A GREAT TIME TO BE AGNOSTIC?

Institutional investors struggle to balance the need to generate returns with the need for downside protection in an uncertain environment.

CME Group in partnership with Pensions & Investments

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EXECUTIVE SUMMARY

The economic cycle may be entering its latter stages. Volatility is rising. The bull market has been going for more than a decade. But long-term projected asset-class returns are shrinking. Investors are justifiably concerned about generating sufficient returns to meet their targets, and that was the dominant concern revealed in a survey of more than 100 institutional investors conducted on behalf of CME Group Inc.

However, in this market environment, institutional investors also appear to be trying to play offense and defense at the same time: On one hand, survey data revealed that investors still believe risk assets (such as stocks and private equity) may be best suited to helping them meet their goals. While nearly half of investors (46%) plan to take a more defensive posture over the next one to three years — increasing fixed-income allocations and decreasing equity allocations — one third also plan to implement "other" and "new" allocations that skew toward risk and volatility management.

When discussing alternative investments, survey respondents showed a similar split between playing offense and defense, putting equal focus on diversification and generating returns. Regarding implementation, alternative allocations skew heavily toward illiquid diversifiers like private equity and direct real estate, with less focus on hedge funds. Investors are even less likely to be using scalable, risk-focused strategies such as risk parity, managed futures and commodity trading advisors, or CTAs. Where alternatives are not used, investors cited a lack of familiarity or investment policy limitations.

The survey revealed distinct sensitivities and approaches within investor groups:

Corporate pension plans are more sensitive to interest rates than other investor groups, more often see Treasuries as suited to meeting their portfolio goals, least interested in changing asset allocation to boost returns and most focused on using alternatives for diversification.

Public pension plans are the most concerned with generating returns and most focused on equity-like risk assets (public and private equity, venture capital) to achieve those goals. They showed the highest interest in using alternatives for increasing return and the lowest interest in using alternatives for diversification. Overall, public plans showed an even split between scaling up and scaling back portfolio equity risk.

Endowments/foundations are most often using broad asset allocation changes to generate higher returns. They are also most frequently using alternatives to limit drawdowns and investing in hedge funds, and more sensitive to equity valuations than other groups, albeit from a low base.

In summary, investors appear to be facing a conundrum that pits generating returns against risk management and downside protection, all in an environment of rising volatility. Even as their risk appetite appears to be declining — and on balance shifting toward defensive

allocation changes — they still tend to favor risk-seeking assets such as equities and equity substitutes. Investors also revealed that they are leaning heavily on traditional assets (equities for return generation and Treasuries for diversification) to meet their goals. They do not appear to be increasing allocations to noncorrelated alternative strategies, which tend to outperform in volatile markets and may increase returns while offering protection from an equity correction and inflation.

Yet today's market regime is marked by rising levels of geopolitical, interest rate, inflation and credit uncertainty. While the U.S. Federal Reserve has begun to ease policy and may continue to do so over the balance of 2019, looking further ahead, there is little clarity regarding the direction of short-term interest rates and inflation. More broadly, economies in Europe, China and Japan are slowing despite heavy doses of monetary stimulus, as U.S. markets fret that the Fed has overtightened policy. Given the uncertainty, it remains to be seen whether traditional assets like equities and bonds will perform their intended role.

This environment raises the question, Why aren't investors taking a more agnostic approach to asset allocation and strategy selection, especially when growth appears to be slowing, equity valuations may not reflect underlying fundamentals, and debt levels are high? Taking a more agnostic approach, and using strategies that may thrive under a wide range of scenarios, may give investors more opportunity to address their twin goals of generating returns and managing risk. But such noncorrelated assets are mostly missing from the current mix. All of which suggests that, in this environment, investors' means may not be quite aligned with their intended ends.

This survey investigates the attitudes and practices of pension funds, defined contribution plans, and endowments and foundations, particularly regarding the current investment environment and the use of systematic alternative investment strategies. The research was sponsored by CME Group Inc. and conducted by Pensions & Investments' Content Solutions during the month of April 2019. The respondents were drawn from P&I's Research Advisory Panel, a group of plan sponsors who serve as an important source of market intelligence for P&I and its partners and a sample selected from the Pensions & Investments audience database, including executives with CFO, CEO and treasurer titles. The 134 respondents represent U.S. and Canadian institutions: defined benefit corporate pension plans, public pension plans, defined contribution plans, and endowments and foundations. Statistical analysis was conducted by Signet Research Inc.

I: UNCERTAIN MARKETS BRING CONCERN ABOUT RETURNS

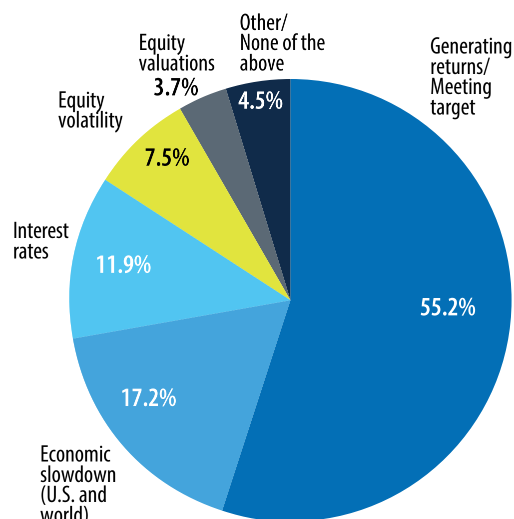
Institutional investors today face a pressing issue: How does one generate returns in an environment of low interest rates when equities are looking a bit rich? The question becomes more acute when one considers that growth is slowing, volatility is picking up and the Federal Reserve is signaling a readiness to reverse course on interest rates in the face of a partially inverted yield curve.

While the Federal Reserve's policy rate is low by historical standards, it remains near an 11-year high. Inflation in the U.S. has remained broadly stable around 2% since 2016 despite unemployment below 4%. Fearing that inflation might rise, the Fed tightened monetary policy significantly during 2017 and 2018, bringing U.S. short-term interest rates to significantly higher levels than in other developed markets, where central bank policy rates have remained much lower. However, short-term interest rate markets are now pricing in expectations that the Fed will cut interest rates roughly in half by early 2020, leaving fixed income-focused pension investors in a more challenging position with regard to generating returns.

