SEPTEMBER 2024

Allocating to Liquid Alternatives.

SEI has been allocating to liquid alternatives for over a decade and a half. In recent years, liquid alternatives have become a more prevalent strategic allocation in many of SEI's multi-asset portfolios.

Joe Comras, CFA
Portfolio Strategist

Risk and return drivers

The SEI Liquid Alternatives Fund is the primary vehicle for exposure to liquid alternatives in our portfolios. The Fund is a systematic strategy that seeks to generate hedge fund-like returns using liquid securities[1]. The fund has two underlying components, a hedge fund replication strategy and a commodity trading advisor (CTA) replication strategy (aka, systematic global macro or managed futures). Taken together, we expect the strategy to deliver roughly 0.4 equity beta over time, while reflecting both (1) the evolving risk factor exposure of a diversified pool of hedge funds and (2) diversification via its CTA strategy.

Investors can conceptualize CTAs as a momentum strategy that performs best in periods of sustained market trends. As illustrated in Exhibit 1, CTAs have historically performed best in extreme down and up S&P 500 markets. In "normal" market environments (think between the 25th and 75th percentile of outcomes), CTAs tend to earn no return over cash (and often below). Said differently, investors in CTAs accept returns at or below the risk-free rate much of the time for the opportunity to experience strong returns in extreme market environments. This curved relationship in returns between CTAs and the broad market is often referred to as "convexity."

Over the long term we expect CTAs to earn a premium over cash. One explanation for this is that market participants tend to anchor to the recent past and underappreciate the persistence of a new economic trend. Take 2022 as an example: as inflation trended higher, the Fund systematically took positions in higher interest rates and a higher U.S. dollar, leading the strategy to generate strong returns in a down year for both stocks and bonds.

There are two important risks to CTA strategies that may cause actual experience to deviate from the convex return profile we generally expect. First, CTA strategies are vulnerable to a sudden reversal in trend (i.e., an exogenous shock). Additionally, CTAs take positions in multiple asset classes, not just stocks. For instance, a CTA strategy may be long equities in an extreme S&P 500 up market, but may still have a negative return due to the strategy's currency and/or rate exposure.

Exhibit 1: Calendar Year Returns: CTAs versus S&P 500 Index

Notes: CTA returns are represented by the SG CTA Index. S&P 500 returns are price returns. Cash is represented by the ICE BofA 3-Month U.S. Treasury Bill Index. The polynomial regression model is statistically significant at the 95% confidence level with an adjusted R-Squared of approximately 20%. The mean CTA excess return is approximately 3% over the full period. Data refers to past performance for calendar year periods 2000 to 2023.

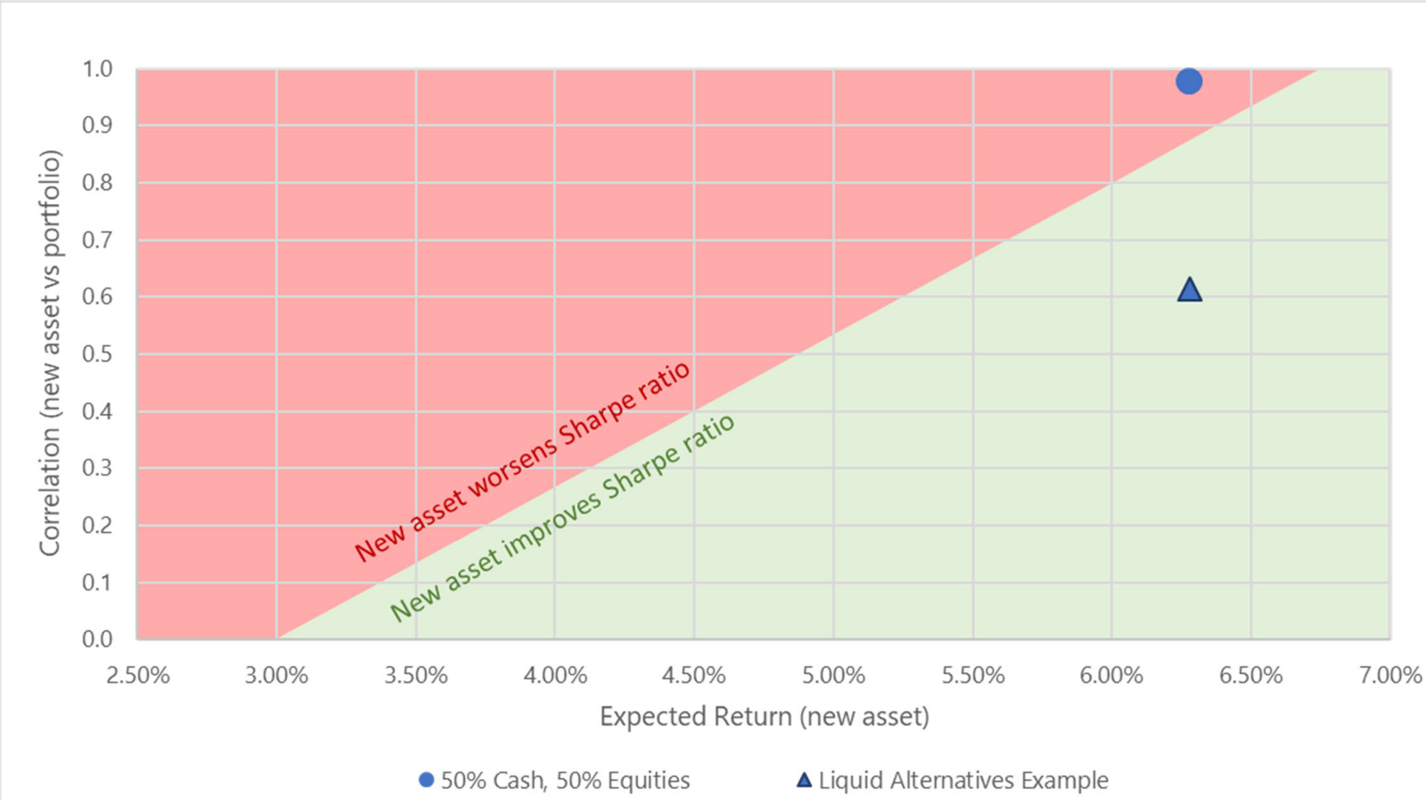
The role of liquid alternatives in portfolios

