HEALTH WEALTH CAREER

DIVERSIFYING ALTERNATIVES

JOHN JACKSON
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Robert Howie interviews John Jackson, Global Leader of the newly renamed Diversifying Alternatives Research Boutique.

John, please tell us a bit about yourself.

Prior to joining Mercer, I served in the hedge fund research group at Hammond Associates. Hammond was acquired by Mercer in January 2011. Earlier, I was an associate consultant, a senior performance analyst and a supervisor in the Performance Analysis department at Hammond. Before joining Hammond Associates, I worked as an associate for a financial planning firm in St. Louis. I received a BSBA in economics from the University of Missouri, St. Louis.

When not reviewing compelling investment opportunities, you can typically find me at one of my two kids' sporting events. My long-term plan involves boating, fishing and golfing somewhere with weather that will allow for all three activities mostly year-round.

What exactly are Diversifying Alternatives?

Diversifying Alternatives includes a spectrum of highly disparate strategies that can largely be viewed as serving to fill the void between public markets (equity and fixed income) and private markets. Within this universe, there can be meaningful variability in what is achieved or captured in terms of diversification/alternative underlying exposures. The one commonality is the expectation that these strategies and approaches can introduce a diversifying and an alternative risk/return profile to some degree and, importantly, one that is not already captured or offered elsewhere within the investor's portfolio.

The value proposition for this universe is — or can be — largely derived from two core attributes:

1. Flexibility across asset classes, liquidity, instruments, directionality, portfolio and risk management

2. The quality of the investment team and process

Of course, as mentioned already, this is not uniform within and across the universe, but for a finite group that possesses the right skill set, we believe there is opportunity to capture unique value for money.

This universe can range from multi-asset through alternative risk premia to traditional unconstrained hedge funds, as well as more esoteric asset classes, like commodities and insurance-linked strategies. Again, the diversification/alternative exposure, liquidity and fees/costs can vary across these options. It is important to understand these attributes and any corresponding trade-offs or opportunity costs across the spectrum as they relate to efficacy in achieving objectives. Our Diversifying Alternatives team is here to help navigate this universe.

What does the Diversifying Alternatives Research Boutique do?

This boutique represents a dedicated team of 24 researchers across North America, Europe and Asia focused on identifying managers and strategies that we believe are "best in class" across this spectrum and can deliver on objectives, net of fees.

Our primary focus remains on manager research, both sourcing new opportunities and staying abreast of our currently rated options. We also actively contribute to Mercer's intellectual capital and strategic research, constantly reviewing and challenging our best thinking as it relates to opportunities and implementation impacting our universe.

We work with clients and consultants in a variety of capacities, from providing education and perspectives to conducting searches, commissioned research and ad-hoc custom projects. As this space can offer some unique complexities and challenges, we also work closely with our global delegated teams to deliver sensible investment solutions. Collectively, we have a team of over 40 researchers dedicated to the Diversifying Alternatives space.

With the inclusion and integration of the recent Summit and Pavilion acquisitions, we believe Mercer is well positioned competitively with regard to breadth and scale relative to most peers — and, importantly, quality of work. Our new colleagues bring fresh and different perspectives to our process, and we're confident our continued growth in resources and enhanced process will lead to better outcomes and allow us to adapt and change to client needs.

How are investors using Diversifying Alternatives in their portfolios?

As a result of the often wider mandate, fewer constraints and a broader investment toolkit, an allocation can be tailored to meet a wide variety of objectives. We divide these broadly into risk reduction or return enhancement.

We believe an allocation can best serve within a risk-reducing role — more specifically, reducing portfolio beta risk while achieving an attractive standalone risk-adjusted return over a full cycle.

We do recognize that investors have different objectives and constraints — for example, they may be looking for something more defensive or more growth orientated. Within Mercer's current universe of highly rated Diversifying Alternatives, we certainly have the full spectrum of individual risk and return profiles available for consideration. Of course, pursuing objectives across the spectrum comes with different implications. An allocation not only needs to consider the risk and return elements, but is often considered along with other elements. Typically, this includes liquidity profile, costs, governance and sizing, among others.

I noticed you have also renamed your Managed Futures universe as Systematic Macro — what is the rationale behind this?

We have witnessed an evolution across the managed futures space. What was once largely dominated by CTAs (Commodity Trading Advisors) and trend-following strategies now includes systematic strategies that are not purely priced based but may incorporate a variety of data inputs. This may include technical and fundamental data sets, either in distinct models or blended within the same models. This evolution has been driven in part by technological innovation and global market growth. This has also further expanded the instruments used, which now may include single securities and their derivatives, in addition to futures.

