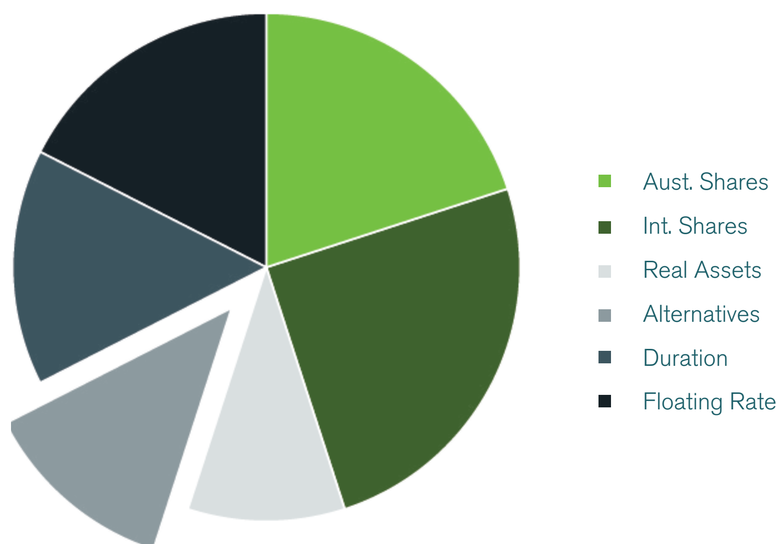
- Equity into domestic and international, and
- Debt into duration and floating subcategories.

These form our five primary 'traditional' asset class categories.

For any new prospective investment, we first aim to allocate within these five elements of the 'traditional' asset class framework (i.e. Option 4 – allocate within traditional asset classes).

Analysis considered includes tracking-error profiles, and sensitivity of investments to key economic and market forces.

Figure 6. Atchison Asset Class Structure



Examples of Strong Sensitivity Alignment and Modest Tracking Error

Figure 7.

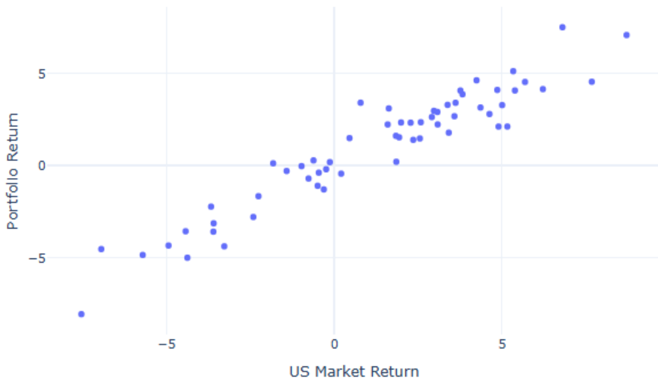
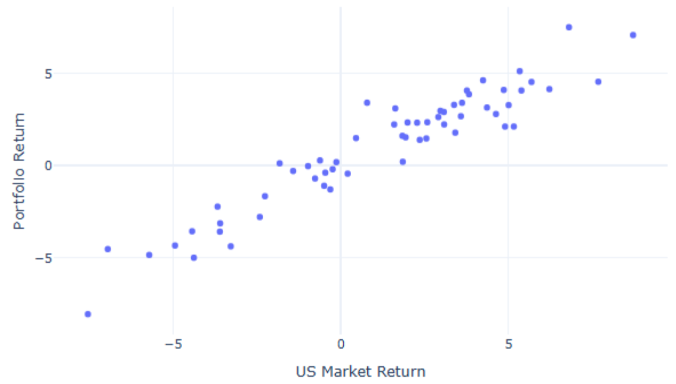


