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ALTERNATIVE INVESTMENTS

SHIFTING GEARS

TROUBLE AHEAD?
EXAMINING THE CASE FOR ALTERNATIVE STRATEGIES

MACRO MATTERS
OPPORTUNITIES AND CHALLENGES ABOUND

HANDY HINTS
WHERE FUND BUYERS ARE LOOKING NOW

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USING LIQUID ALTERNATIVES TO MEET INVESTORS' OBJECTIVES

With the current US bull market, already the longest in history, heading toward its 10th year, many investors have begun to consider how much longer it can run, as well as what comes next. Many expect that the next market cycle will be characterized by lower equity returns and increased volatility.

Against this backdrop, investors are left wondering how to respond. Do they continue to ride the current bull market to the end? Or do they lighten up on equities? If they allocate away from stocks, do they increase their exposure to fixed income, despite low rates and a rising interest rate environment, or do they go to cash?

In my view, now may be a good time to consider alternatives. Historically, alternative investments were only available to institutional and high-net-worth investors, but today retail investors also have access to 'liquid alternatives' in the form of mutual funds or ETFs.

ALIGNING SPECIFIC LIQUID ALTERNATIVES WITH COMMON INVESTMENT OBJECTIVES

In my experience, one of the biggest challenges retail investors have with liquid alternatives is figuring out which one is right for them. To assist in this decision, listed opposite are several common investor objectives and alts that could potentially help meet those objectives:

KEY TAKEAWAY

In my experience, the most common mistake investors make with alternatives is that they invest following a period in which they would have benefited from holding alternatives. Instead, I encourage investors to take a proactive stance and plan for what's ahead – not what's in the rear-view mirror.

Invesco has a wide range of liquid alternatives in each of the categories discussed.

To learn more, visit: invesco.com/alternatives.

BOOSTING RETURNS IN A LOWER RETURN AND MORE VOLATILE ENVIRONMENT FOR EQUITIES	**Consider: Alternative assets and global macro funds** Alternative assets (also known as real assets), are investments in asset classes other than stocks and bonds. Investments in real estate, commodities, natural resources and infrastructure are all examples. Such investments have unique performance characteristics and, collectively, have outperformed equities over the past 20 years.[1] Strategies such as global macro invest opportunistically on a long and short basis across the global equity, fixed income, currency and commodity markets. Because they can invest on both a long and short basis, they have the potential to achieve profits in both rising and falling market environments.
PRINCIPAL PRESERVATION OR LOSS AVOIDANCE	**Consider: Market-neutral** Market-neutral funds trade related equities on a long and short basis, such that the fund has close to zero net market exposure. The key to generating a positive return is determining which equities to go long and which to go short. Given the lack of net market exposure, these funds tend to be insulated against market swings, have the potential to generate positive returns in all market environments and typically produce returns that have low correlation to stocks and bonds.
HEDGING THE IMPACT OF RISING INTEREST RATES	**Consider: Senior loans and market-neutral** Senior loans (also known as bank loans) are loans made by banks to non-investment grade companies, commonly in relation to leveraged buyouts, mergers and acquisitions. The loans are contractually senior to other debt and equity, and are typically secured by collateral. Given that the loans are made to non-investment grade companies, the yield associated with them tends to be higher than on investment grade corporate bonds. Another key aspect is that the interest rate paid is a floating rate that resets every 30 to 90 days. This means that in a rising interest rate environment, as long as the rate rises above a predetermined minimum level, the investor will receive increased payments from the borrower. Market-neutral funds might make sense given that they are typically not exposed to interest rate risk and have a return/risk profile similar to that of bonds.
HEDGING THE IMPACT OF INFLATION	**Consider: Alternative assets** Alternative assets have historically increased in value during periods of inflation, and for this reason, can potentially help protect a portfolio during inflationary periods.
UPSIDE PARTICIPATION IN A RISING STOCK MARKET WITH DOWNSIDE PROTECTION	**Consider: Long/short equity** Long/short equity funds combine both long and short equity positions in a portfolio, while typically being net long equities. As a result, performance tends to follow the equity market directionally, while the short positions have the potential to cushion performance during periods of stock market decline.
BOOSTING CURRENT INCOME	**Consider: Senior loans and income-generating real assets** For the reasons mentioned above, senior loans tend to produce attractive yield for investors. Income-producing real asset investments such as infrastructure and certain types of real estate investments have the potential to deliver levels of current income above that of government and investment grade corporate bonds.

