IMAP Independent Thought Podcast
Episode 18: Global alternatives in volatile markets - Janus Henderson

This podcast examines;

- How alternatives perform during market volatility
- Whether private investors should be allocating to alternatives
- How to meet income needs with alternatives
- How alternatives can be accessed by retail investors
- Whether alternatives offer an uncorrelated option to bonds and equities
- How higher interest rates and inflation impact alternatives

Featuring Mathew Kaleel, Janus Henderson
Moderated by David McDonald, CFA IMAP

IMAP Disclaimer (00:01):

This podcast series is not meant for retail investors, but instead is meant for financial advice and investment professionals. Please refer to IMAP's website **https://imap.asn.au** for more details.

David McDonald (00:16):

Welcome to this podcast in the Independent Thought series and today joining me on the podcast is Matthew Kalel from Janus Henderson. Matt is a portfolio manager in the Diversified alternative funds at Janus Henderson. Welcome Matt.

Matthew Kalel (00:33):

Thank you for having me, David.

David McDonald (00:36):

So Matt, if perhaps to start with you could just talk a little bit about what are diversified alternatives and how exactly your fund works.

Matthew Kalel (00:48):

Sure. So we have a team of portfolio managers and a broader team that sits across a number of regions in Australia, London, and North America in a number of different offices. Diversified means by geography, by trading style and by the things that we hold in the fund. So we trade a lot of different things over all time horizons. We trade in all major sectors, so equities and bonds and commodities and currencies. So it is truly a diversified product by what it's holding and where the portfolio's managers are sitting and what they're trading.

(01: **David McDonald** 31):

That's great. Okay, well that certainly gives us plenty to talk about. There's a lot of different things you're covering there.

Maybe just to start off with, can we just chat about the macro environment, because obviously inflation, and interest rates are front of mind for everyone in the market and probably have been for the last 12 months at least now, and lot of talk about recession potentially in the US, Europe, maybe not quite so much in Australia, but perhaps on the edge there.

And interest rates have been going up very rapidly everywhere, and the RBA has now shocked people, I think last week by suggesting there's several more great hikes to come. What's your outlook for the world, Matt, and perhaps we'll go on afterwards and just talk about how that might impact where you're positioned.

Matthew Kalel (02:21):

I think to be completely frank, nobody including central bankers know what is going on. And that's not the fault of anybody. This is not speaking to the forecasting ability or depth of knowledge anywhere.

But, you know, if you step back to January 2020 and you did your 10 year forecast, if you're an investment committee saying, what are the types of things we could see happening in the next decade that could come out of left field, I don't think there would've been a single investment committee saying within three years you're going to have a "once in a century pandemic", a land war in Europe, inflation, rising interest rates and all within a three year period.

So the ability to forecast with those kinds of huge macro impacts is very difficult. You don't envy the central bankers having to try and work out is inflation transitory or structural?

Matthew Kalel (03:21):

Do we think inflation's going to sit at 3% or more on average for the whole decade as it did in the seventies? Or is it quickly coming back and staying there? There's now an increasing chance you could have some form of soft landing, which again has never happened before.

So I think the one thing you can count on is a lot of volatility and this event risk remains "front and center" as the world goes into really what I think is going to be a very interesting period. Interesting in a good and bad way.

David McDonald (03:55):

Yes, I think most people could certainly agree the volatility and as you say it's hard to know what's going to happen next. You know, we've gone from wars in Ukraine to cyclones in New Zealand, all sorts of unexpected events.

There's also a lot of talk out there about lower returns going forward. You know, that the 8%, 9%, or 10% returns the super funds and the like have been getting the last 10 years, may perhaps not be the cae for the decade ahead.

Is that something you would agree with that we're looking for "lower for longer"?

Matthew Kalel (04:28):

It depends on your viewpoint. If you've done the right thing and saved a lot of money, you'd be laughing right now because for the first time in a long time you're getting paid to be prudent and disciplined and saved money.

I think the big winners are people that have actually done the right thing and saved a higher cash rate by default reduces the value of a lot of things when you discount them.

I think people have to get used to the fact that, you know, China, which was really a growth engine for so much of the world for many, many decades, you know you've taken a lot of people and to be quite frank, you know, they've done a brilliant job in bringing over half a billion people into the world as consumers.