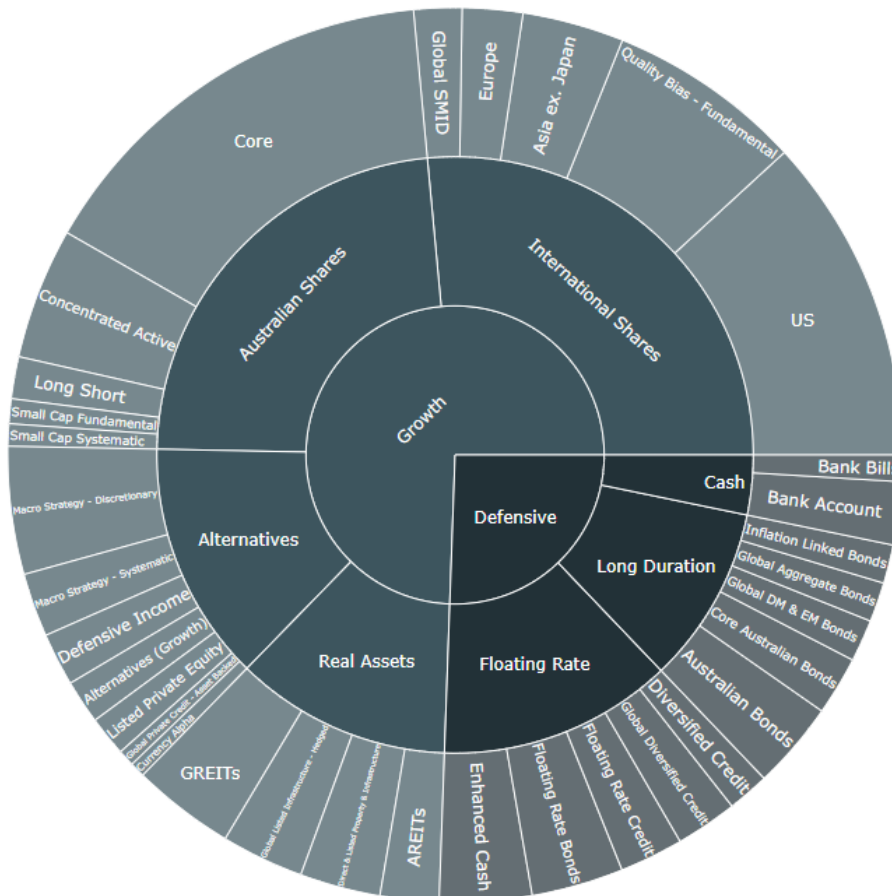
Figure 8.



The below depicts a range of specific asset-class 'sleeves' that represent a collection of selective bias and thematic overweights/underweights.

Any assets that deviate too far from the core characteristics of the traditional asset classes – or those that are multi-asset in nature (that is, they bridge across multiple categories) – then become considered as part of our alternative allocation (***i.e. Options 1 & 2 – a specific alternatives allocation***).

Figure 9. Look-through sub-category



Examples of Low-Sensitivity to Traditional Asset Class & Inflation Outcomes

Figure 10.