The pressing issue of return generation is relevant to equity-focused and bond-focused investors alike. More than one-half of institutional investors who responded to the CME Group survey said that in such an economic environment, their main concern is whether they can generate sufficient returns to meet their investment targets. Most of the remaining investors reported their main concern to be about the U.S. economy slowing and interest rates, but those ranked a distant second and third. (See Exhibit 1)

Exhibit 1

What is your organization's main investment concern right now?[1]



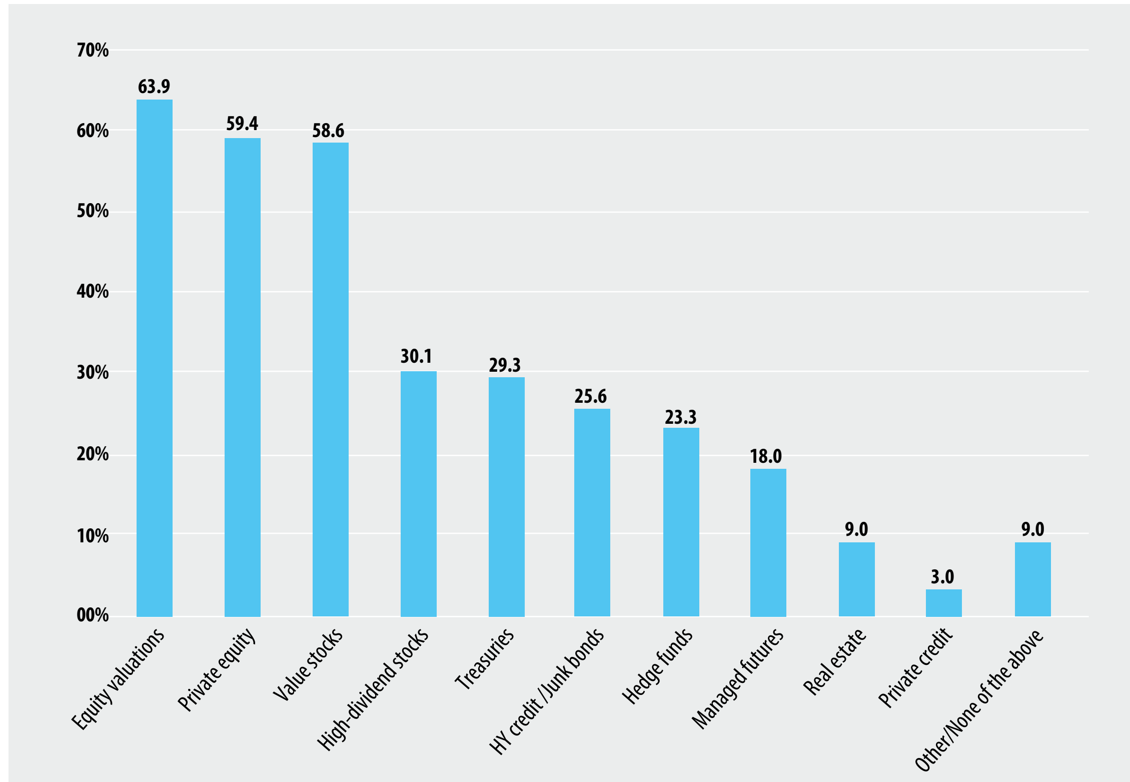
[1]Unless otherwise noted, the source for all charts and graphs is the CME Group Inc. survey of institutional investors conducted in April 2019.

Given today's market backdrop, the concern over generating returns is understandable. U.S. equities have had a spectacular bull run, with the S&P 500 rising more than 300% in a decade: from 666 points on March 9, 2009, to just under 3,000 in July 2019.

"Sometimes such a bull run is self-sustaining, with equities pushing ever higher, albeit with periodic corrections. Yet today, as economic growth slows, it's not obvious that the equity rally can continue for a great deal longer," said Erik

Exhibit 2

Which of the following investment vehicles and/or asset classes do you think can best help reach your organization's portfolio goals?



Norland, executive director and senior economist of CME Group. "Meanwhile, investors are seeing 2.5% interest rates on the long end of the yield curve, which is not very attractive either."

That backdrop is important to understanding why institutional investors are focusing on risk assets as their preferred means of reaching their investment targets. Overall, survey respondents cited equity assets as best suited to helping them meet their goals. (See Exhibit 2)

Fixed-income assets were cited about half as often, with alternatives falling even further behind. Yet investors are facing markets in which equity valuations may not reflect fundamentals, corporate debt levels are high and returns on risk assets have been diminishing.

This scenario raises the question of why investors are putting such a large emphasis on equity risk and indicates that equity-reliant investors may be vulnerable to a kind of recency bias, the belief that the current bull market will persist despite warning signs.

"The truth is that nobody really knows for sure whether equities are overvalued right now. Or whether they can maintain or extend their exceptionally high valuations," Norland said. "Everybody's nervous but nobody is ready to call it quits just yet.

"The conundrum is that equities have risen a great deal, and when measured as a percentage of GDP, valuations have reached heights not seen since 2000," he said. "The difference, however, is that in 2000, equities had to compete with bonds that were yielding around 6%. Today equities may actually look undervalued relative to significantly lower bond yields of about 2%. So are equities overvalued? It's a slippery question." (See Exhibit 3)

Uncertain, too, is the prospect for continued low volatility. In a period of persistent low interest rates, markets have been in a volatility

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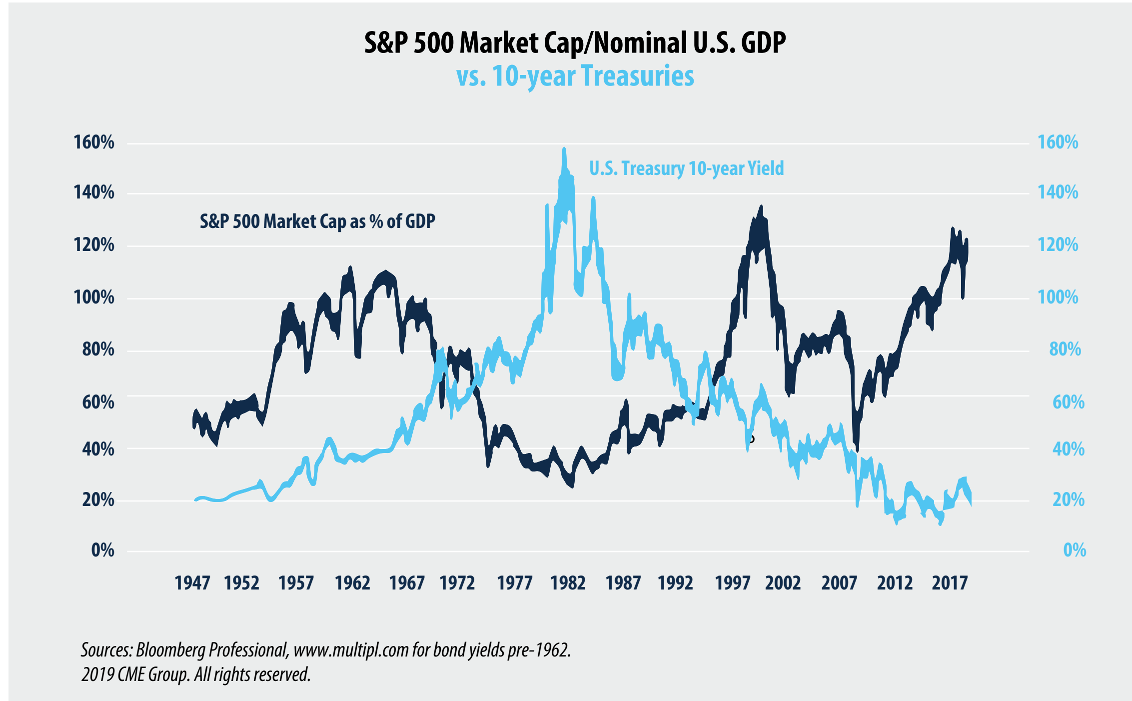
Exhibit 3

