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Virtual Event Series

Building All-Weather Strategies in 2023

Guest Speaker:

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CEO
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DiffuseTap: Building All-Weather Strategies in 2023

Last time on DiffuseTap, Alan Dunne, CEO of Archive Capital, talked to us about why creating sound strategies is better than forecasting the markets, return stacking ETFs and other systematic strategies to consider, and some lessons to learn from a tumultuous 2022.

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DiffuseTap

This networking session is part of our weekly virtual events series. Networking (you'll bump into at least a dozen high caliber fund managers) meets purposeful (you'll tap into brand-new sources of ideas)… straight from your armchair like a boss.

Meet the Speaker

ALAN DUNNE is the Founder and CEO of Archive Capital, an alternative investments and investment research firm focused on global macro, managed futures, and multi-asset investing. Alan has worked for over 25 years at global macro and managed futures hedge funds and large investment banks, and his research spans macroeconomic analysis, economic and financial market history, behavioral biases in investing, and the use of quantitative strategies in asset allocation. LinkedIn: @alanjdunne

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KENNY ESTES: Mr. Alan Dunne is the man of the hour. Alan, would you mind telling us a little bit about your background and what you're up to over at Archive Capital?

ALAN DUNNE: Sure. Thanks for the introduction, Kenny. Delighted to be here. I'm the CEO of Archive Capital. We're a specialist in liquid alternative investments, and we're focused on global macro managed futures, and strategies like trend following and multi-asset investing.

We work with investors in terms of constructing portfolios and selecting managers. We serve as an outsource resource typically for family offices, multifamily offices, and wealth management firms who are looking to build either diversified portfolios or better portfolios, and that want to access alternative investments in those spheres.

AYLA KREMB: Beautiful. That is the shortest introduction ever. So efficient, I love it. We will hop right into it. Number one, what brought you into the space of trying to figure out what is a good strategy for investments? And second, was that your background from the beginning? Or did you make some massive mistakes and here you are, trying to fix them?

ALAN: Well, I guess a bit of both. I started off in the markets in foreign exchange trading. I studied economics in Trinity College here in Dublin, Ireland, where I'm based and I went to London, where a lot of Irish people started off back in the 90s. That was when I started in markets, where I was an FX Trader and an FX researcher.

From there, I migrated into working for a macro CTA. And from there, I moved into private wealth management. I guess the final piece of my experience, which I have been doing for the last 10 years, is that I've been working as a hedge fund allocator. I think in my experience in asset and wealth management, a lot of what you do is working with investors and trying to figure out what's a good portfolio for the long term that can withstand market cycles.

The approach that we use now is very much a fusion of all the experiences I've had, in terms of we can build asset allocation plans as you would in a traditional wealth management space. But we use techniques that I've learned from the alternative space, particularly futures trading. And I also use some strategies such as in the macro and managed futures space that I've been involved in over a number of years. Where I am today is very much a reflection of all of those experiences.

KENNY: That's great. You mentioned you were Dublin born or raised, and then you went to London. CTA is a US construct, so it sounds like you've got a bit of a global perspective on things. Tell us, when people are investing in alternatives across the globe and trying to build this portfolio, what are the main things you counsel on? What are the characteristics to focus on?

ALAN: I think the key thing is ensuring you're getting adequately diversified in your investment. A lot of people think in terms of the 60-40 portfolio that's designed to be a robust portfolio over time. You've got a 60% allocation to equities, and 40% to bonds, with the idea being the equities are the offense and the bonds are the defense. So, it makes sense.

But what we've seen in 2022 is an environment where that type of approach can struggle. Obviously, last year we had an environment where both bonds and equities were declining. What we've learned in that instance, and it's something that we've known for a long time, is that often investors are under-allocated to dynamic strategies. These are strategies which can adjust and get you short in some markets, or give you exposure to other markets that are moving to ensure that your overall portfolio is sufficiently diversified.

People might think well, I've invested in a hedge fund or real estate, or credit, or things like that. But actually, one of the things that you have to be aware of is that just because something might have a relatively low correlation to equities when equities are going up, it doesn't mean they're necessarily going to generate returns when equities are going down. Again, that's something that we saw last year.

So what we're counseling on is helping people understand how to get genuine diversification into your portfolio, how to size those allocations correctly, and how to stick with those allocations and think about how the portfolios can perform in various economic and market environments, as opposed to forecasting what the world is going to look like next year and building an optimized portfolio for one scenario.

AYLA: Got it. I think I read 10 of the 2023 global macro reports, and they were all extremely different. You could run 10 different portfolios of those and see which one will perform. Are there any novel strategies that you and your team use? You mentioned something like return stacking, which sounds interesting. Is there anything that you want to share with us, just to get a feel for what are the ways that people could potentially invest?