That's behind the world. You have now got demographic issues and debt to deal with.

Matthew Kalel (05:16):

I just think if you're expecting the returns of eight to 12% from a stock standard portfolio of stocks and bonds over the next 10 to 20 years, I think that assumption we would say is challenged.

And you have to say, are we in a regime which is conducive to stocks and bonds as your bulk holdings or are other things in there?

And it's not just alternatives, it's real assets and things that tend to be robust and anti-fragile with respect to inflation or benefit from that. And, you know, one asset class would be commodities.

David McDonald (05:54):

Yes. Okay. Just touching on the bond equities, first of all, and we've seen quite strong correlation between bonds and equities in recent period, which is probably an unusual thing.

Is that something you see continuing or do you think that's has been a one-off?

Matthew Kalel (06:15):

I think if we're near the end of that tightening path by all central banks, it looks like the Bank of Canada is stopped or is on hold for the moment. We're probably close in Australia within two to three raises.

And you can see the light at the end of the tunnel for other central banks. I think at that point you can assess where bonds are sitting and where inflation is and real yields and make the case that you know the Federal Reserve, for example, where real yields are now.

That's quite tight, especially if you think inflation's going to fall.

So central banks have probably done most of the work they need to, which would mean that it's very unlikely, but not impossible, that bonds will do what they did again in 2022. I mean I think we've both seen a few cycles

David McDonald (07:08):

<Laugh> Yes.

Matthew Kalel (07:09):

I don't think we've ever seen, I I think the last year was in the seventies or the 1920s where that 60/40% portfolio lost so much and bonds lost more than equities. I don't think you'll see that again.

David McDonald (07:20):

Right. Commodities, Matt,you mentioned just briefly there was something you think would do well, particularly out of inflation. I mean, commodity prices, energy obviously, but a lot of others have been strong in the last year or so.

Is that something you see as a continuing cause of inflation outlook, rather than just because of supply issues?

Matthew Kalel (07:43):

I think when you have two or three very large political geopolitical and investment reasons driving commodities you know, just take ESG.

ESG is automatically a constraint on oil companies investing in further oil development, whether you agree with the merits or not of more oil in 20, 30 years.

The simple fact of the matter is oil demand is going to be with us at least for the next couple of decades, but you're not getting a supply response. Demand is almost back to where it was near record highs.

You are not finding enough copper. You know there's some studies showing the amount of large copper discoveries globally, they've almost disappeared.

So our view honestly is with that lack of investment and large deposits and deposits closer to ground, being harder to find, then that is inflationary.

We need a lot of copper, nickel, lithium, and all sorts of resources if we're going to build out this infrastructure and electrify the grid, it is inflationary if we're de-globalising and building supply chains regionally, as opposed to what we've had, which is a global network, a globalized world, that is inflationary.

Matthew Kalel (09:04):

I honestly believe we're just in a very different regime where commodities will reflect supply constraints will be the cause of inflation. And unless there's significant investment in that sector you're going to continue to see elevated inflation from commodities.

David McDonald (09:25):

Yes, I mean I think we're seeing that very much locally as a prime example, isn't it?

We're several states in Australia banned gas exploration and wonder why gas prices are surging through the roof.

Matthew Kalel (09:37):

Yes. And you can have these perverse consequences where in Europe, you know, with the right intentions and good intentions, Germany ended up using coal and wood for energy last year simply because nuclear reactors were being decommissioned.

And again we're not talking about the rights and wrongs of this or climate change, it's just the simple facts on the ground. The world still basically relies on fossil fuels and will for some time. That's a statement of fact. Where we want to be? That's a very different thing.

David McDonald (10:09):

Sure. Just still on the commodities, Matt, I saw on your website this interesting research piece where you suggested that “commodity carry” was providing a signal for asset allocation. Can you maybe just give us a simple explanation of how that works, and what it might be telling us at the moment?

Matthew Kalel (10:30):

Yes, sure. So when you look at commodity markets if you take oil markets, for example and you know, we trade futures, you're not only trading at the front end or the spot market, you're trading all across multiple time horizons.

And the benefit of using futures is that it's very liquid. So you can liquidate that position, you can put that position on, but you get pricing out over almost 10 years.