Stocks are highly valued compared with earnings and GDP, but look undervalued in light of low yields



Sources: Bloomberg Professional, www.multipl.com for bond yields pre-1962.
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Table: **Volatility cycles by economic season**

ECONOMIC SEASON	MONETARY POLICY	VOLATILITY
Early Recovery	**Easy monetary policy** Two-year moving average of the 3M30Y* yield curve greater than 200 basis points (bps) in steepness.	**High volatility** Volatility Index (VIX) two-year moving average greater than 16%.
Mid-Expansion	**Easy monetary policy** Two-year moving average of the 3M30Y greater than 200 bps in steepness.	**Low volatility** VIX two-year moving average less than 16%.
Late Expansion	**Tighter monetary policy** Two-year moving average of the 3M30Y below 200 bps.	**Low volatility** VIX two-year moving average still below 16%.
Recession	**Tight monetary policy** Two-year moving average of the 3M30Y less than 200 bps in steepness.	**High volatility** VIX two-year moving average greater than 16%.

* 3M30Y = 30 year/3-month yield curve

Source: CME Group Inc.

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slump since 2013. Such an economic regime has been great for some asset classes such as stocks, while not great for others including alternatives such as CTAs and risk parity. But markets appear to be at the end of a low-volatility cycle that started in 2011. (See Exhibit 4)

Examples of higher volatility regimes (recession/early recovery) would be the end of the 1980s and the beginning of the 1990s, from 1997 to 2003, and from about 2007 to 2011 — with implied equity volatility typically at about 20% or higher. Examples of lower volatility regimes (mid- and late-expansion) would be the mid-1990s, the mid-2000s, and from 2012 to 2019 — with implied volatility hovering just above 10%. These low volatility regimes — which included a flat yield curve from 1996 to 2000 and 2006 to 2007 — are typically followed by a massive expansion in volatility.

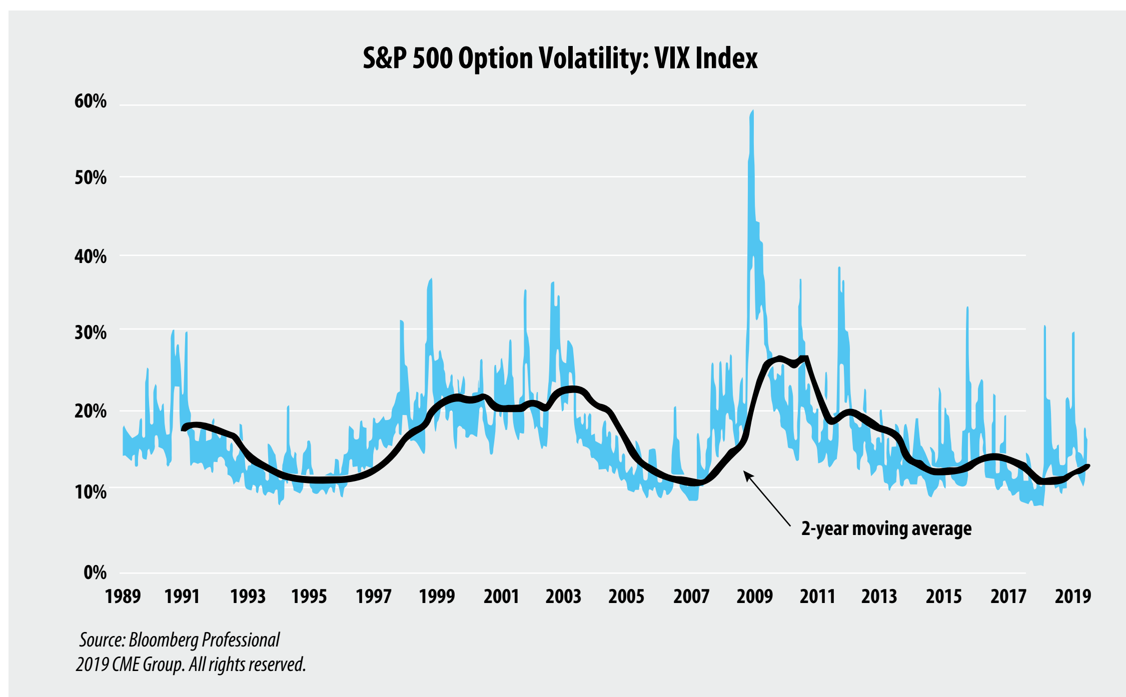
"How and why do markets transition from one volatility regime to the other?" asked Norland. "I believe such transitions are closely tied to monetary policy. Easy money drives volatility down and tight money sends volatility higher with about a one- to two-year lag. Recently, money has become tight because of the Fed hiking interest rates nine times and shrinking its balance sheet. And even though the Fed took back one of those rate hikes at the end of July, U.S. monetary policy remains quite tight. Moreover, two Federal Open Market Committee members voted against easing policy and, more broadly, the Fed didn't appear to commit to further easing, as many market participants believed. It would take multiple interest rate cuts to significantly ease monetary policy and re-steepen the yield curve in meaningful fashion," he said.

The yield curve flattened and volatility increased throughout 2018 and the first half of 2019. If the past patterns hold, investors may be facing the near-term possibility of markets moving into a very high-volatility regime similar to the early 1990s, 1997 to 2003 and 2007 to 2011. So even if the Fed cuts rates, it will not guarantee a return to low volatility.

"If the Fed cuts a few times, everything may be off to the races," Norland said. "The

Exhibit 4

When will today's low volatility end?



Source: Bloomberg Professional

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> THE TRUTH IS THAT NO ONE KNOWS WHETHER EQUITIES ARE OVERVALUED...EVERYBODY'S NERVOUS BUT NOBODY IS READY TO CALL IT QUITS JUST YET.
>
> —**Erik Norland**
> *Executive Director and Senior Economist of CME Group*

equity bull could keep running, the yield curve could re-steepen. But after a year or so, if the rally continues, the Federal Reserve may hike rates back up again, in which case equity markets might reverse course as they did in 2000 after a second round of Fed tightening at the end of the 1990s. This is what happened in 1998 when the Fed cut rates three times in the aftermath of the Russian default and the collapse of Long-Term Capital Management. In the next 18 months, the S&P 500 rallied 68% and the Nasdaq rose 186%, prompting the Fed to begin raising rates again in 1999. The second tightening cycle at the end of the 1990s produced a terrible period for stocks, when the Nasdaq fell 85% and the S&P 500 fell 50%. At the same time, alternative strategies like CTAs did quite well."

Finally, rate cuts do not guarantee a tailwind for bonds either. One of the weaknesses of traditional assets — both equities and bonds — is that they can both simultaneously be disadvantaged if the economy returns to high levels of inflation and market volatility. Such a regime would typically be bad for fixed income in particular, but could also be bad for stocks, according to Norland. If both stocks and bonds are overvalued, commodities may be the more attractive asset class.