Compared to traditional long-only strategies, alternative investment strategies tend to maintain less directional exposure to equity and fixed-income markets, and this exposure can be highly dynamic. As a result, we generally expect the SEI Liquid Alternatives Fund to exhibit significantly lower volatility than long-only equities. Given this lower volatility, liquid alternatives can serve a valuable role in a broader portfolio even if expected returns are lower than those of long-only equities, particularly if their correlation profile is favorable.

Consider an example where an investor currently owns a 60/40 stocks/bonds portfolio and is deciding whether to add an allocation to liquid alternatives that carry roughly 50% of the risk of the S&P 500. Exhibit 2 illustrates when it would be worthwhile from a mean-variance perspective (green) and when it would not (red) to add that asset, based on the given expected returns and correlations.

Note that if we were to simply add a strategy consisting of 50% stocks and 50% cash, the resulting portfolio would have a lower return at essentially the same level of risk as the initial 60/40. Therefore, adding this watered-down version of equity beta does not improve portfolio efficiency. However, if liquid alternatives can offer the same risk and return as this 50% stocks, 50% cash option but a more favorable correlation profile (e.g. correlation = 0.6), a 10% allocation can improve expected risk-adjusted returns.

Exhibit 2: Scenario Analysis: Allocating to Liquid Alternatives in a 60/40



Notes: Risk, return, and correlation of "50% Cash, 50% Equities" are based on our capital markets assumptions (CMAs). For illustrative purposes, we assume the risk and return of the "Liquid Alternatives Example" are equal to the "50% Cash, 50% Equities" asset. We also assume a 0.6 correlation between liquid alternatives and a 60/40, consistent with our CMAs.

How SEI allocates to liquid alternatives

The goal of asset allocation is generally to maximize return given a target risk level, based on the investor's risk tolerance. Since investment performance is never guaranteed, we must consider the entire range of probable outcomes. For instance, in the previous exhibit, the blue triangle represents an expectation for the liquid alternatives fund on average. But any forward-looking estimates – and particularly those for a strategy as dynamic as our liquid alts strategy- are inevitably subject to uncertainty. For this reason, we believe investors should size liquid alternatives allocations appropriately such that traditional sources of risk premia, like stocks and bonds, generate most of the portfolio's risk[2]. We typically fund liquid alternatives from a roughly risk-equivalent combination of equities and fixed income.

For a 100% equities portfolio, we are unable to add liquid alternatives because it would cause the portfolio to become under-risked. A portfolio with 80/20-like risk is still dominated by equities—in an 80/20, we expect equities to contribute 97% of the risk over the long-run, based on our capital market assumptions. We believe asset classes with duration exposure, such as core fixed income, remain the best diversifiers when portfolios are dominated by equity risk, given their correlation profile.

In middle- and lower-risk portfolios, where risk is less dominated by equities, we find that liquid alternatives can play a larger role. We believe that adding modest exposure to liquid alternatives in these portfolios can improve diversification and return efficiency. Our allocations to liquid alternatives typically peak in more risk-balanced portfolios (e.g., a 40/60). In the lowest risk profiles, we also find a role for liquid alternatives. However, when risk budget allows, we tend to prioritize exposure to equity risk, often paired with short duration to manage the overall level of portfolio volatility. This enhances exposure to economic growth risk in an asset allocation where it is in short supply.

The decision to add a liquid alternative investment to a diversified multi-asset portfolio is not a question of whether or not it will outperform stocks, but whether expected return efficiency and diversification benefits will improve risk-adjusted returns.

For the SEI Liquid Alternatives Fund, we expect risk roughly similar to 50% of equities and returns between investment-grade fixed income and equities. The strategy's differentiation to 50% equities/50% cash comes from both the factor tilts related to its hedge fund replication component and its CTA component. For the CTA component, we generally expect a convex return profile wherein the strategy experiences muted returns in normal market environments and its best returns in extreme up and down equities markets. Investors should be aware of risks that could cause the strategy to deviate from this expected return profile—for instance, if an exogenous shock causes a sharp reversal in trend. Taken altogether, we view liquid alternatives as a valuable complement to traditional long-only strategies, offering the potential to increase portfolios' overall risk-adjusted returns.

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[1]Liquid alternatives funds can also involve security selection and are not necessarily systematic by definition. For instance, the SEI Multi Strategy Alternative Fund is a 40 Act compliant fund that implements hedge fund trades. In cases such as this, costs are generally somewhere between HF replication strategies and actual HFs. However, given 40 Act regulations, managers are more constrained in their security selection opportunities; for instance, they may not be allowed to use certain instruments, have leverage constraints, and may have concentration limitations.

[2]We expect traditional asset classes to deliver an excess return above the risk-free rate over the long run, compensating investors for exposure to economic growth risk, interest rate risk, and credit risk. While we also expect liquid alternatives to outperform cash over time, there is not quite as clear an ex ante economic risk premium associated with them, as covered in the previous section.