And when you're in an environment where there's supply constraints… we saw that last year with European gas prices, there's an immediate need to secure physical gas. You don't have the luxury of waiting three to six months if you're going to freeze.

So what you see is prices nearer the present time much higher than prices in the future.

And so you pick up what's called a "positive carry" where if you're taking that trade … effectively what you're doing is you are rolling your futures contracts and picking up a positive return because you're providing liquidity to the market that indicates a level of heightened supply constraints and it's a very bullish signal for commodities.

Matthew Kalel (11:44):

And when you look at the broad index of commodities such as the Bloomberg Commodity Index, most of the time you don't get a positive carry, holding futures, and then rolling them.

But the last two years, you've been picking up a few percent a year as a positive carry, almost akin to a dividend in the stock market, which is unusual, which speaks to how supply constrained commodities are in the broad sense.

David McDonald (12:11):

Right okay, thanks for that. So commodities, you're positive on commodities and we've talked about the outlook for bonds and equities and potential weak, or even negative returns in the year or so ahead.

So what other asset classes are you positive on in your funds, and where else are you putting, putting the money?

Matthew Kalel (12:34):

When we look at the opportunity set for the multi-strategy fund, if you start with equities, you know, last year we were positive slightly for the fund, but you know, we would've liked to have made more money.

The thing that did hold the fund back from doing better was just the lack of opportunities.

IPO activity dropped… issuance of bonds really fell off a cliff.

What we see happening once central banks are finished their tightening cycle is a lot more corporate activity. M&A, issuance of debt and equity. And that's good for a lot of the strategies that we employ which are aligned upon transaction and capital flows.

Fundamentally we think assets such as gold will do particularly well in this environment.

And you know where you do have the ability to hold cash, you're getting paid to hold cash and be patient for the first time in a long time.

Matthew Kalel (13:34):

So yes, if you're not constrained and you've got the ability to sit back and wait for opportunities for the first time in many years, you're getting paid a decent amount on your cash holdings and your collateral where you can be patient and wait for opportunities and not have to take a lot of risk.

I mean as you know one of the unfortunate outcomes is you chase risk and you go up the risk spectrum when cash rates are so low.

We now have attractive cash rates globally where people can get a term deposit with a bank or by a government bond and get something decent.

So yes, I think the things you can hold now and the portfolio you can hold now is quite different than what you would've held a few years ago, and that will be the case going forward.

David McDonald (14:27):

Maybe just one last question about the funds before we can talk maybe some more sort of general issues about where they might fit into a portfolio and so on. And that's the volatility.

I mean, as we've talked about, and I'm sure everyone's aware that for the last two, three years volatility's been incredible, whether it be covid wars, or whatever. And we're talking about volatility continuing to be high. Is that a plus for your sort of fund?

How have the funds performed the last year or two during these very volatile periods like COVID and so on?

b (15:01):

Yes, we're fortunate in that again we are not constrained. We can take risk on the fund tends to be relatively neutral. We can take on and buy protection for example, you know, one of the sleeves that the fund uses is called portfolio protection, where we can buy downside puts and buy protection on the market. And that did incredibly well, for example in February/March of 2020, where you get these once in 10 or 15 year events where you get a significant short sharp shock and markets fall very quickly in a very short amount of time.

That's not something you can predict or model up. But you know, one of the tenets that the lead PMs have and we all have is you want to be positively exposed to that volatility by having that convex payoff profile.

We have trend following, which did particularly well last year. It did well in 2008 where volatility and extended moves or short sharp moves in either direction are beneficial for the fund.

David McDonald (16:12):

All right, thanks Matt. Let's just talk about alternatives in a portfolio and where they fit in. I mean, I guess a lot of people think when you hear the word alternatives and hedge funds, they think of high risk. Is that necessarily the case? I mean, could it be part of a balanced or even a defensive portfolio?

Matthew Kalel (16:33):

I think it's absolutely critical that you include, and again, if we're entering a regime, which is not going to be like we've seen for the last three to four decades whereas 60/40 portfolio won't make enough to get you where you need to get, alternatives become absolutely critical.

And it's such a broad term. You start by saying, well, you've got liquid alternatives and illiquid alternatives. So you can look at private equity ….you can look at direct property. I mean they, they fit into that alternative asset class. They offer certain benefits, but one of the things they don't offer is liquidity if you need it.