"We have to be agnostic," he added. "We just don't know where equities are headed, or how far the Fed will push down interest rates before hiking again, or where inflation is headed or how high volatility may spike. There are too many unknowns to build a strategy based on the idea that today's broad performance trends — which have been so positive for traditional long-only investments such as equities, long-term government bonds and high-yield credit over the past decade — will persist. As such, diversification is crucial."

SUMMARY

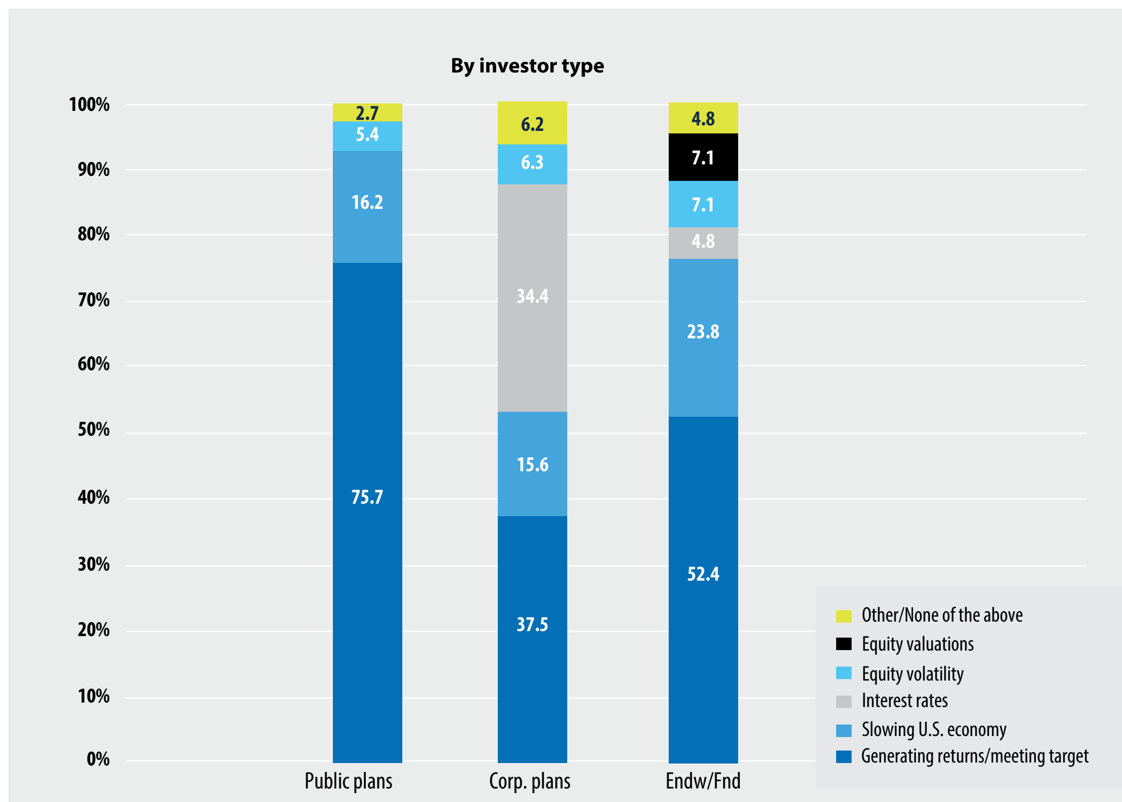
- *Investors' greatest concern is generating sufficient returns to meet their targets.*
- *Risk assets (public and private equities) are cited as the most relevant assets for helping them meet their portfolio goals.*
- *Equity valuations are difficult to pin down when bond yields are so low.*
- *Though the market expects several rate cuts, money remains tight.*
- *Markets appear to be moving toward a higher-volatility regime despite expected rate cuts.*
- *Equities and bonds may both underperform if markets experience high volatility and rising inflation.*

II: DIFFERENT INVESTOR GROUPS ARE VULNERABLE IN DIFFERENT WAYS

Survey results showed distinct areas of concern within different investor groups. Corporate pension plans showed the greatest concern about generating returns and meeting targets, which was nearly equal to their concern about interest rates. Public pension funds also reported the greatest concern about generating sufficient returns to meet their targets, but reported literally zero concern about the path of interest rates and equity valuations. (See Exhibit 5)

Exhibit 5

What is your organization's main investment concern right now?



OVERALL FUNDING LEVELS IMPROVED SLIGHTLY FOR PUBLIC PLANS, REACHING 72% IN THE FIRST QUARTER OF 2019 THANKS TO A CONTINUED EQUITY BULL MARKET.

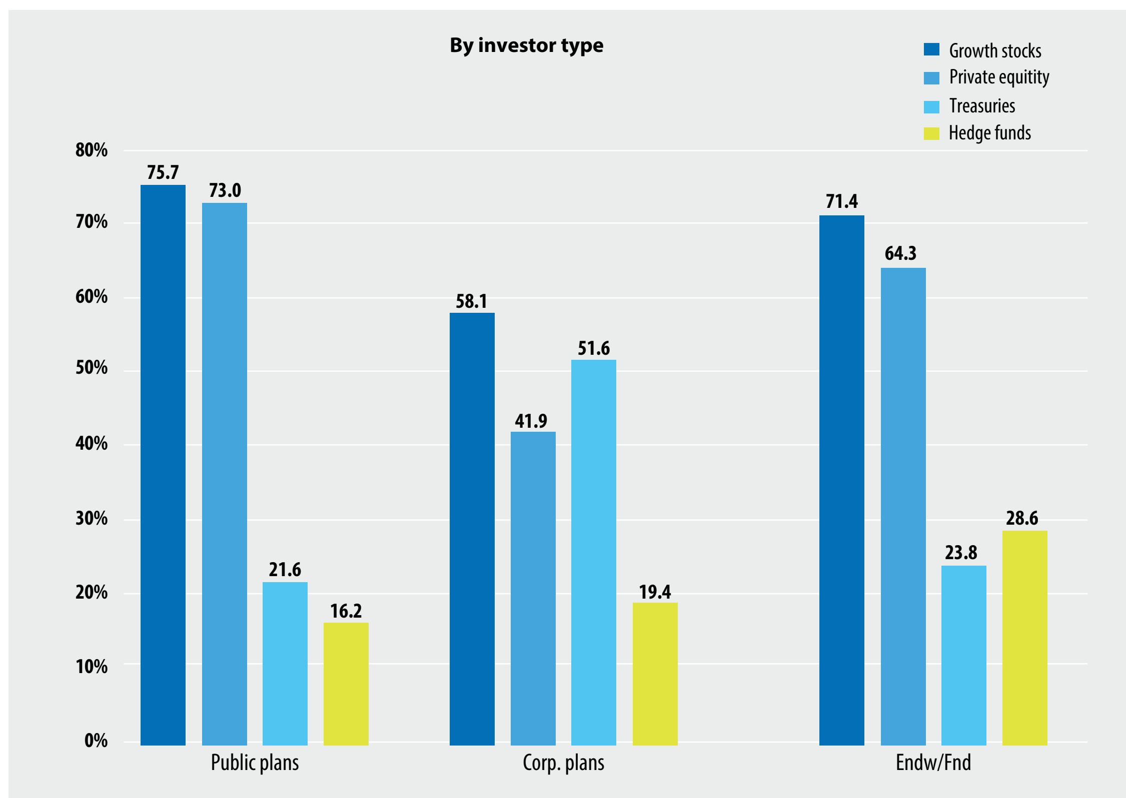
Interestingly, no investor group had material concerns about equity volatility or valuations, at a time when valuations appear by some measures to be quite high, and tight monetary policy may be ushering in a higher-volatility market regime.

