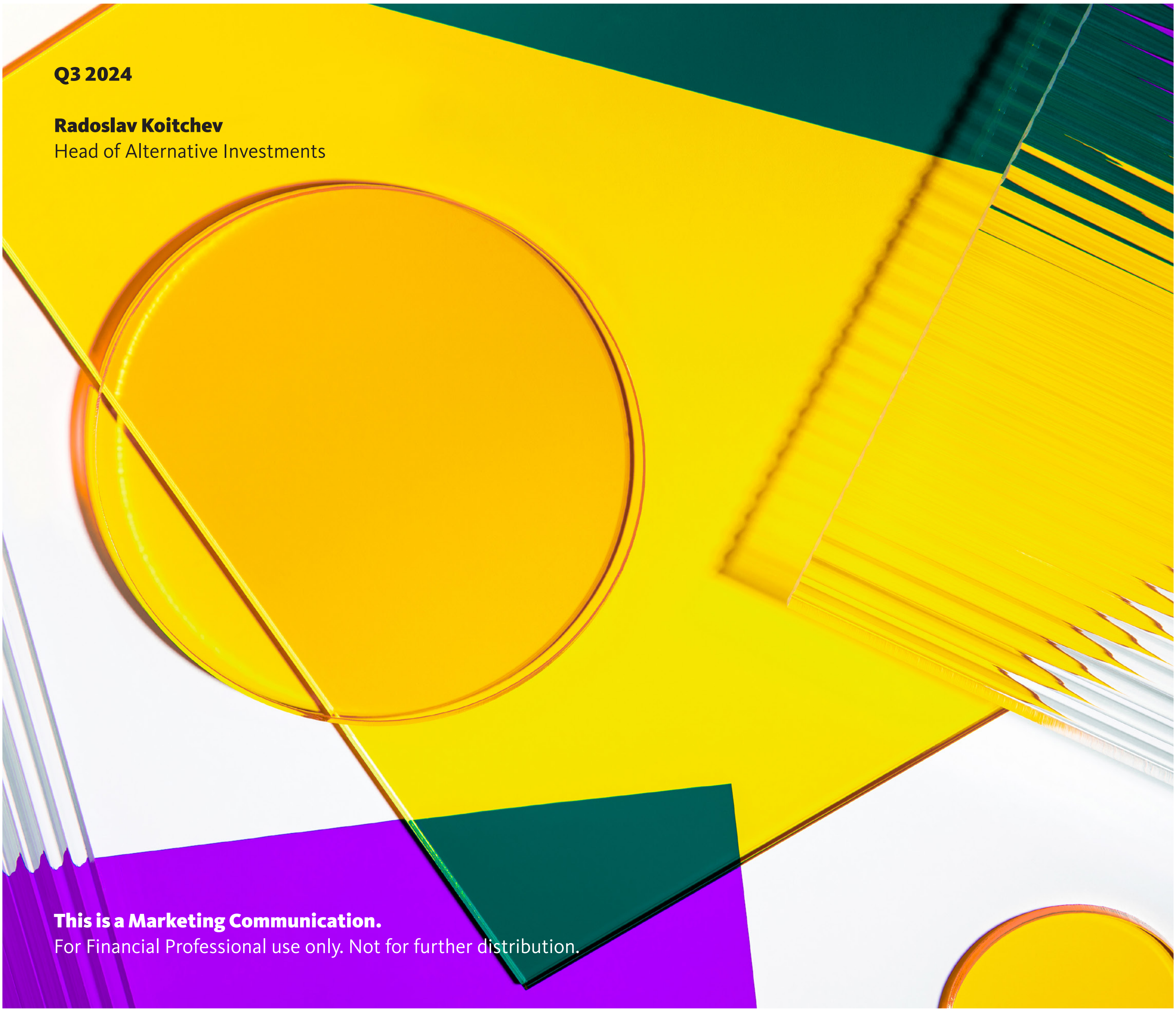
UK INTERMEDIARIES TEAM

Liquid alternatives: A different way to diversify?



Q3 2024

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We believe liquid alts can bolster traditional 60/40 portfolios, especially in times of inflation.