ALAN: I'll give you a couple of things to think about. One, you mentioned that if you read a bunch of global macro reports, you will get loads of different views. The global macro universe is extremely interesting. We could sit and talk here about the outlook for geopolitics for the Fed, European Central Bank, and all of that for hours. It is very interesting. But the reality is, it's impossible to forecast.

At the start of last year, not many people were anticipating the kind of Fed moves we've seen. People weren’t anticipating things like wars, volatility, and inflation hitting 10%. So, one of the things that we like is systematic strategies like managed futures and trend following strategies.

These are strategies that are built and traded using computer algorithms and designed to capture momentum in markets, and these are the types of strategies that won't do well if there's very little happening in markets. Now, markets go through periods of being very stable, and your traditional assets will tend to do well in those types of environments.

But when you get big dislocations in markets, and when the US 10-year yield goes from, say 1.5% percent to 4% in a year, that's a big dislocation. These are the types of strategies that systematically follow the trends without question. That's one of the cornerstones of a lot of the strategies that we run.

You mentioned return stacking. Return stacking is an interesting concept that comes from the futures trading world. I'm sure a lot of your guests here are familiar with ETFs. Everybody's keen to trade ETFs. If you want to get exposure to US equities, you could buy a US ETF. But another way to do it is just trading the future on the S&P 500. It's actually a lot more capital efficient to do that.

If you set up a brokerage account, you can buy and you can get exposure to the US equity market via futures, and you only have to fund the margin on that. What that does is it frees up capital to invest in other strategies, and you can stack your portfolio.

Now obviously, by stacking returns, you can say you're stacking risk as well, and that's true. But the trick is to ensure that you blend equities with other strategies that are genuinely diversifying. So that comes back to what I said at the outset.

The key to a lot of this is to really understand our strategies and to understand the characteristics of them, and that they can actually generate returns in environments where traditional assets struggle. Those two things are really key elements of our approach, which are allocating to systematic trend following strategies and blending those with equities, but equities using futures for leverage.

KENNY: Totally makes sense. You mentioned that you really need to understand these strategies. You mentioned hedge funds, you mentioned CTAs. Often, they're not the most transparent things in the world, and you don't really understand what is happening under the hood. I'm assuming you're allocating external managers fairly regularly. So, how do you Jive that lack of transparency with the need to deeply understand what the risk profile is?

ALAN: That's a good question. I would say that you get different degrees of transparency depending on how you're allocating. If you go back 20 years ago and you allocated to a macro hedge fund, you would probably get an annual letter from them telling how you did, and that was it. But these days, you can allocate to external managers and as an institutional investor, you can certainly allocate using managed accounts and have full transparency of your positions.

But also in more recent years, we've seen the growth of ETFs, which are somewhat simplified versions of some of these strategies. They may not have all the bells and whistles, but you're getting the nature of the return profile. And certainly, in the managed futures trend following space, there's at least three ETFs where you can get full transparency on positions.

Obviously, with an ETF, you can click in and see the holdings on a daily basis. I think we've had a move towards greater transparency generally in the quant world, in the managed futures trend following space. If you want to go in and go for a more high alpha strategy, you might have to give up a little bit on transparency depending on your needs. But if transparency is a high requirement, you can also certainly get that.

AYLA: Talking about risk and risk exposure, earlier you said "properly diversify". What does that really mean? I was talking to someone the other day and they said, "Oh, only if you invest in a minimum of 150 different stocks can you say that you're actually diversified." So, what's the minimum threshold for diversification? And what's the threshold for avoiding putting hope into a stock before it goes down the drain?

ALAN: That's a good question. I guess if you think about it, if you have 150 stocks, yes, you're diversified in the stock market. But you've got a lot of equity market risk there. If equity markets struggled for the next number of years, and you just have equity markets, that portfolio is going to struggle.

If you think about risk factors and not just asset classes, one of the things that you have to avoid doing is focusing on the average correlation of different assets and strategies to equities over time. There's an old joke among statisticians. The joke goes, the statistician had his head in the freezer and his feet in the oven. On average, his body temperature was reasonably good. But obviously, at one end it's freezing, and at the other it's burning.

It's the same thing when it comes to investing. You could have an asset that is lowly correlated to equities in an up market but very positively correlated to equities in a down market. During an equity bull market, you might think you've got great diversification, but you don't. So, what I mean by good diversification is really understanding that you have different assets and strategies that can do well in different environments.

Obviously, sometimes you could think ahead to next year and read about all of the different reports. At the moment, some people are talking about a soft landing and okay, that would probably be good for both equities and bonds at this stage. But if you get stagflation, where you have persistently high inflation and weak growth, that's probably going to be both negative for bonds and equities.