The difference in concern among these groups makes sense when set against funding data that shows progress among corporate pension plans, but continued challenges for many public plans.

Overall funding levels improved slightly for public plans in the first quarter of 2019, reaching 72% thanks to a continued equity bull market. But according to a recent study from the Center for Retirement Research at Boston College[1], funding levels of public plans have been dropping steadily since 2007, leaving a large swath of public plans with significant gaps. In the period from 2001 through 2018,

Exhibit 6

Which of the following investment vehicles and/or asset classes do you think can best help your organization reach its portfolio goals?



[1]*Center for State & Local Government Excellence, October 2018,* https://slge.org/assets/uploads/2018/10/2018-10-fundingbrief.pdf

funding levels fell in the top-, middle- and least-funded groups:

- From 110% to 90% for the top third.
- From 100% to 73% for the middle third.
- From 90% to 55% for the bottom third.

By contrast, the funded status of the average corporate pension plan has improved since 2007, reaching 87.1% at the end of 2018, despite the "worst asset performance in a decade," according to a report[2] from independent actuarial firm Milliman Inc. At the same time, these plans saw the second-highest increase in their discount rate on record — 52 basis points.

Additional survey data point to the tangible impact that funding levels may be having on investment strategy and asset preferences (see Exhibit 6):

Corporate plans cite Treasuries more than twice as often as public plans to help them meet their portfolio goals.

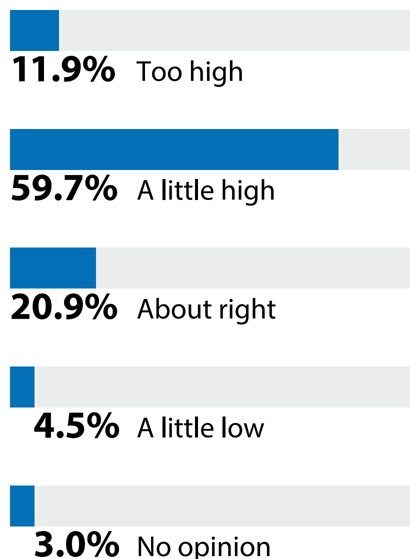
Public plans cite growth stocks as their asset of choice 30% more than corporate plans.

The CME Group survey data suggests that corporate plans may be trying to lock in their funding improvements with liability-matching strategies, hence their concern over interest rates and a focus on Treasury assets. At the same time, public funds may be trying to close their funding gaps by focusing on generating returns purely through risk assets, primarily equities. This makes sense, considering the difficulty that many states and municipalities have been having making necessary — and, in many cases, long overdue — pension fund contributions.

"Part of the problem for better-funded plans is they want to be defensive and invest a great deal in Treasuries so funding levels don't deteriorate if equity markets tank," Norland said. "But Treasury yields are terribly low, essentially 1.7% to 2.5% depending on the maturity. It may be difficult to meet pension obligations with yields at those levels. Now, if the Federal Reserve cuts interest rates, which by all appearances they're about to do, that will steepen the yield curve. Bond investors could boost return by going out the yield curve, or by levering up through derivatives. But

Exhibit 7

Do you think global equity market valuations are too high, a little high, about right, a little low or you have no opinion?



the risk is that fixed income markets fall out of bed if we have a lot of inflation."

Poorly funded plans have their own set of vulnerabilities, primarily owing to their near-exclusive reliance on equity-like risk to close funding gaps. A large majority of survey respondents (70%) — including public plans — think equity valuations are high. (See Exhibit 7) Almost none of the survey respondents believe that equities are undervalued or attractively valued.

Nevertheless, as Exhibit 6 showed, public plans favor equities over other asset classes to help meet their portfolio goals. Equity-like risk even features prominently in the alternative allocations of survey respondents (See Exhibit 8), particularly public plans, according to survey data. Private equity is the most common alternative allocation cited by respondents, with public plans more often favoring both private equity and venture capital than corporate plans.

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[2] *Milliman Inc., April 2019.* *http://assets.milliman.com/ektron/2019-corporate-pension-funding-study.pdf*

Exhibit 8

In which of the following alternative investments does your organization and/or employed external money manager(s) invest?