[1] SOURCE: STYLEADVISOR. SEPTEMBER 2001 – MARCH 2018. PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

IMPORTANT INFORMATION

Stocks are related if driven by the same fundamental factors. For example, two stocks from the same industry would be related.

Long/short strategies (equity or credit) typically take both long and short positions to benefit from rising prices on the long side and declining prices on the short side. Long positions are buying a security with the expectation that it will increase in value. Short positions/short selling is the sale of a security not owned by the seller, then buying later. The belief is that security prices will decline and the price paid to buy it back at will be lower than the price it was sold. Short selling is a speculative investment and may require investors to meet margin requirements and repurchase the security at a higher price, causing a loss. As there is no limit on how much the price of the security can increase, loss potential is unlimited.

Most senior loans are made to corporations with below-investment grade credit ratings and are subject to significant credit, valuation and liquidity risk. The value of the collateral securing a loan may not be sufficient to cover the amount owed, may be found invalid or may be used to pay other outstanding obligations of the borrower under applicable law. There is also the risk that the collateral may be difficult to liquidate, or that a majority of the collateral may be illiquid.

Investments in real estate related instruments may be affected by economic, legal, or environmental factors that affect property values, rents or occupancies of real estate. Real estate companies, including REITs or similar structures, tend to be small and mid-cap companies and their shares may be more volatile and less liquid.

Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

Alternative investments can be less liquid and more volatile than traditional investments such as stocks and bonds, and often lack longer-term track records. Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.
Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.
An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lower the issuer's credit rating.

The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

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JASON BLOOM
DIRECTOR OF GLOBAL MACRO ETF STRATEGY
INVESCO ETFs

THREE REASONS WHY COMMODITIES MAY BE BACK IN VOGUE AMONG ALLOCATORS

Over the past 10 years, commodity returns have been disappointing, falling from the lofty perch they occupied before the global financial crisis. Given this decade-long trend, commodities are still viewed by many investors as a tactical rather than a strategic allocation – to be deployed only in limited circumstances. However, for the first time in a long time, investors may finally be opening up to including commodities in their strategic allocation.

Why? Three reasons.

1. INFLATION EXPECTATIONS

Investors today are concerned about the potential for rising inflation, and many are looking at ways to hedge the negative impact that inflation can have on a portfolio. Unlike stocks, bonds or Treasury inflation-protected securities, commodities have historically had a strong positive correlation to inflation – when inflation rises, commodities typically rise. This is shown in Figure 1 on the next page.

2. THE POTENTIAL FOR LATE-CYCLE RETURNS

Investors are also looking for a reason to have hope that commodities may actually make money over the next few years. With the bull market in US equities at a record length, we may be entering a period that could be positive for commodities.

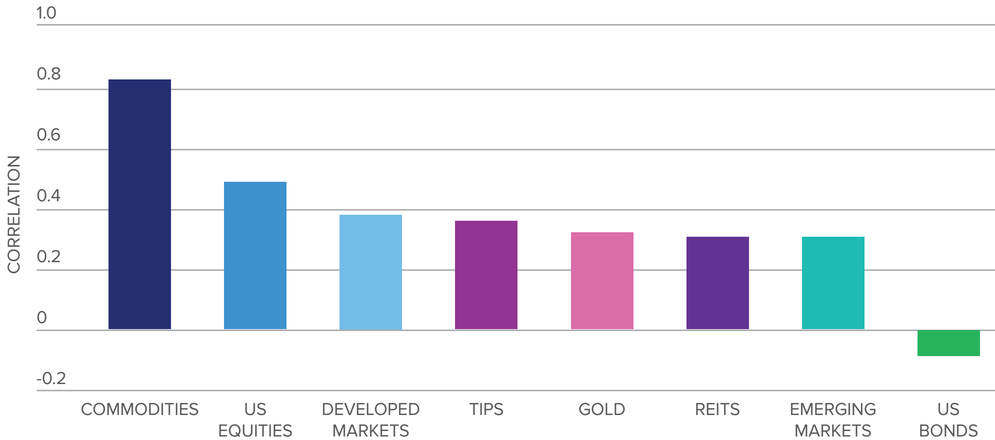
Commodities have historically been strong performers very late in the market cycle. They typically haven't peaked until after a recession has started. As Figure 2 shows, when equities have started to fall, commodities usually continued to show strength.