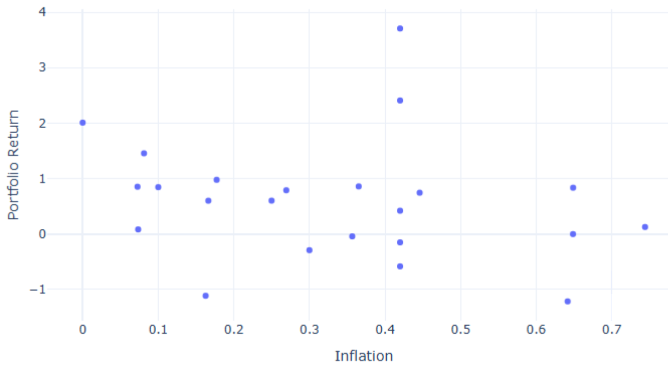
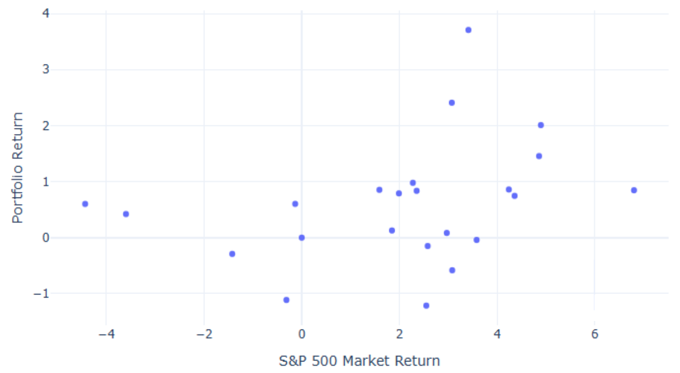
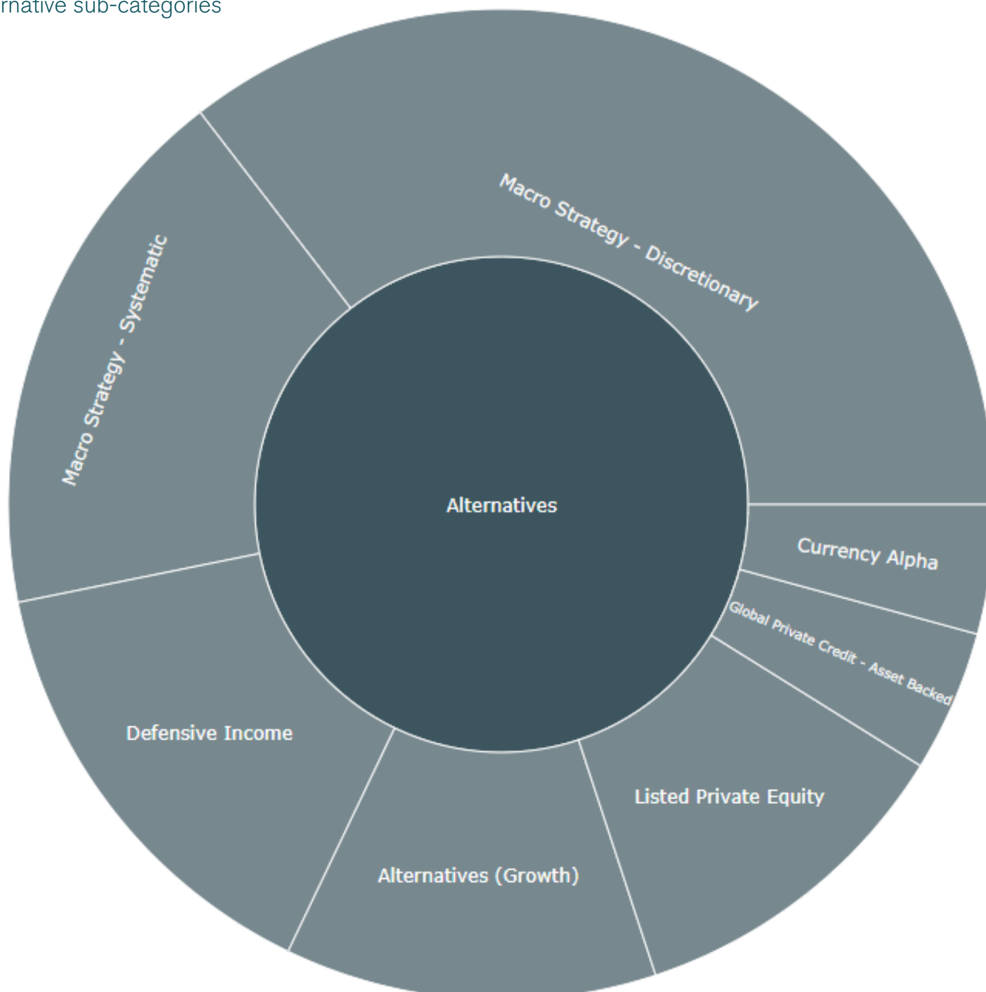


Figure 11.



Our alternatives sleeve then focuses on structuring a blend of strategies that collectively deliver enhanced downside diversification and differentiated return drivers.

Figure 12. Alternative sub-categories



Further, we consider the liquidity profile of any strategy in the context of both the liquidity profile of the end-client user, and importance of the liquidity profile of any other investors with whom you share access to liquidity pools.

This is particularly salient in a platform separately managed account (SMA) investment structure, where the liquidity profile of every asset must avoid providing a liquidity-related impact on the functioning of the balance of the asset class structure.

Where the asset is unlikely to be able to support sufficient real liquidity through full market cycles to match the liquidity structure required, we prefer to use explicit client-level side-pocket semi-liquid alternative allocations (***option three – side pocket***).

Common examples of these include private equity and private debt opportunities.

Atchison leverages its experience managing private asset allocations through the GFC and managing-out (that is, to wind-up) failed structured semi-liquid investment vehicles on behalf of superannuation funds.

