Investment insight

The Low Correlation Strategy – MLC's alternative way to hedge share market risk

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"Simply investing in mainstream assets, like shares, fixed income and cash, won't always provide the returns you need."

With market volatility always threatening global share markets, it's worthwhile looking at the role alternatives play in MLC's multi-asset portfolios and the benefits they may bring you.

Our multi-asset portfolios are extensively diversified

Investment markets, and the returns they deliver, can be unpredictable and volatile. So you may feel uncertain about simply relying on market performance to deliver the returns you need. This is why we have multi-asset portfolios that are extensively diversified across a wide range of assets, strategies and investment managers to enhance returns and manage risk.

Using alternatives to smooth returns and manage risk

Different types of assets perform well in different times and circumstances – when some are providing strong returns others may not be. And in some market environments, simply investing in mainstream assets (like shares, fixed income and cash) won't always provide the returns you need to achieve your investment objectives.

Our multi-asset portfolios include investments in carefully chosen alternative assets and strategies that aim to produce returns that are different from other asset classes, particularly share markets. Including alternatives helps us smooth the portfolios' returns and reduce reliance on share markets to deliver on their objectives.

'Alternatives' is a very broad label that masks many different strategies – with varying levels of liquidity, risk and diversification to shares. The Low Correlation Strategy (LCS), managed by MLC's Alternative Strategies team, seeks to identify alternative strategies that are high quality and meet the needs of our multi-asset portfolios.

The purpose of LCS is to increase the diversity of sources of return and risk in our MLC Horizon and Inflation Plus portfolios. By combining several carefully selected specialist managers and strategies, mostly hedge funds, LCS aims to provide a pattern of returns that is both positive and mostly independent of, or 'uncorrelated', with each other and share markets. We expect this will help to smooth out the pattern of returns in these portfolios.

The underlying strategies in the LCS are 'alternative' strategies. This means their managers:

- adopt strategies that are different to the traditional asset classes of shares, fixed income and property, and
- take an 'absolute return' approach to investing: instead of trying to beat a market benchmark, they aim to deliver consistent positive returns regardless of what markets deliver.

Effectively, LCS is designed to deliver returns, even when shares are doing poorly or drifting sideways. While the strategy doesn't have the big upward movements of share markets, it aims to avoid those big downward movements, thereby helping to smooth these portfolios' returns.

LCS has been part of the MLC Horizon and MLC Inflation Plus portfolios since 2012 and the Alternative Strategies team has successfully managed this strategy for some of MLC's large institutional clients since 2008.

MLC's Alternative Strategies team

The MLC Alternative Strategies team has four experienced investment professionals, who have worked with MLC for many years. They are very familiar with MLC's approach to portfolio construction and the investment objectives of the MLC Horizon and Inflation Plus portfolios.

The team works closely with MLC's Capital Markets Research team, which manages those portfolios, to provide a stream of returns that is complementary to the other strategies the portfolios invest in.

LCS is diversified across several hedge fund managers and strategies

LCS currently has 11 managers running different strategies, each chosen because their returns are largely unconnected both with one another and share market performance.

Most of the strategies we invest in are either only open to institutional money or in some cases are also completely closed to new institutional clients. This makes LCS a powerful way for investors to gain exposure to strategies that would otherwise be largely inaccessible.

When choosing strategies, there are two main drivers of return we are looking to access

1. Exposure to unique, uncorrelated risks

Some strategies provide a return for taking on a specific type of risk that isn't correlated with the usual investment risks, such as share market and interest rate risks. These types of strategy are hard to find, but can be very attractive. One example is mortgage prepayment risk. These are investments in securities exposed to the risk that US mortgagees prepay their mortgages faster than expected. As mortgagees prepaying their mortgage isn't directly connected to share market movements, the strategy is an attractive source of diversification. For specialist managers with a high degree of expertise in this niche corner of the US debt markets, there is also potential to add additional value on top of the return that derives from the mortgage prepayment risk.

2. Active management, generally via hedge funds

Hedge funds have a structure that will attract the best investment talent. They're attracted for two main reasons. One is simply that if you're a skilled fund manager, hedge funds tend to pay the best. The second is that hedge funds also provide the most flexible investment vehicle for that talent to manifest - there's no need to hug benchmarks, they can be opportunistic and focus on absolute returns, they can focus on exploiting their skills in a very precise manner (eg hedging out unwanted risks), and they can go long and short (which means they can make money when assets go up and when they go down).

Case study: Merger appraisal rights

Merger appraisal rights is a good example of the type of strategy we like. This is a niche, litigation based strategy which involves investing in merger deals where the target company is being acquired at a price that is deemed to significantly undervalue its shares. This is rare – most transactions have an attractive takeover premium – but sometimes there can be a flawed sales process, or misaligned executive incentives that see a deal done that is below the 'fair value' of the company. Merger appraisal rights exist to protect disadvantaged minority shareholders in these cases. The opportunity is to identify these situations and buy shares in the company being taken over before the deal closes, exercise these appraisal rights, and then litigate to achieve a fair value, which is determined by the Delaware Courts (if not settled beforehand). If done selectively, there is a strong chance of the Court awarding a higher price.

What makes this strategy attractive is that there is also statutory interest paid to the shareholder pursuing appraisal rights, which is currently cash+5% pa, to compensate them for their capital being locked up during the process. This is paid on top of any uplift to the merger price. Overall, this investment has potential upside, very low downside risk and a very low correlation to share markets.

Conclusion

Through investing in our MLC Horizon and Inflation Plus portfolios, you're accessing carefully selected hedge fund managers and strategies that we hold in high regard and which are usually only available to large institutional investors. We believe LCS provides our investors with an efficient and low risk means of accessing alternative strategies.

With volatility always threatening global share markets, it can be difficult for you to feel confident about your investments and financial future. Knowing that our portfolios are extensively diversified and include strategies that aim to provide you with smooth returns, whatever the ups and downs of the market, may give you more confidence you'll get the returns you need to help achieve your financial goals.