Why invest in alternatives?

StatePlus

Formerly State Super Financial Services

Investment Series

In simple terms, alternatives are investments that don't fit into the traditional asset classes such as shares, property, cash and bonds. This can be because either:

- *the asset class itself is non-traditional, or*
- *the strategy takes an innovative approach to investing in traditional asset classes.*

How do we use alternatives?

We use alternatives to help us to reduce risk in portfolios because they can behave differently from other investments.

At StatePlus we have created two alternatives sectors, each designed to improve the return per unit of risk in different types of portfolios.

For growth portfolios

For our growth-oriented portfolios, we use alternatives to reduce the influence of volatile share markets. We call this the *Growth Asset Diversifiers* sector and we introduced this across the StatePlus product range in 2014.

For defensive portfolios

For our more defensive portfolios, that have less invested in shares, we have introduced return-seeking alternatives that behave independently of share markets. We call this sector *Absolute Returns*, and we introduced it in 2015.

Types of
Growth Asset Diversifiers

Why invest in alternatives?

What are Growth Asset Diversifiers?

To achieve returns above inflation over the long term, you need to take some degree of risk with your investments. This generally involves investing in what is commonly known as growth assets, such as Australian or international shares. The drivers of returns for growth assets are the underlying business conditions affecting company earnings.

The economy tends to grow over time, so investing in shares is a way to benefit from this. Over the long run you can earn higher returns that can make your retirement savings last longer. Over the short term though, share prices can be volatile, and if you need to sell your assets to generate an income, this volatility can negatively affect your financial plan.

One of the ways we try to lessen this volatility is by investing in an alternatives sector we call *Growth Asset Diversifiers*. This sector aims to generate strong returns as volatility in markets increases, to provide a boost to portfolios when share markets can experience significant falls.

How does it work?

The Growth Asset Diversifiers sector invests in three main types of alternative strategies:

- Long Volatility
- Trend Following
- Global Macro.

Long Volatility

This is a specialist strategy that invests in a diversified portfolio of derivatives, such as options. The prices of these derivatives are linked to the market's perception of future uncertainty.

When investors are optimistic about the future, this strategy will deliver flat or even negative returns, but when investors become fearful – such as in times of great market turbulence – we expect the returns from this strategy to be strong.

Trend Following

This strategy involves buying and selling investments that are displaying *trending behaviour*, also known as momentum. Momentum is a feature in the prices of most assets: something that has recently gone up on average tends to keep going up, whereas something that has recently gone down on average tends to keep going down.

Of course it doesn't always work this way, so it's important to be diversified and trade across a wide range of assets including shares, commodities, bonds and currencies. This strategy's ability to make positive returns in falling markets helps provide the defensive characteristics we need in the sector.

Global Macro

This is a broad-based style of investing across many markets, using specialist techniques to manage risk and exploit mispricing opportunities.

Returns rely on our managers' skill, rather than on underlying market performance. A good manager can deliver positive returns under most market conditions, although there are no guarantees.

We include these strategies in the sector because:

- they tend to deliver good returns during strong markets, and
- they're more robust during volatile periods than a more traditional investment style.

Investing in the Absolute Return sector

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What's the Absolute Return sector?

The Absolute Return sector is our second alternatives sector, designed mainly for our lower-risk options such as Capital Stable and Moderate.

Lower-risk options have less exposure to shares but more exposure to cash and fixed-interest. With the current low yields, we introduced the Absolute Return sector aiming to achieve additional returns above inflation in a diversified way.

How does it work?

We look for alternative investments that can deliver returns independent of what is happening in share markets or fixed-income markets. This doesn't mean returns will always be positive, but, by diversifying we can improve the overall return per unit of risk.

Our first Absolute Return allocation is to a strategy where the investment manager uses quantitative research to identify market anomalies, and invests specifically to remove the general risk of the market rising or falling. An example of the type of anomaly is a 'carry', which is the tendency for higher-yielding assets to provide higher returns than lower-yielding assets.

This sector is relatively new, and we will build it up as we identify more assets and strategies that meet our criteria of improving the expected return without just adding to the risks our portfolios already have.

We will also be realistic: if we can't find investments that meet our strict criteria then we simply won't invest.

Key
Points

Why invest in alternatives?

Key points

- We use these two alternatives sectors in portfolios to try to improve the risk-adjusted returns, and each is suited to its specific purpose.
- The Growth Asset Diversifiers sector tries to improve returns by providing diversification during periods when overall portfolio performance is likely to be weak. By contrast, the Absolute Returns sector tries to add returns steadily over time.

For more information, or to book an appointment, contact StatePlus

www stateplus.com.au call 1800 620 305 face to face

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