# PELAGOS CAPITAL

*<Investment Research>*

PELAGOS CAPITAL
Navigating Market Regimes

## Alternative Strategies Timeliness

*Do they deliver when needed most?*

**John C. Pickart, CFA**

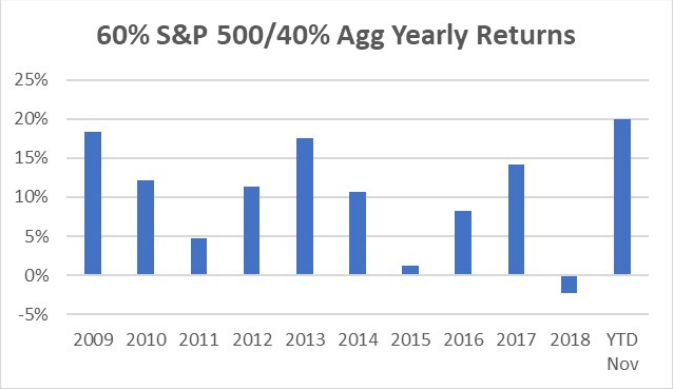
December 12, 2019

### Current Backdrop

Investors have much to be thankful for but there has been an influx of weak data to digest, clouding the investment outlook. The total return for the S&P 500 is greater than 27% year-to-date while the Bloomberg Barclays U.S. Aggregate Bond Index return is 8.8%. Even gold has performed well with spot prices up 14.3% year-to-date through November. It has been a terrific 3-year stretch for stocks too, as the 3-year annualized return for the S&P 500 is 14.9%.

With both the S&P 500 and Agg Index up significantly, the 60/40 mix of the two asset classes was up 20.0% YTD. This is an extraordinary return as chart 1 highlights. If the 60/40 mix is flat for the remainder of the year,

Chart 1




source: Pelagos, Bloomberg

the return would be the highest yearly return of the post financial crisis period. In fact, the 60/40 mix has not exceeded this annual return since 1998 when it returned 21.0%.

However, with some signs of economic weakness, especially in manufacturing, some caution may be warranted on the equity component of returns. Manufacturing data has weakened with ISM below 50 and dropping. Employment does continue to be strong while inflation remains under 2.0%.

The bond component of the 60/40 mix may have headwinds too. The 10-year U.S.

Chart 2

source: Bloomberg

Treasury yield ended November at 1.78%, only 42 basis points above the post crisis low of 1.36% in 2016 (chart 2). With a duration of roughly 9 for the 10-yr Treasury, significant prices gains, and losses, can occur. For instance, if the yield falls to 1.00%, the price change is about 7.8%.

### Alternatives

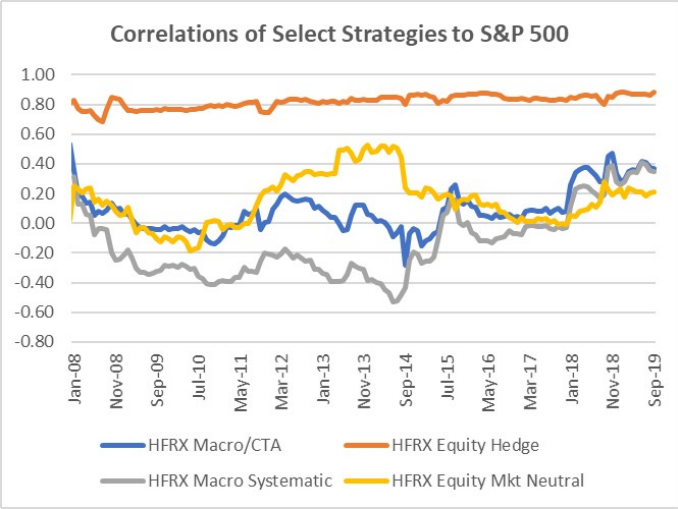
Alternative strategies, especially those with high correlations to equities, have performed

Past performance is not a guarantee or a reliable indicator of future results. This article contains the current opinions of the author but not necessarily those of Pelagos Capital. The author's opinions are subject to change without notice. This article has been distributed for informational purposes only. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Pelagos Capital. Please refer to disclosures on pages 3 and 4.

well but still lagged equities. Equity Hedge strategies, as measured by the HFRX Equity Hedge Index, increased 9.38% through November. Managed Futures Strategies, HFRX Macro Systematic Index, were up 6.71% while Global Macro Strategies, HFRX Macro/CTA Index, increased 4.53%. Lagging equities is not a complete measure of relative performance, as many strategies are targeting a different alpha and also may perform well in poor equity markets. As mentioned earlier, the 60/40 portfolio has been a tough benchmark to beat this year too.

The long stretch of good equity returns has allowed the benefits of some alternative strategies to fade in our memories. We know bonds typically provide protection in poor equity markets because their returns are often negatively correlated to equity returns. Alternatives also can provide protection but not all are created equal. Some strategies can be negatively correlated with equities while others are positively correlated and yet others may fluctuate between both negative and positive correlations over time (chart 3). Of course, one method of protecting against equity market weakness is to buy put options. However,

Chart 3

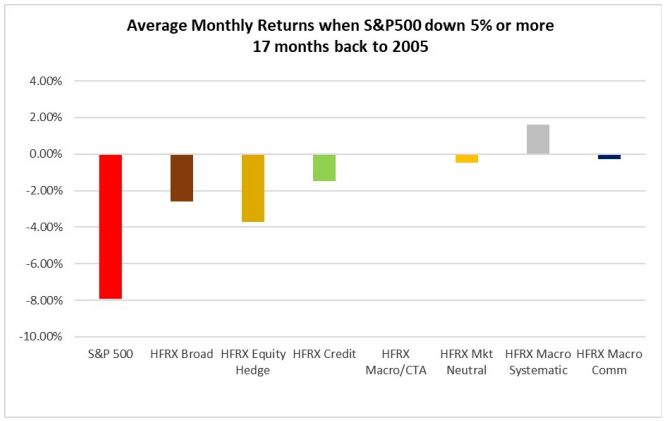



source: Bloomberg

some investors may not like paying "insurance" premiums. For instance, the last 10 years of generally good equity returns would have been a period when option premiums likely exceeded the protection payoff. The benefit of puts is the small premium needed for hedging. This paper focuses on hedge fund strategies.