We continue to subdivide the systematic macro universe to strategies that are still dependent on trend and those that are less so, to reflect the nature of the return profile and better differentiate expectations.

What do you see as the best of opportunities in Diversifying Alternatives?

We generally caution against forecasting an outlook for specific strategies. Rather, our focus remains on bottom-up manager selection and then combining those strategies or opportunities to build a diversifying risk basket that will be relatively weather-proof. Skilled execution is more critical than catching the right wave.

That said, the contrarian in us believes that skill and alpha will be valued and rewarded at some point. We are beginning to see signs that it may be soon — dispersion has picked up across many markets and there seems to be a bifurcation of sorts across high quality and low quality. The most recent bull market is likely to provide ample opportunities for dynamic, tactical and highly skilled managers to provide liquidity to markets at times when others are seeking it most.

In general, we believe a dedicated focus on alternative risk factors, such as the complexity premium, the illiquidity premium and time horizon arbitrage, will serve investors well over the long term and likely over the near term, as these are largely being abandoned by a meaningful segment of investors.

What are some of the challenges?

For an effective allocation, we believe the best practice is to build a diversified portfolio of Diversifying Alternatives to achieve broad risk factor exposures. As such, paramount to long-term success is a dedicated effort that seeks to understand effective implementation within the allocation itself and how the collective exposures interact with the rest of the portfolio.

We're not suggesting that the complexity places an allocation out of reach — to the contrary. However, an allocation does take a certain level of dedication and commitment. Maintaining conviction is likely most challenging when beta-driven market opportunities have done well for an extended period, as they have for the last decade. Abandoning the allocation before the benefits can be fully realized/appreciated may be tested. That said, we take comfort that we have history on our side.

There is also a fee and liquidity budget consideration to varying degrees, depending on implementation.

The industry is dynamic in nature, presenting challenges in sourcing and implementing good opportunities in the Diversifying Alternatives space. Mercer has the experience, network and analytics to sort through opportunities and distinguish the great from the average — or at least that is our intent.

Despite some of the challenges, we would argue the benefits can outweigh the hurdles. While finite, in some cases, we see strong justification and evidence that suggests high alpha for money, net of fees and over extended periods. This is reflected in our current investable ratings across the spectrum.

Finally, how do these strategies fit with investors who have responsible investment objectives and for those who place importance on environmental, social and governance (ESG) factors?

Increasingly, alternative managers are adopting ESG policies and frameworks as well as building the infrastructure and resources to support these initiatives. We are beginning to see more and more strategies and solutions come to market with an ESG focus or degree of influence.

The "G" (governance) in ESG has long been a focus of unconstrained hedge funds, most visible in activism, in an effort to influence and effectuate change to unlock shareholder value. This is being expanded now across the environmental and social aspects, with more work to be done and progress to be achieved.

While the Diversifying Alternatives space presents some unique challenges (systematic strategies, shorting, credit, index and derivatives), Mercer's research team remains focused on rating strategies within our ESG framework and identifying those that are leading this effort.

John Jackson, CFA, is Global Leader of Mercer's Diversifying Alternatives Research Boutique. This boutique (formerly named Hedge Funds) focuses on researching hedge funds and multi-asset strategies, developing intellectual capital and working with clients on portfolio construction. He can be reached at john.jackson@mercer.com.

Robert Howie, FIA, is a principal in Mercer's Diversifying Alternatives Research Boutique. He leads manager research and the generation of intellectual capital for alternative assets in Europe, focusing on hedge funds, insurance-linked securities, multi-asset and other liquid alternative strategies. He can be reached at robert.howie@mercer.com.

ABOUT MERCER INVESTMENTS

Mercer is a leading global provider of investment services and offers customized guidance at every stage of the investment decision, risk management and investment monitoring process. We assist with every aspect of institutional investing (and retail portfolios in some geographies), from strategy, structure and implementation to ongoing fiduciary management.

Our Manager Research team consists of experienced individuals based in various locations throughout the world. There are a number of specialist boutiques that provide comprehensive research into the strategy offerings in the relevant asset class. Each boutique is staffed with professionals who have research and consulting capabilities; conduct forward-looking, institutional-quality research on investment management products; and work closely with both internal and external clients on manager structuring and selection projects. The research process is consistent across all boutiques and across all regions, providing a common language and a seamless offering to clients.

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