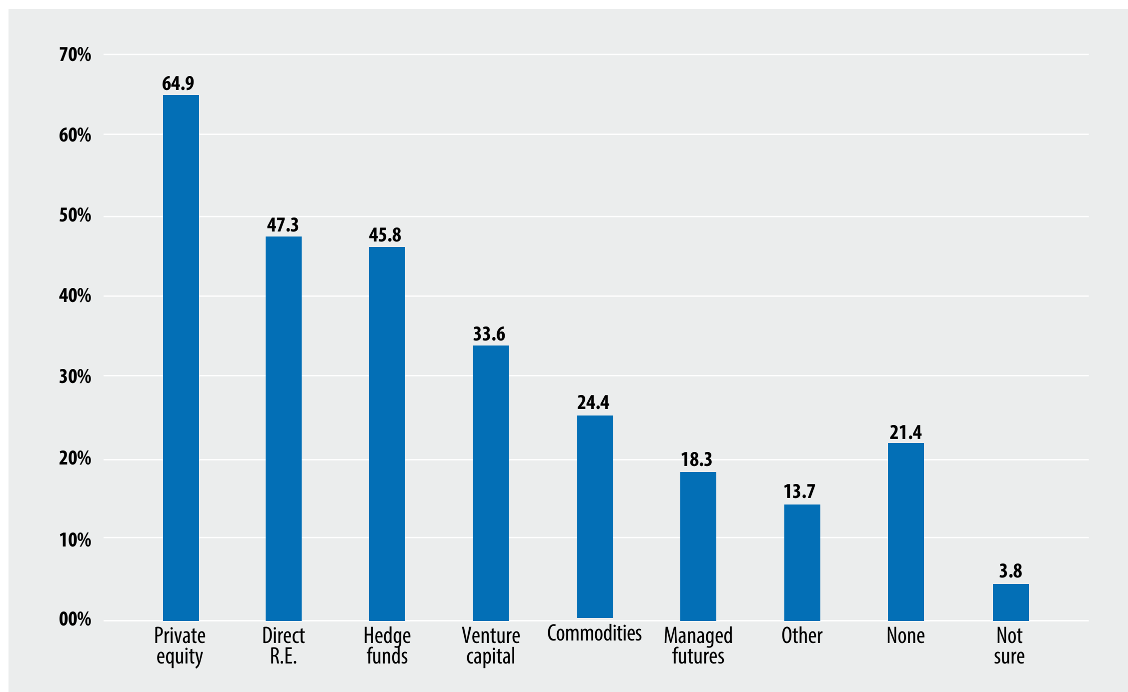
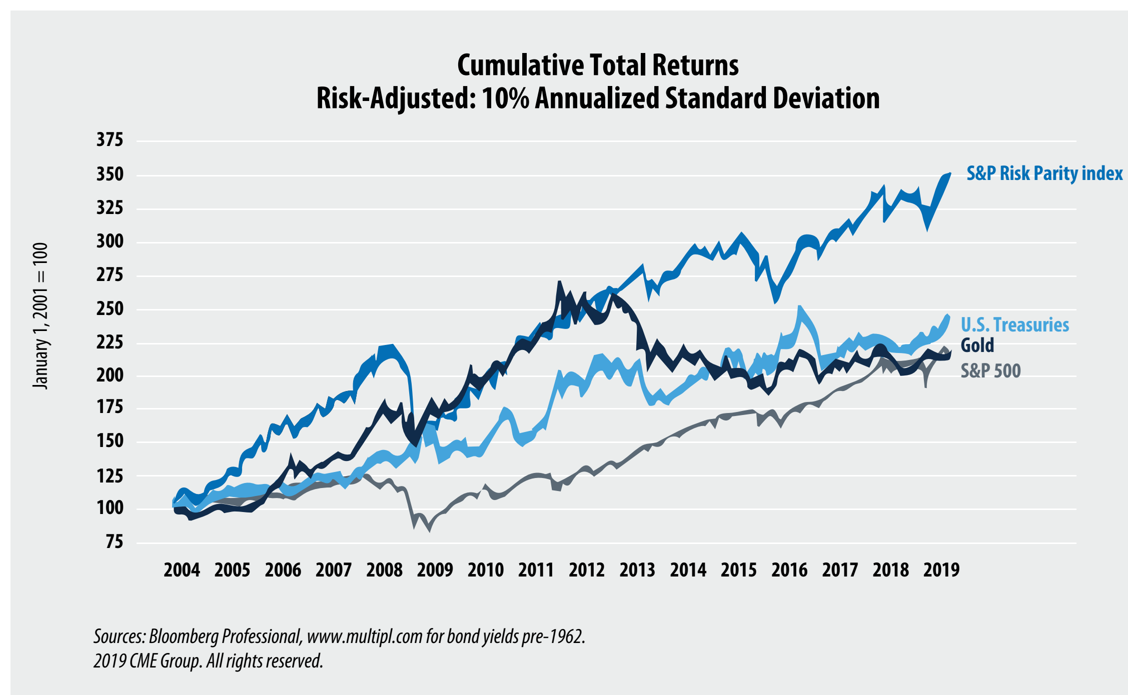


Exhibit 9

Risk parity dominates components (equities, gold, Treasuries) in risk-adjusted returns



Sources: Bloomberg Professional, www.multipl.com for bond yields pre-1962.
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"It's a sobering thought that investors might be allocating to equities not because they think equities are a well-valued investment, but simply because it's the one investment that has enough risk to get them to where they know they have to go," said Norland. "In the absence of raising contributions, they are looking for a purely market-based solution. And equities appear to be the only asset class which, in its raw form, could deliver the risk levels required to meet their goals."

As a cautionary example, Norland pointed to the late 1960s when bond yields were low and equity valuations were high. "Today actually looks a bit like an exaggerated version of the mid-1960s. Equity valuations are higher than they were then, and bond yields are lower," he said. "What happened after that was a miserable period for both asset classes."

Bond yields soared, which meant that prices declined. At the same time, stock market values crashed to 30% of GDP from 110%, and money lost 70% of its value between 1966 and 1982 because of sky-high inflation. Gold soared from $35 to $800 per ounce and commodities were the only asset class that did well in that economic period.

Norland noted that today, institutional investors appear to favor private equity and venture capital — both of which are probably highly correlated to the equity market — to the exclusion of non-correlated alternative strategies such as CTAs and managed futures, which have performed well in unpredictable, volatile markets. In addition, such risk-focused strategies can be scaled to suit the objectives and constraints of both fixed-income and equity investors, and have, at times, outperformed their underlying constituent asset classes. (See Exhibit 9)

"The beauty of scalable risk products is that they can get on board commodity and other strong market trends as those trends unfold, because the strategies themselves are agnostic about the future," he said. "And now might be the perfect time to adopt an agnostic approach rather than betting on equity or fixed income trends continuing as they are. Nobody really knows what's going to happen."

SUMMARY

- *Corporate plan sponsors are equally concerned with interest rates and generating returns, and mostly favor growth stocks and Treasuries to meet portfolio goals.*
- *Public plan sponsors are overwhelmingly concerned with generating returns and look almost exclusively to risk assets (public and private equities) to meet portfolio goals.*
- *No investor group showed significant concern over high equity valuations or increasing equity volaility.*
- *Funding levels are probably the driver of each group's sensitivities and asset class preferences.*
- *Alternative strategies and assets focus mostly on private equities and to a lesser extent on real assets and hedge funds.*
- *Scalable risk products in the alternative category saw comparatively low uptake in institutional portfolios.*

III: INVESTORS SIMULTANEOUSLY TRYING TO PLAY OFFENSE AND DEFENSE

Nearly two-thirds of investors reported plans to implement asset allocation changes in the next one to three years. (See Exhibit 10) Again, responses from corporate and public plan sponsors diverged. Nearly three-quarters of public plans said they planned allocation changes while only about half of corporate plans said so. The rest of corporate plan respondents were split between saying "no" or "not sure" to asset allocation changes. Close to two-thirds of endowments and foundations said they were planning changes.

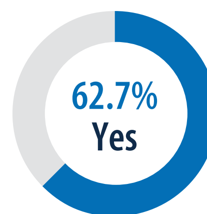
These results suggest that corporate plans, seeking to preserve their funded status with fixed income-focused strategies (such as liability-driven investing), may be waiting to gauge the path of interest rates before making a call on allocation changes. Hence the higher likelihood of being unsure about making asset allocation changes. By contrast, public plans are more open to making immediate portfolio adjustments, particularly to equity allocations.

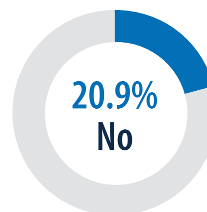
In a somewhat surprising result, when asked what is the most significant kind of allocation change they were planning, nearly half of respondents (46%) indicated they would be making defensive changes — decreasing equities and/or increasing fixed income. (See Exhibit 11) This result was unexpected given investors' high degree of sensitivity to the issue of generating returns.

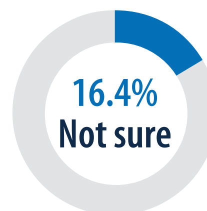
As one might expect, corporate respondents appear much more likely to plan increases to fixed income allocations; they are also more likely to leave equity allocations untouched. By contrast, public plans were about twice as likely as corporate plans or endowments/foundations to make changes to equity allocations — with additional survey data suggesting a split

Exhibit 10

Do you intend to make allocation changes in the next one to three years?







between well-funded public plans versus under-funded plans.