The last two years have proven challenging for UK investors. From dizzying politics and eye-watering levels of inflation to a monumental shift in the global economic regime, there's certainly been a lot to contend with.

One thing that's been particularly hard to navigate is the changing relationship between stocks and bonds. Clearly, the 'diversified' 60/40 portfolio of old—with a 60% allocation to stocks and a 40% allocation to bonds—has been affected by this change. Where we go from here is less clear.

In this paper, we'll make the case for liquid alternatives—an investment we believe offers an additional, and complementary, source of returns. We'll then turn our attention to what differentiates the SEI Liquid Alternative Fund.

Why are 60/40 portfolios having such a hard time?

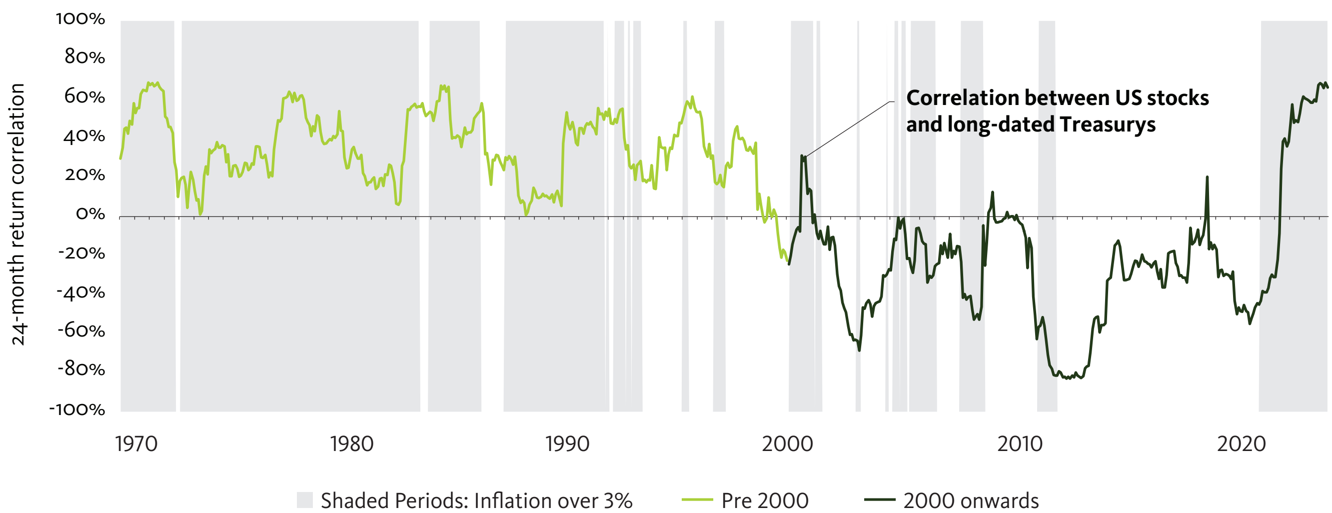
For the best part of two decades, the returns from stocks and bonds have been inversely correlated, i.e., when one rose, the other fell.

Think about an economic slowdown: in this environment, growth assets like stocks typically sell off, whereas bonds appreciate. Likewise, in a recession, stocks typically suffer (due to low earnings), whereas bonds stand to benefit from interest rate cuts. This dynamic is important. Bonds have been credited with providing shock absorption within a portfolio, helping to smooth returns over time.

Post-pandemic, this has all changed—stocks and bonds have instead become positively correlated. As **Chart 1** shows, this recent reversal coincides with an episode of elevated inflation, which hasn't passed as quickly as many initially predicted.

And this is far from an anomaly. If you look back as far as 1969, you see that stocks and bonds have tended to exhibit positive correlation whenever inflation has risen above 3%.

Chart 1 – Correlation between asset classes can be highly dependent on the macroeconomic regime



Source: SEI, Bloomberg. As at 30 September 2022 (Date range: Dec 1969-May 24). Stocks represent the US dollar return on the Center for Research in Security Prices US Total Stock Market Index. Bonds represent the US dollar returns of the ICE Bank of America 10+ Year US Treasury Index from January 1987 onwards, and prior to that returns derived from the Composite Yield on U.S. Treasury Bonds with Maturity over 10 Years Index provided by the Federal Reserve Bank of St. Louis. CPI Inflation is the Consumer Price Index for All Urban Consumers: All Items in U.S. City Average from the Federal Reserve Bank of St. Louis. Index returns are for illustrative purposes only and do not represent actual fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Past performance does not predict future returns.