The one thing that liquid alternative managers of all types can offer, and the better ones do offer, is really good risk control. If you look at say, trend following or the product that we are, you know, good multi-strategy funds the people running them that have lasted more than a cycle tend to be much better risk managers than return seekers.

Matthew Kalel (17:36):

First and foremost, control your risks ….don't blow up, protect your clients, protect capital mm- and then when the opportunities arise, you can take advantage of that.

I think that's the key. And again, when you've got the ability to control risk, you can then target certain levels of volatility. So when you look across the alternative spectrum, you've got managers targeting volatility of 15 to 20%, which is quite volatile.

We tend to sit at the other end of the spectrum where we want to set our volatility between about four to 8%.

So we categorize what we do as defensive alternatives and you know, as with anything you have to diversify. You don't just hold one thing. If you're going to put together an alternative portfolio, it should be made up of various components with various liquidity profiles and risk profiles.

Matthew Kalel (18:33):

And that should hopefully, if they're true to label, if they are alternative by nature, if they perform well when stock and bond markets aren't doing well, then that definitely has a positive impact.

I mean, a good example of that is “trend following as an index”.

There's an index called the, the SG trend index that was up over 20% last year, which looks at a group of managers that are trend followers That would've been incredibly additive, had you had enough of that in your portfolio last year.

That did similarly well, in 2008…. commodities were up 15 to 20%. Gold held its own.

The multi-strategy fund we run and others were up macro funds had a good year. So yes, this is why we would argue that it's actually critical to have good alternatives in your portfolio with the right type of liquidity.

David McDonald (19:31):

Okay. And within a managed account, is it possible to put something like your global alternatives into a managed account?

Matthew Kalel (19:40):

Yes, our product sits on a lot of platforms because we're trading in effectively listed instruments globally. The liquidity profile allows for that with daily pricing and liquidity. if you look at a lot of long short funds or trend following funds, you know, the alternative products that are listed, trading enlisted instruments Yes, they sit well within a broader portfolio because they should be able to offer pretty good liquidity conditions.

David McDonald (20:10):

Right. So there's no issues with “liquidity lockups” and things like you hear from some of the private equity and those types of funds.

Matthew Kalel (20:17):

That's right. But look, those also have a role, but I think people just have to be cognisant that, look, you have to assume I think Warren Buffet had a quote where you buy your stock and assume you're not going to look at it or the market's going to be open for 10 years.

I think you have to have that same approach with these other alternative funds. They're not bad in and of themself if they've invested in a good asset that's a liquid, that's just the nature of what you're investing in. You shouldn't have more than a certain amount of your portfolio in it. That doesn't say you shouldn't have it, but you should definitely have some liquid alternatives that offer that kind of tail protection.

David McDonald (20:57):

And do you find you spend a lot of time having to educate advisors about the funds? I mean, is it something that's well understood or you get a lot of questions from people?

Matthew Kalel (21:08):

Yes, definitely. And we actually enjoy it because you know, the things we're holding and the fund are quite different to what you typically see in a 60/40 portfolio based in Australia, for example, because we are part of a global group, Janus Henderson, we get offered IPOs and placements in stocks all through Europe and America and Asia.

You know, we can participate in IPOs in Hong Kong, in Sweden, in all types of jurisdictions. We can take equity and bond exposure. We trade commodities and currencies. So there is a lot of education. But I think the critical thing is you've got to understand liquidity profile and you've really got to trust the managers and that's really, really important.

But in the end, the best advice as with anything is you've got to have an understanding of the return profile.

What types of returns should this fund give you through the cycle?

When will it make money?

When will it tend to flatline?

And if you blend that with other things, you should get a decent result over time.

David McDonald (22:18):

That's great. Alright, thanks. Look, we've covered a lot of things there, Matt. I think that's really useful. I think we've definitely agreed that we're still in for interesting times for at least the next few years and potentially lower returns than people have been used to.

But that doesn't mean you can't diversify into some of these different assets and perhaps more, more.

I want to thank Matthew ELE from Janet Henderson for joining us today. And also before we finish a reminder that we have the IMAP Portfolio Management Conference coming up soon in March in Melbourne, Sydney, and Brisbane.

There's details of all of those on our website now, including the speakers and the topics that are being covered at each venue. And you're able to register there on the website now, so please have a look at that.

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