In another surprising result, public plans appeared to be split on changes to equity allocations, with equal numbers expecting increases and decreases to equities. Considering the large disparity in funding status between well-funded public plans (averaging 90%) and under-funded plans (averaging less than 60%), it would make sense for the former to be taking risk off the table while the latter might be ramping up risk to close any funding gaps.

For their part, endowments and foundations reported planning new allocations or taking an "other" approach instead of increasing or decreasing traditional assets (e.g., bonds and stocks), much more often than other institutional investors. And their verbatim responses in the "new allocation" and "other" categories pointed in a defensive direction. Those categories included:

- **Real assets and illiquids** (direct real estate, commodities, infrastructure, private market allocations)
- **Alternative strategies** (hedge funds, managed futures, opportunistic, global macro)
- **Liability-focused strategies** (annuitization, liability matching)

When asked about the No. 1 reason for their allocation changes, respondents overall again gave answers that were evenly split between generating returns and protecting the downside. (See Exhibit 12) But each respondent group was unique in its point of view:

- **Endowments/foundations** were much more likely than average to say allocation changes were aimed at generating returns.
- **Corporate plans** were least focused on generating returns.
- **Public plans** were evenly split between generating returns and protecting the downside — results that mirrored the even split on increasing/decreasing equity allocations. Taken together, such results suggest that about half of public plans may be concerned about the impact of a potential market correction on equity-heavy portfolios.

When asked about the specific goals for their portfolio investments in alternatives,

Exhibit 11

What is the most significant allocation change you expect to make in the next one to three years?

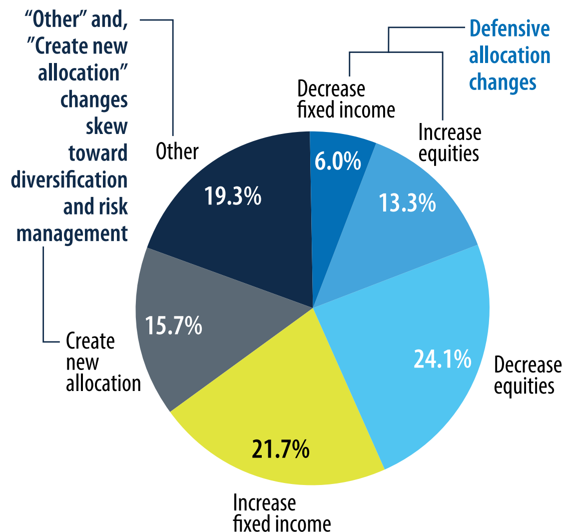


Exhibit 12

In your opinion, what is the No. 1 reason for the asset allocation changes your organization has planned?

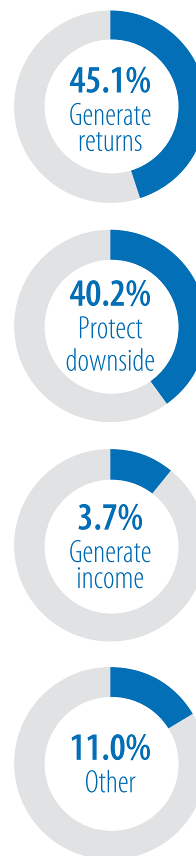
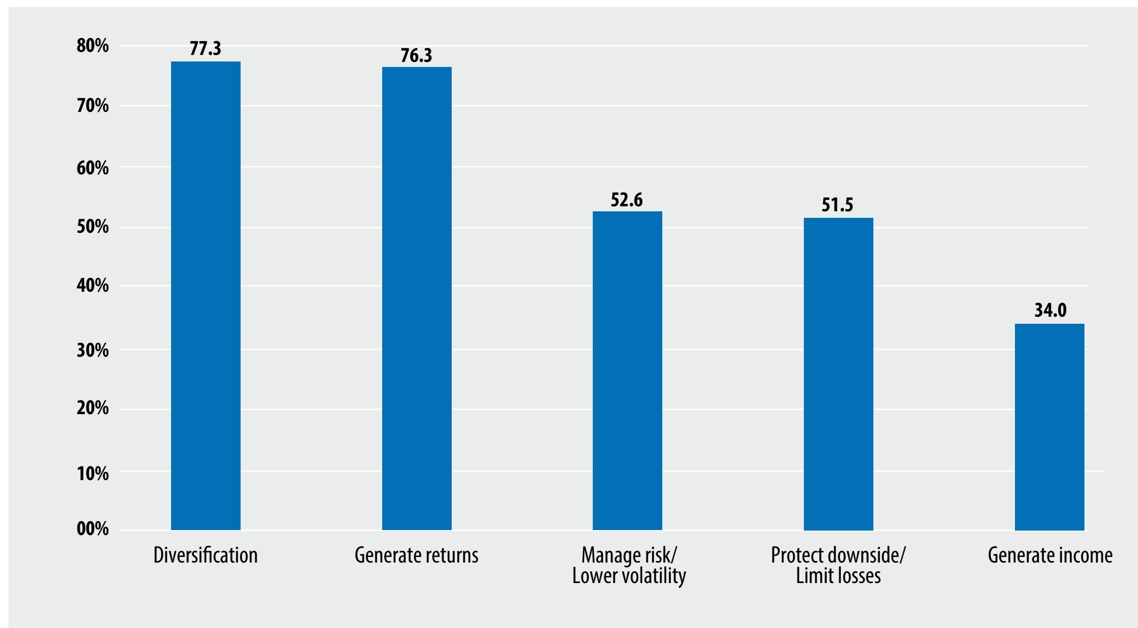


Exhibit 13

What goals does your organization seek to reach with its alternative investments?

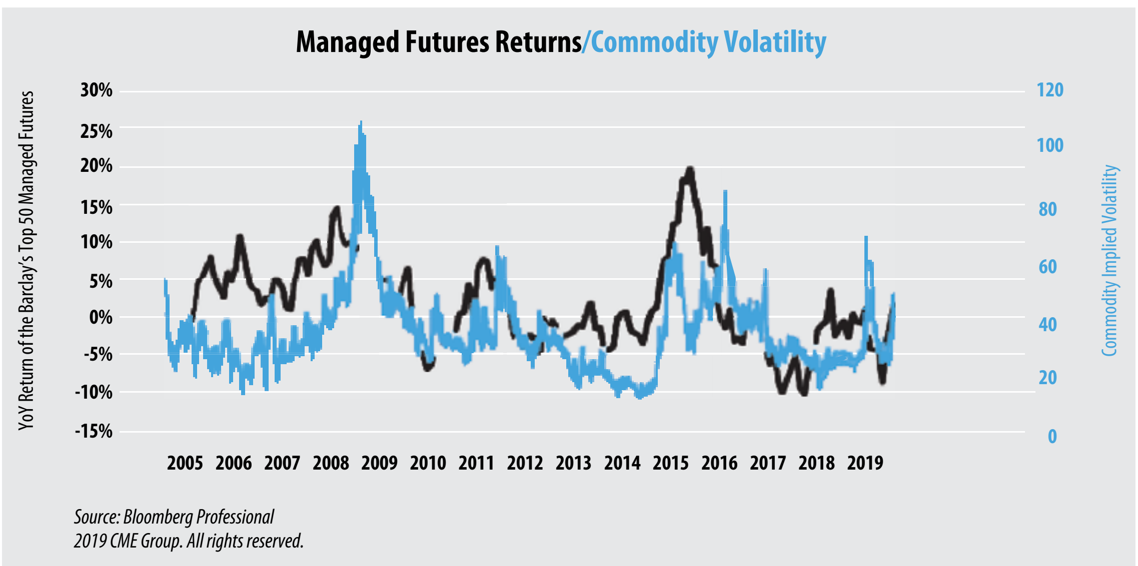


institutional investors once again were split — this time equally ranking generating returns and improving diversification as their two top choices. (See Exhibit 13) Volatility management and downside protection received significantly lower rankings, and individual respondent groups showed unique sensitivities:

Public funds: Highest interest in using alter-

Exhibit 14

Extended periods of low volatility are difficult for managed futures, but if volatility rises, so might managed futures returns



Source: Bloomberg Professional

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natives to generate returns, lowest interest in using alts to improve diversification.