This teaches us two things. First, the relationship between stocks and bonds isn't static—it's heavily influenced by the macroeconomic regime. Second, the last 20 years are the exception, not the rule. As inflation stays higher for longer, it's becoming increasingly unlikely that bonds will deliver the same diversification benefits they did 20 years ago. Investors need to look elsewhere.

What can liquid alternatives (liquid alts) offer in an inflationary environment?

As discussed, a portfolio built around traditional investments like stocks and bonds will likely find sustained periods of high inflation difficult to weather. In this environment, complementing your 60/40 portfolio with investment in liquid alternatives may offer several benefits.

Why now? SEI's top four reasons to consider liquid alts.

1. A different way to diversify

Liquid alts tend to employ non-traditional investment strategies, which may exhibit low or even negative correlation to stocks and bonds. This is key: accessing return drivers outside traditional long equity and credit markets can provide diversification, in turn bolstering portfolio resilience.

2. A potential hedge against inflation

Some liquid alternatives, such as managed futures, have the potential to act as a hedge against inflation. Unlike stocks and bonds, such investments may benefit from rising inflation by capturing price increases in commodities, currencies, or other inflation-sensitive assets.

3. The liquidity to better manage risk and capitalise on opportunity

Unlike typical alternative investments, liquid alts offer daily liquidity, which can be particularly valuable at times of uncertainty or volatility. Liquidity gives investors the flexibility to manage risk and reallocate capital to take advantage of emerging opportunities.

4. The confidence of regulatory oversight

Liquid alts are typically offered as regulated investment products—for example, UCITS funds. Compared to typical alternative investments, this means investors stand to benefit from better transparency and certain regulatory protections.

RECAP

What are liquid alts?

Liquid alts are investment strategies that offer exposure to alternative investments—such as hedge funds, commodities, or real estate—but in the form of liquid and regulated investment vehicles, like mutual funds or exchange-traded funds (ETFs).

Why choose SEI for your liquid alts exposure?

At SEI, we've been running multi-manager investment strategies in the alternatives space since 2003. When it came to considering our product offering in liquid alts, we knew we wanted to use hedge fund replication to provide smaller investors with cost-efficient access to hedge fund strategies. We also wanted to partner with a firm capable of customising an investment product to our specifications.

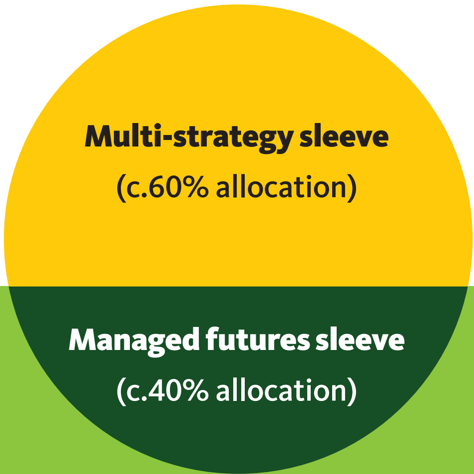
Dynamic Beta Investments (DBi) ticked all our boxes. Unlike some of the large investment banks we spoke to at the time, DBi offered the opportunity to partner and create a solution from scratch, designed to our specifications. What's more, DBi demonstrated true expertise in their field—with hedge fund replication the firm's sole focus and experience dating to 2007.

We appointed Dynamic Beta Investments (DBi) as sub-adviser for the SEI Liquid Alternative Fund in 2015.

How is the fund structured?

If customisation was one of the key reasons we chose to work with DBi, then it's worth noting that the SEI Liquid Alternative Fund has two distinct and complementary components. This is key to understanding the fund's performance in different market environments.

SEI Liquid Alternative Fund



Focus on 'strategic alpha', by seeking the factor shifts that underpin the performance of multi-strategy hedge funds (value versus growth, small versus large cap, etc.).