3. DIVERSIFICATION POTENTIAL

Commodities have historically demonstrated

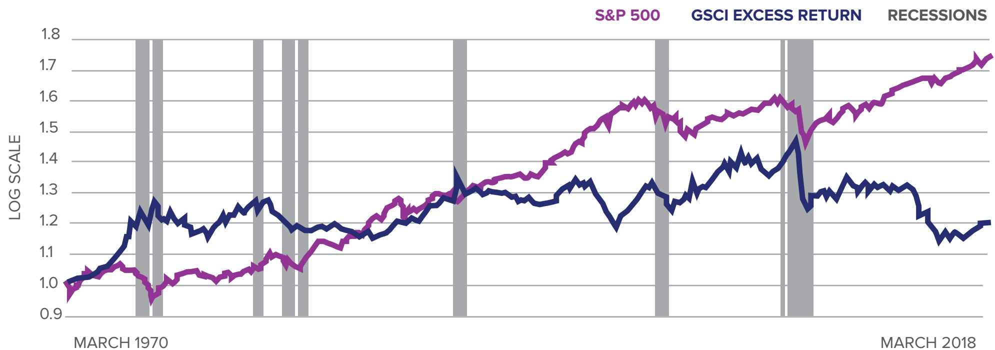
moderate correlations to US stocks, developed markets and emerging markets, and a very low correlation to US bonds, as shown in Figure 3. This means that commodities were typically less influenced by market dynamics affecting other asset classes, thereby offering potential diversification benefits when incorporated into traditional allocation models.

FIGURE 1: COMMODITIES HAVE HISTORICALLY HAD A HIGH CORRELATION WITH INFLATION



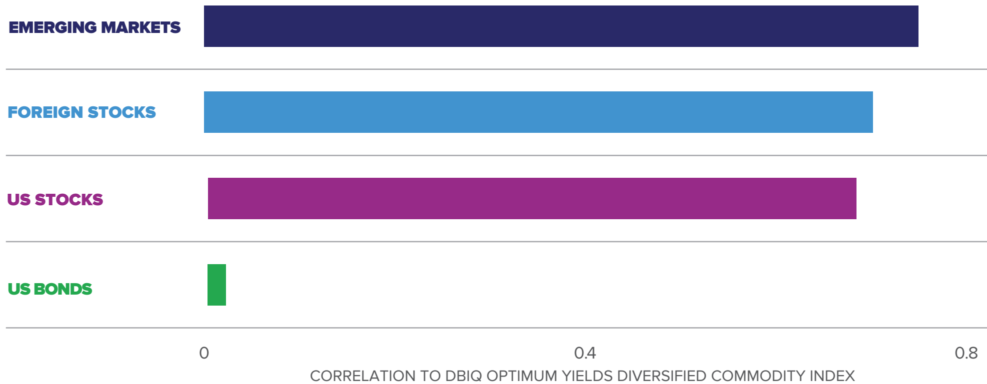
SOURCE: BLOOMBERG, AS OF JUNE 30 2018. PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. AN INVESTMENT CANNOT BE MADE DIRECTLY INTO AN INDEX. 1 INFLATION IS MEASURED BY CHANGES IN THE CONSUMER PRICE INDEX (CPI). CORRELATION IS THE DEGREE TO WHICH TWO INVESTMENTS HAVE HISTORICALLY MOVED IN RELATION TO EACH OTHER. ASSET CLASSES WERE REPRESENTED BY THE FOLLOWING INDICES RESPECTIVELY: COMMODITIES: DBIQ OPTIMUM YIELD DIVERSIFIED COMMODITY EXCESS RETURNTM; TIPS: ICE BOFAML US INFLATION-LINKED TREASURY INDEX; GOLD: GOLD SPOT FIX PM; REITS: MSCI US REIT INDEX; EMERGING MARKETS: MSCI EMERGING MARKETS INDEX; DEVELOPED MARKETS: MSCI EAFE INDEX; US EQUITIES: S&P 500 INDEX; AND US BONDS: BLOOMBERG BARCLAYS US AGGREGATE BOND INDEX.