So you have to think about what kinds of strategies could do well in that environment. Commodities, possibly. There are certain strategies that can be directional, can go short, and could be positive in that environment. But lots of strategies like credit might struggle. It's about scenario planning and thinking about which strategies can deliver returns in multiple environments.

One of the things that we like about the systematic strategies like trend following is that they're trading not just traditional assets like bonds and equities, but they're trading across lots of commodity markets and a whole range of commodities such as energy markets, agricultural commodities, grains, meats, metals, as well as currencies, in both developed markets and emerging markets.

They're also increasingly trading niche and alternative markets like Nordic coal markets or German power markets, where we've seen huge volatility in the last 12 months. So that's how you get more diversification. It's by trading more markets, but by trading markets that have different characteristics.

KENNY: Totally makes sense. So that's the way to go about diversification. You mentioned a couple of things, but you want to be prepared for surprises. And last year, it was tumultuous, let's just say that. What are some of the surprises the audience might not necessarily have been aware of? You mentioned the Fed hike. I think everybody's on top of that. But there's also the shock from the Russia-Ukraine war. What are some of the other things that are having massive macro global impacts, but many people aren't aware of?

ALAN: Well, the Fed comes top of mind. I think interest rates are a big big driver here. Because if you look at it now, we've basically gone from zero rates to probably up to 5% or so once the Fed is done hiking. That's an enormous shift. If you go back maybe three, four years ago, most people were investing in equities because there was no alternative. Interest rates were so low, you can't generate a yield anywhere else.

I think that's a huge shift in the market environment that investors are just starting to digest at the moment. We've gotten to 10% inflation in Europe, it's a little bit less than in the US, but it's been a huge shock as well. I think what might surprise people going forward is that we might see much more volatility in inflation.

If you go back to maybe the last decade, in the 2010s, not only did we have fairly stable economic growth, we had very little volatility in inflation as well. You had growth around 1.5 to 2%. You also had inflation around 1.5% to 2%. This decade, we've already had COVID, a very sharp recession, and a very sharp recovery. Now, we've had inflation. Maybe we'll have a hard landing on the back of it. I think going forward, what we should expect is more volatility.

I think the other thing that people are adjusting to now is, from a macro perspective, most of the analysis that we've been thinking about for the last number of years is very much focused on the demand side. Is demand picking up? Is the economy strong or not? But now, increasingly, economists have to think about the supply side.

What I mean by the supply side is, obviously, with COVID, you might recall that we had all of these supply side shocks. Travel was disrupted, people left the labor market, etc. That's another supply side challenge. In some places, like the UK, the number of people still struggling with long COVID is very high.

As companies are responding to this changing environment and adjusting their supply chains, it's all about certainty of supply, as opposed to efficiency of supply. And then coupled with that, you have structural themes like the greening of the global economy, and under investment in energy markets. There are multiple ways that we could see further supply shocks in the future.

Obviously, we also had the disruption with Russia and Ukraine. The general view is that if you had a similar scenario with China and Taiwan, that would have a multiple of the disruption that we've already seen. Thinking about a more volatile macro environment is really important. Just because we are seeing initial signs of inflation coming down, it doesn't mean everything is going to go back to 2019 all of a sudden again.

AYLA: One last question for you. When you were hypothesizing what 2022 was going to be like, what are some of the things that you got right or had in mind? And then, what are some of the things that were surprises for you as well?

ALAN: If you go back to the start of 2022, you probably could have painted a reasonably good picture of how things would have played out. But you could have probably predicted all these things happening over a number of years as opposed to just one year. That would have been my sense. If you go back to the start of the year, I think US ten-year yields were at 1.5%. There was a general recognition that yields were low. We were at the start of a tightening cycle. Rates were probably going to go up.

But it was certainly a surprise that they got so aggressive, raising rates by 75 basis points. We haven't seen that since Paul Volcker in the early 1980s. It was a surprise that it did get so aggressive. And obviously, we had the worst year for bonds in about a century. So, while you might have said bond returns would be lower going forward, you might not necessarily have anticipated that we would see such big moves in the market. I think that's certainly two of the things.

Obviously, I didn't anticipate the war in Ukraine as well. That one came somewhat out of left field. I think people closer to the geopolitical scene were warning about it, but it certainly wasn't a consensus at all that it would happen. So, again, these random shocks are things you just have to be prepared for.

I'm based in Europe here, and the European Central Bank responding so aggressively as well was also a surprise. We don't try and forecast all these kinds of events. We're very much thinking about the risks and thinking about what kind of portfolios can withstand volatility, no matter what comes in markets.

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