Corporate plans: Highest interest in using alts to improve diversification, lowest rank for using alts to manage risk and lower volatility.

Endowments/foundations: Significantly higher focus on using alts to protect the downside and limit losses.

But investors' heavy reliance on risk-seeking assets in the alternatives category may be putting their investment objectives in danger. Even investors seeking to use alts for downside protection appear to favor private equity and venture capital, rather than noncorrelated strategies that may outperform in volatile and/or declining markets.

"In the current cycle, tons of money has flowed into venture capital, and I think the low hanging fruit has been picked very quickly. A lot of venture investments aren't likely to pan out if there's a sell-off in technology stocks," CME's Norland said. "The same applies to private equity, which is less connected to technology, but still very much connected to the rest of the stock market. It's just an illiquid version of the public stock market."

He said his concern is that in both alternatives and traditional assets, investors may be vulnerable to a recency or trend-following bias, meaning that they are down on certain strategies because they have performed poorly recently and vice versa. He cautioned that those may actually be the best times to allocate capital toward these strategies, as markets often act in a way contrary to investor expectations. Likewise, assets and strategies that have done well might represent crowded trades that are on the cusp of mean reverting and/or underperforming.

"For example, CTAs and global macro funds tend to do well under strong market trends, but in the last decade, we have had exceptionally low volatility across almost every market," he said. "When markets don't have volatility, they typically also don't have strong trends. And CTA managers have basically been churning for the last decade, spending money transacting in the markets but not making enough money to deliver outperformance. That may be about to change with a potential shift to a higher volatility regime."

MANAGED FUTURES

Investor experience:

- *Half of allocations less than five years old.*
- *One-third more than 10 years old.*

Past 5 years: *Most allocations increased or stayed the same.*

Next 12-18 months: *Most allocations will remain the same or slightly increase.*

Rank of most-used strategies:

1. *Trend following*
2. *Macro*
3. *Option writing*
4. *Pattern recognition*
5. *Counter trend*
6. *Other*

Rank of objectives for managed futures allocation:

1. *Diversification*
2. *Protecting downside*
3. *Generating returns*

Most common reasons for not using alts:

1. *Policy statement restrictions*
2. *Fees*
3. *Lack of knowledge*
4. *Illiquidity*
5. *Volatility of returns*

He pointed out that risk-parity strategies have shown promising signs in the past in volatile markets by exploiting trends across a range of underlying assets. (See Exhibit 14) Even at a time of low equity volatility, risk-parity strategies were able to exploit an explosion in commodity volatility around the two-year crash in oil prices between 2014 and 2016.

When asked about managed futures strategies specifically, respondents were split in the length of their experience: most allocations were relatively new (less than five years), with about a third being more than 10 years old. Over the next 12-18 months, they reported, such allocations are likely to stay the same or only slightly increase.

"These kinds of alternative strategies are generally noncorrelated with traditional assets and have the advantage of being scalable," Norland said. "Risk-seeking investors can scale them up to equity-like risk while still adding diversification and downside protection in the event of an equity correction. Bond investors can scale these strategies back to suit more moderate risk-return goals, and potentially improve fixed-income returns even when yields are low and the curve is flat."

Yet investors appear to be forgoing these options, according to the survey — focusing heavily on equity-like return profiles of private equity and illiquid diversifiers such as direct real estate.

SUMMARY

- *Nearly two-thirds of investors plan to make allocation changes in the next one to three years.*
- *The majority of those changes are likely to be defensive (decrease equities/increase bonds) or focused on risk management and downside protection.*
- *Public funds have the highest sensitivity to increasing returns, while endowments and foundations have the highest sensitivity to limiting drawdowns.*
- *Public finds appear split between adding equity risk and protecting portfolios from an equity correction.*
- *Current alternative allocations skew toward equity-like risk, using private equity or illiquid diversifiers such as direct real estate.*
- *Use of non-correlated, scalable, risk-focused strategies (CTAs, managed futures, global macro, risk parity) is not expected to increase significantly over the next 12 to 18 months.*

IV: CONCLUSION

This survey revealed a potential disconnect between investors' high level of concern about returns and their increasingly defensive mood. They face many tangible risks on the horizon as the business cycle winds down: geopolitical risks, elections, inflation, recession, etc. Yet their portfolio strategies may not be adapting fast enough to address emerging risks.

Rather than taking an agnostic approach in an uncertain market, institutional investors appear to be doubling down on expectations that recent asset class performance will continue — especially counting on a continuation of today's equity rally. That may be a dangerous strategy, and begs the question of why investors are not adapting portfolios to prepare for significant potential downside risk.

Growth is slowing. Equity and risk-asset returns have been diminishing. High equity valuations may not reflect current fundamentals. Debt levels are high. Risks abound. Markets may be on the brink of an entirely new high-volatility regime. Sticking with the status quo may push investors into crowded trades and overvalued assets that are at risk for a correction. It also may lead them to avoid strategies that performed poorly during the current market regime, even though those strategies may be well-positioned for the next.

Historical parallels for today's market environment (low bond yields, high equity valuations, increasing volatility, relatively tight monetary policy, and rising inflation) are everywhere. The most concerning parallel is the "stagflation" that emerged in the mid-1960s and lasted will into the 1970s. Low volatility regimes with a flat yield curve are often followed by a rapid expansion of volatility. And a tight-money, high-volatility, high-inflation regime would probably be difficult for both stocks and bonds — at the same time being a boon to commodities and leveraged, derivative-based strategies like risk parity and managed futures.

Rather than putting most of their eggs in the equity basket, so to speak, investors may be well-served by taking a more agnostic approach and adapting portfolios to withstand significant potential downside risk. Allocating to noncorrelated risk-focused strategies such as CTAs, global macro and risk-parity is one way to adopt an agnostic approach to markets, deploying strategies whose return potentials do not hinge on a specific outlook for individual asset classes. Such strategies have performed well in the past when strong market trends emerged, and may in fact serve investors well in an uncertain market with many unpredictable variables at play such as interest rates, bond yields, equity volatility, inflation and more.

Allocating to these non-correlated strategies may be a way to address both the return and risk management issues that appear to be of equal priority to institutional investors today. ■

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