FIGURE 2: COMMODITIES HAVE OFTEN BEEN A 'LATE-CYCLE' PERFORMER



SOURCE: BLOOMBERG. DATA FROM MARCH 31, 1970 THROUGH SEPTEMBER 18, 2018. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. AN INVESTOR CANNOT INVEST DIRECTLY IN AN INDEX.

FIGURE 3: COMMODITIES CAN BE A KEY PORTFOLIO DIVERSIFIER



SOURCE: BLOOMBERG, JUNE 1, 2008 TO JUNE 30, 2018. PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. AN INVESTMENT CANNOT BE MADE DIRECTLY INTO AN INDEX. CORRELATION IS THE DEGREE TO WHICH TWO INVESTMENTS HAVE HISTORICALLY MOVED IN RELATION TO EACH OTHER. ASSET CLASSES WERE REPRESENTED BY THE FOLLOWING INDEXES RESPECTIVELY: COMMODITIES: DBIQ OPTIMUM YIELD DIVERSIFIED COMMODITY EXCESS RETURN™; EMERGING MARKETS: MSCI EMERGING MARKETS INDEX; DEVELOPED MARKETS: MSCI EAFE INDEX; US EQUITIES: S&P 500 INDEX; AND US BONDS: BLOOMBERG BARCLAYS US AGGREGATE BOND INDEX.

OUTLOOK FOR SPECIFIC COMMODITIES

In order to be truly optimistic about the return outlook in a diversified commodity portfolio, investors have to be optimistic about crude oil. Energy can represent between a third and a half of many broad commodity indices, depending on which benchmark you're using as a measuring stick.

With energy, supply fundamentals tend to be the primary driver of price direction and volatility. According to Bloomberg, energy demand growth has followed a very steady path over the past 25 years, so prices have been linked to supply gluts or disruptions. The Organization of Petroleum Exporting Countries (Opec) has been quite disciplined recently in limiting the amount of supply in the market, and the snap back of sanctions on Iranian crude oil has significantly dented global supply. Furthermore, North African production is at risk from political instability and terrorist activities, while Venezuelan production has declined precipitously – by the end of 2018, it is projected to fall to around 1 million barrels per day, down from 3 million barrels per day in 2011.[1]

Two other key commodity sectors are agriculture and industrial metals.

- With respect to industrial metals, changes in demand – more specifically, changes in Chinese demand – tend to be the driver of price volatility, as China consumes half of all industrial metals globally. Currently, metals are cheap as the US-China trade dispute has hit this sector hard.

[1] SOURCE: FORBES, 'VENEZUELA'S OIL EXPORTS ARE HEADED TOWARD ZERO,' JUNE 8, 2018

- Demand for food, like energy, tends to be fairly consistent from year to year, so changes in supply are often viewed as the primary driver of price volatility in agricultural commodities. And no other force affects the supply of food more than the weather, making price forecasts with respect to agricultural commodities one of the most difficult tasks in the financial markets. Nevertheless, the combination of positive growing conditions and developments in genetically engineered plant seeds have resulted in plentiful harvests in many agricultural staples, driving prices to historically low levels and creating uncertainty around the supply-demand balance in the coming year.

KEY TAKEAWAY

Rising concerns about inflation, the potential for late-cycle returns and the ability to diversify portfolios all bode well for commodities in the coming year, in our view. Invesco offers a range of strategies that give investors exposure to this unique asset class.

IMPORTANT INFORMATION

Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax and other regulatory and market developments.

Diversification does not guarantee a profit or eliminate the risk of loss.

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