Focus on 'tactical alpha', by way of managed futures strategies, which seek out trends in currencies, rates, and equities and may take long or short positions in these markets.

- **Both sleeves are implemented using the most liquid trading instruments in the markets**—exchange-traded futures on major equity, bond, and currency indices—helping to mitigate counterparty risk and minimise trading costs.
- **The fund avoids some of the 'hidden risks' typically associated with alternatives** (i.e., loss of liquidity during periods of volatility, or investor crowding, which may lead to underperformance at the security level).

Source: SEI. For illustrative purposes only.

RECAP

What is hedge fund replication?

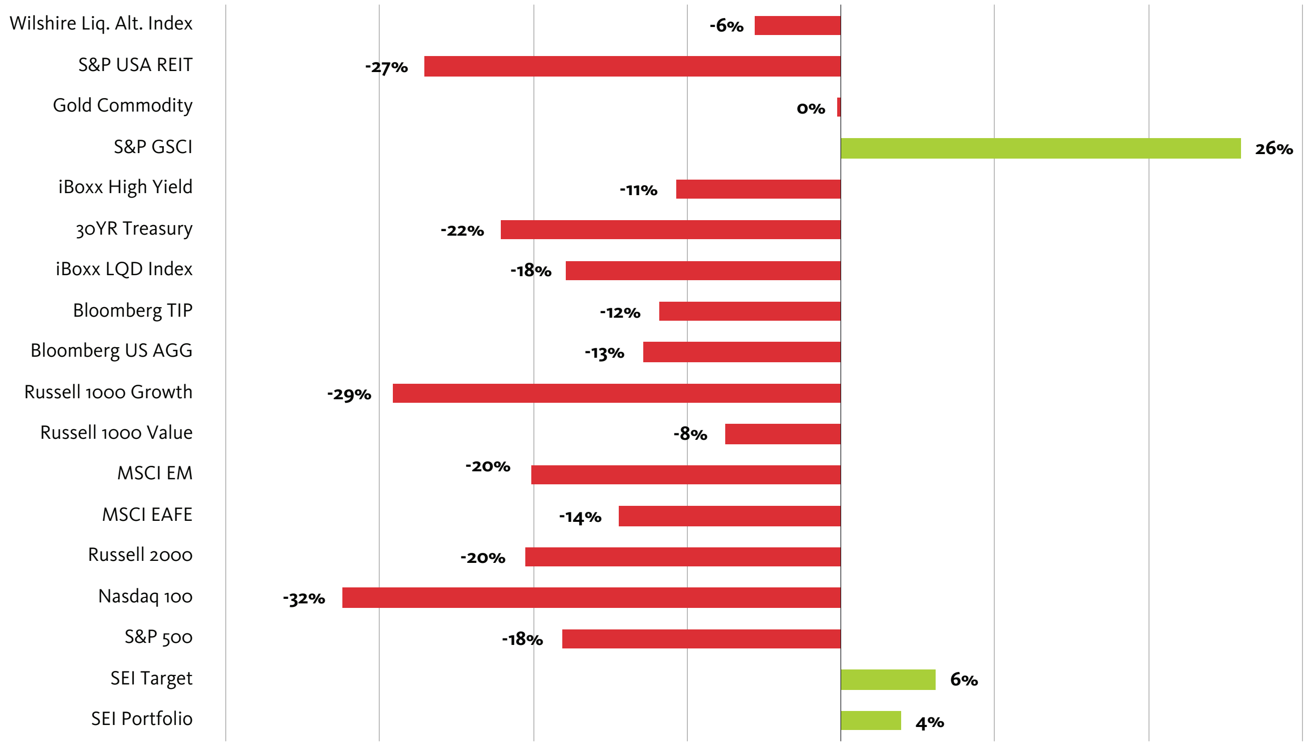
Hedge fund replication attempts to mimic the pre-fee returns of a portfolio of hedge funds—it does not invest directly in hedge funds. Ultimately, we believe hedge fund replication has the potential to deliver value because it incurs lower fees. Illiquidity and single-manager risk are also less of an issue for a hedge fund replication strategy than they would be if an investor were to invest directly in the strategy's underlying hedge funds.