Equity hedge strategies, as measured by the HFRX Equity Hedge Index, consistently exhibit high positive correlations to equities over time (chart 3). So, even though shorting equities is a key feature of these strategies,

Chart 4




source: Bloomberg

net exposure appears to be consistently long. This helps explains the strong returns YTD. The positive correlation is highlighted by the returns of these strategies during equity weakness. When the S&P 500 has been down 5% or more in a month, the HFRX Equity Hedge index was down on average 3.71% (Chart 4). Even equity market neutral strategies, at least as measured by the HFRX Equity Market Neutral Index, have tended to maintain positive correlations to equities. This occurs even though these strategies, at least by definition, attempt to be market neutral. The Index faired better than most but still recorded negative returns on average during those months of large negative S&P 500 returns.

The strategies that provided positive returns or at least were flat were those that have the ability to be negatively correlated to equities. Note that the HFRX Macro Systematic Index spent significant time in negative correlation territory and outperformed all others during weak equity markets. Similarly, the HFRX Macro/CTA index has a dynamic correlation over time, though not experiencing the large

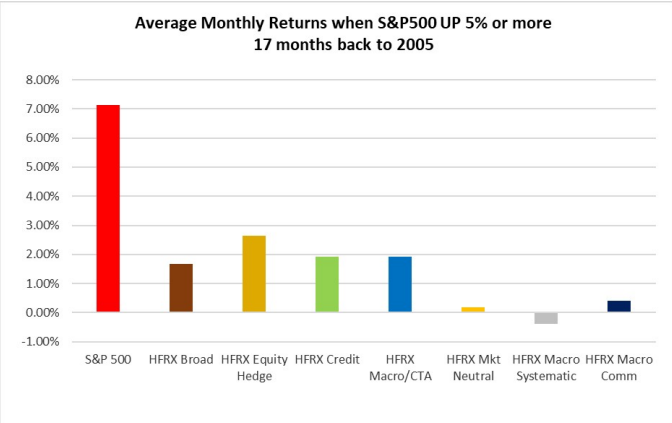
negative correlations of the Macro Systematic Index. As a result, the Macro/CTA returns during poor equity returns was flat at 0.01%.

**Up market participation**

While downside protection is one reason to use alternative strategies, the performance during strong markets may dictate whether the strategies are used tactically or strategically. If weak stock market performance can be predicted with reasonable accuracy, a tactical allocation may be appropriate. However, for investors not inclined to rely on short-term market predictions, a permanent allocation to alternatives is warranted, much like bond allocations. Therefore, a balance between downside protection and ability to perform in up markets is key. To be fair, not all alternative strategies are designed to be direct hedges against stocks.

Looking back at chart 3, we see that Equity Hedge Strategies have a high correlation to the S&P 500. As with down equity markets, these strategies track equities to the upside as well (chart 5). So, in some respects, Equity Hedge Strategies as measured by the HFRX index are just low beta equity strategies. Highly correlated but with returns, both positive and negative, a fraction of the S&P 500. In fact, many strategies appear to be low beta equity strategies. This does not mean they don't generate alpha, but if portfolio diversification is sought, these correlations and betas can be instructive.

Chart 5




source: Bloomberg

The strategies that appear to have unique properties are Macro/CTA and Macro Systematic. Both had positive returns when the S&P fell more than 5%, though barely for Macro/CTA. However, the HFRX Macro Systematic Index had negative returns on average when the S&P 500 increased more than 5%. So, only the Macro/CTA Index preserved capital in big down markets and had positive returns in large up markets.

As a permanent allocation to a portfolio with expectation of downside protection but also the ability to participate on the upside, global macro strategies may be beneficial. Their dynamic correlations to equities provide the opportunity to provide positive returns in both up and down markets.

Pelagos Capital is an alternative investments specialist with extensive experience managing multiple alternative investment strategies. Stephen Burke and John Pickart founded Pelagos in 2005, sold the Company to Franklin Templeton, and recently acquired Pelagos Capital from Franklin Templeton. The founders have worked together for 20 years.

*Pelagos, Pelagos Capital, and Pelagos Capital Management are registered in the U.S. Patent and Trademark Office. All trademarks and services mentioned herein are their owner's property. This report or portions of it may not be reprinted, sold, or redistributed without the written consent of Pelagos Capital.*

*This article contains the current opinions of the author, but not necessarily those of Pelagos Capital. The author's opinions are subject to change without notice. Pelagos Capital has no obligation to inform you of when opinions or information in this report change. Actual investments or investment decisions made by Pelagos Capital, its own account, or on behalf of clients will not necessarily reflect the views expressed in this report. This article is distributed for informational purposes only. Forecasts, estimates, and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. There is neither representation nor warranty as to the current accuracy of, nor liability for, decisions based on such information. The information we provide does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or and offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status, or investment horizon. Pelagos Capital is not responsible for any trading decisions, damages, or losses resulting from, or relating to the information, data, analysis, commentary, or opinions in this report or their use.*

**FOR INFORMATIONAL PURPOSES ONLY. NOT A SOLICITATION.**

PAST PERFORMANCE IS NOT A GUARANTEE OR RELIABLE INDICATOR OF FUTURE RESULTS