The Case for an Increased Alternative Investment Allocation

We know some readers have been burned by alternative investments in the past. However, readers will also remember times in which they've been burned by equity investments as well. The fact that losing periods in core investments and alternative investments have generally occurred at different times is a good thing…etc…etc…etc.

You've heard all this before, and, although it's all true, it's not the point of this note.

Believe it or not, **this note will argue that the proper response to a recent comparison of core returns to alternative returns is to *increase* alternative allocations, even at the expense of fantastically performing core allocations.**

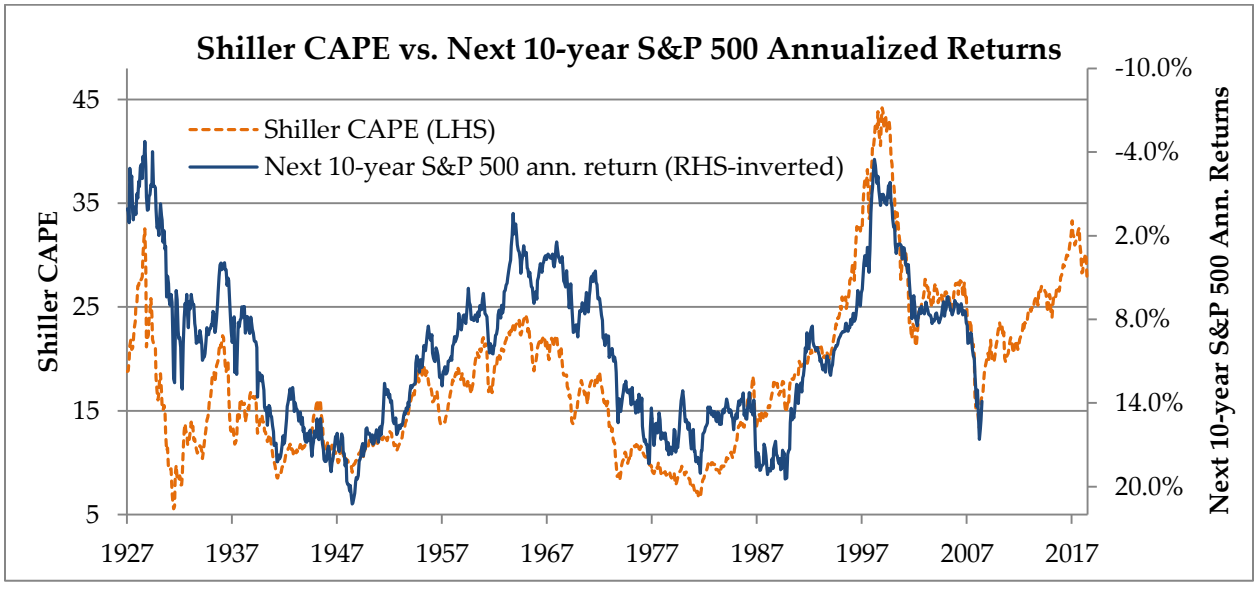
Investors' fears of missing out on a strong bull run should be minimal at these levels, and the opportunity cost of increasing alternative allocations, at the expense of core stock and bond allocations, may be about as low as it has ever been, provided investors have at least decade-long outlooks.

The Previous Decade

The S&P 500 was up 20% in 2019, as of the end of July. Since the low point on March 9, 2009, the S&P 500 has returned an annualized 17.8%. It's been a great time to be an equity investor. But is it still a great time, or are some investors trying to invest in the previous decade, not the next decade?

The Next Decade

It's time to dust off a graph we've all seen before. The below graph shows the Shiller CAPE (cyclically adjusted price-to-earnings ratio) vs. the next 10-year S&P 500 annualized return (inverted on the right-hand scale to illustrate the relationship). **The current Shiller CAPE of about 30 has historically indicated an S&P 500 annualized return of only about 3% over the next decade. If that isn't buzzkill enough, the U.S. 10-year interest rate is only about 2%.**



The Shiller CAPE has not been useful in predicting the specific market conditions that have led to the 10-year annualized S&P 500 returns in the previous graph. A low return could have come in part from a big crash followed by a strong recovery (two distinct trends), an environment that has historically been good for many trend-following alternative strategies. However, a low return could also have come in part from a choppy, sideways market (with lots of short trends and reversals), an environment that has historically been good for many mean-reversion alternative strategies.

Regardless of how it may occur, though, the previous graph is noteworthy and suggests that investors may not see the returns they expect (or need?) from core allocations over the next decade. **The point is simple. <u>The opportunity cost of increasing allocations to carefully selected alternatives may be about as low as it has ever been, considering both the Shiller CAPE for equities and the current interest rate for bonds.</u>**

For more information on ABR's alternative strategies for strongly trending and for mean reverting market environments, as well as the possibility of blending them together for an uncertain future, please contact us at (212) 918-4663 or info@abrfunds.com.

Notes on the Shiller CAPE

The Shiller CAPE is the price of the S&P 500 divided by the inflation-adjusted average earnings over the past 10 years. It is meant as a valuation measurement to compare what investors pay for their equity exposure to what investors get from their equity exposure.

It is worth noting that because the Shiller CAPE uses 10 years of data, and 10-year returns of course also use 10 years of data, the sample size of independent data points is much less than 90 years * 12 months/year = 1,080 months. The result is that the historical relationship is less significant than the above graph may make it appear, although the relationship is still worthy of attention in light of both the theory and the data.

As the above graph shows, the Shiller CAPE has had some historical value in anchoring equity return expectations over time periods of ~10 years. However, it has not been nearly as useful over shorter time periods, and, even over 10-year time horizons, there is still an element of uncertainty and a range of historically observed values (shown in the following graph).