In effect we combine elements of:

- Option One (specific alts allocation),
- Option Three (side-pocket allocation) and;
- Option Four (allocation within traditional classes)

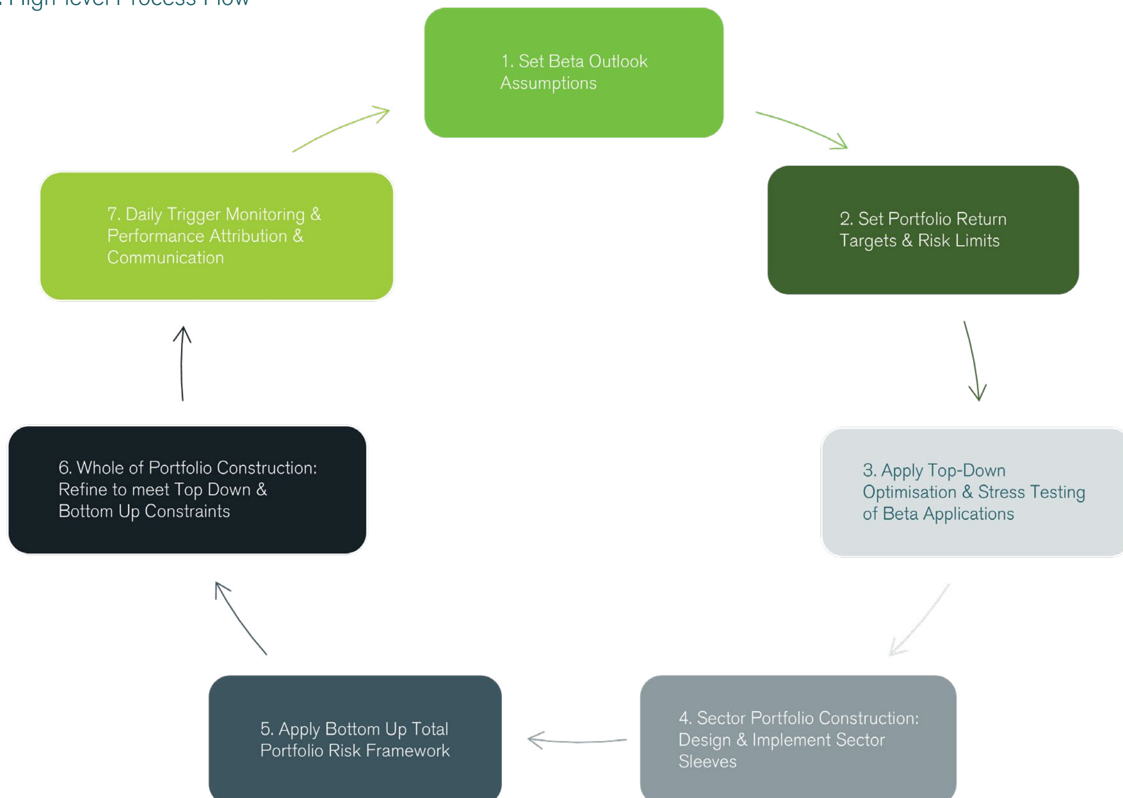
Whole of Portfolio Analysis

Key components of our investment process are provided below. It enables us to allocate our top-down core asset-class allocation decisions, in combination with bottom-up sub-asset beta or manager alpha opportunities we identify.

This is relevant for how we allocate to 'alternative' strategies, and from where they are funded within the portfolio architecture.

The process provides a framework for balancing these various return drivers with a structure for ongoing iterative risk management.

Figure 13. High-level Process Flow



Alternatives
Pitfalls to Mitigate

1. Don't buy black boxes, i.e., investments that lack DD transparency
2. If you don't understand how and why a strategy adds value – don't invest.
3. Beware of low correlations that are masked by investments that are not frequently traded.
4. Beware of less-liquid strategies, of low historically realised volatility, being a poor measure of implied actual risk being taken
5. Not all liquidity is equal: 'structured' liquidity tends to dry up when you really need it.
6. Who are you in the liquidity pool with – will they run for the hills at the first sign of a problem?

Atchison

Atchison
Level 4, 125 Flinders Lane,
Melbourne Vic 3000
P: +61 (0) 3 9642 3835
enquiries@atchison.com.au
www.atchison.com.au