Alternative Investments in a Rising-rate Environment

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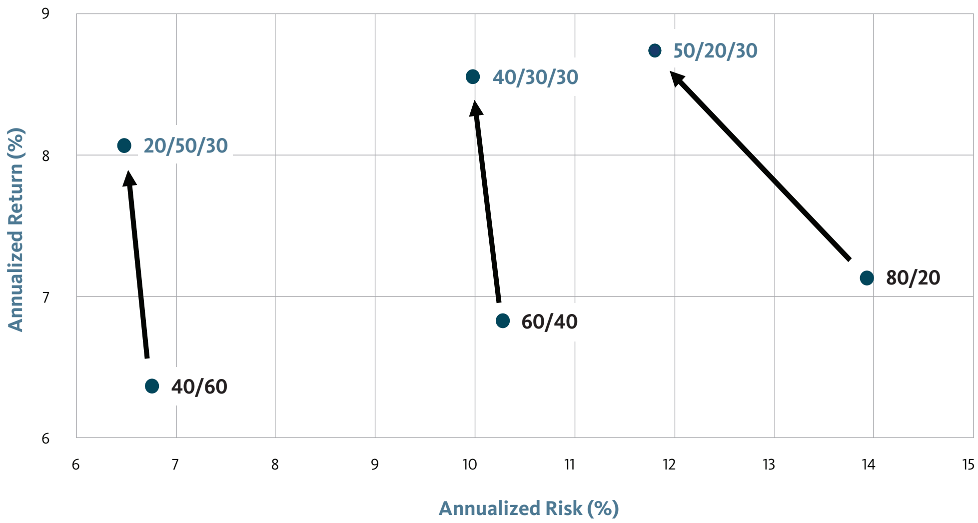
Alternative investments provide broad exposure across areas of the financial markets that would otherwise be absent in a typical portfolio. These exposures can enhance portfolio diversification and seek to improve the overall risk-reward profile for an investor. As alternatives are not perfectly correlated with traditional asset classes like equities and fixed income, incorporating them into asset-allocation strategies can increase expected returns for given levels of risk or decrease the level of risk for a given level of return.

The following exhibit visualizes the historical benefit of adding alternatives to an investor portfolio of equities and fixed income: increased returns with lower annualized volatility.

Historical Portfolio Risks and Returns



Source: MSCI, Bloomberg. Data spans 1/1/1997-12/31/2021. Indicated weights refer to equities (MSCI World Index) / fixed income (Bloomberg US Aggregate Bond Index) / alternatives (10% real estate: NCREIF Property Index, 10% private equity: Refinitiv Venture & Buyout Index, 10% hedge funds: HFRI Composite Index). Past performance is not a reliable indicator of future results.

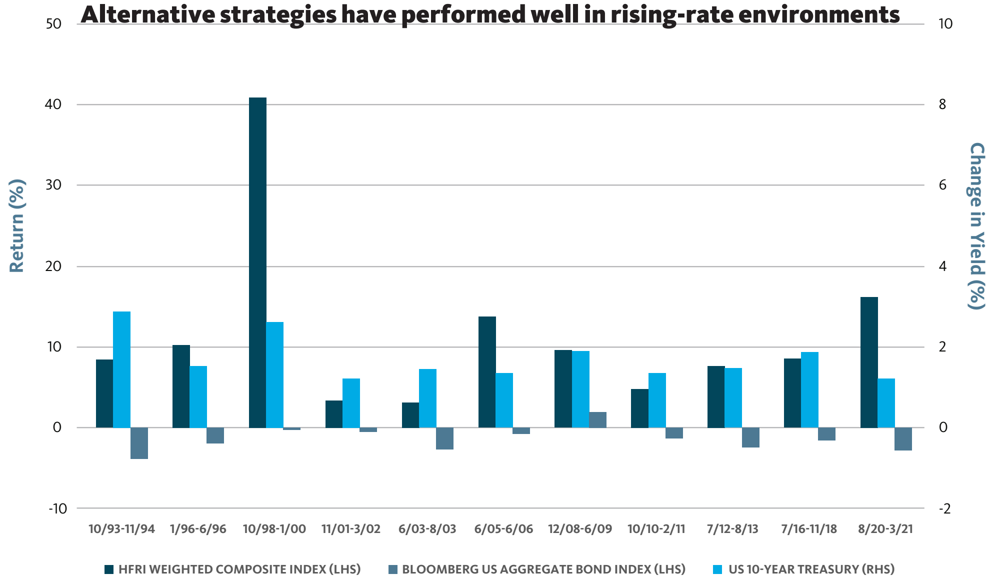
We believe the distinct set of strategies offered by alternative investments can broaden the diversification opportunities beyond those available via traditional investments, thereby helping to improve upon the limited risk-reduction and return-enhancement opportunities that traditional asset classes can offer.

The impact of rising rates

Rising bond prices and falling yields have been the norm in fixed-income markets over the past four decades. The U.S. three-month Treasury bill yielded near 0% at the end of December, while the yield on U.S. 10-year Treasurys was around 1.5% (after falling near 0.5% at the start of the pandemic). As the U.S. economy displays signs of significant economic growth, the Federal Reserve (Fed) has maintained that it could withdraw accommodative policy action and eventually allow interest rates to normalize across the yield curve.

We examined previous spikes in interest rates since 1990 when the yield on U.S. 10-year Treasurys increased by 1% or more. During each period, alternative strategies (as measured by the HFRI Weighted Composite Index—a global index designed to measure the performance of the largest hedge funds) delivered positive absolute performance; the Bloomberg US Aggregate Bond Index fell in each period but one, highlighting the benefit of alternatives within a diversified portfolio.

Alternative strategies have performed well in rising-rate environments



Source: Bloomberg, SEI. Data spans 10/1/1993-12/31/2021. Past performance is not a reliable indicator of future results.

Higher interest rates should support the following strategies within the alternatives asset class:

- Long/short equity: the yield on short-term cash lending can provide a boost to long/short equity returns. As we move to a more normalized interest-rate environment, we expect these strategies to benefit from the compounding of higher rates.
- Merger arbitrage: the potential profit (called the spread) is composed of a risk premium plus the risk-free rate. All other considerations being equal, an increase in the risk-free rate will therefore result in wider spreads and potentially greater returns.

- Managed futures and global macro strategies: managed futures fund managers are generally required to post little collateral on futures contracts, allowing them to invest most of a fund's assets in U.S. three-month Treasurys. Therefore, the performance of these strategies is directly impacted by the level of short-term interest rates.

- Thematic investing: funds positioned for higher rates or built around potential inflection points in inflation will benefit.

- Core property strategies can benefit as property values and rental income will tend to rise in an inflationary environment that is also characterized by a strong economy.

- Structured credit should benefit from higher yields as the interest charged on loans generally increases with rising short-term benchmark rates, a characteristic that increases inflation protection.

By broadening the diversity of an overall portfolio with alternative strategies and aligning them with the goals they're best suited to achieve, we believe investors can build more efficient portfolios and improve their risk-adjusted returns. In an environment of higher rates, we see the promise for alternative investment strategies to further expand the opportunity-set for generating returns.

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