So, how did the SEI Liquid Alternative Fund fare in a challenging 2022 and 2023?

We've already alluded to 2022 as a volatile year, with equities and bonds sustaining losses at the same time. In this environment, the fund's multi-strategy sleeve experienced a moderate loss due to its exposure to equities. However, this was more than offset by the tactical nature of—and large gains made by—the managed futures sleeve, which was able to nimbly adjust its exposure (by taking a short position in fixed income, for example).

Ultimately, this meant the fund benefitted from the surge in global inflation over the period.

Chart 2 – Amidst a sea of red, the fund posted positive returns in 2022



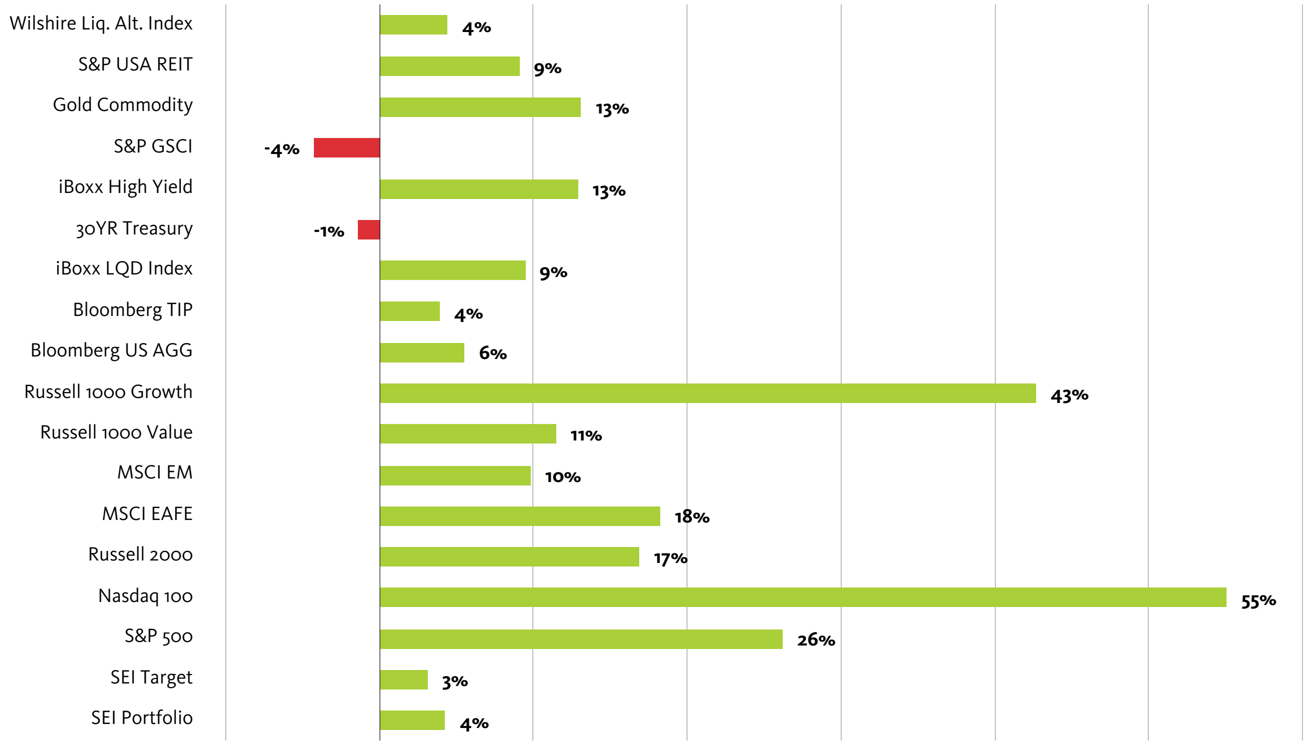
Source: Bloomberg, DBI. For the period 1 January 2022 to 31 December 2022. 'SEI Portfolio' refers to the SEI Liquid Alternative Fund. 'SEI Target' refers to the hedge fund portfolio our quantitative model looks to replicate. Given differences among share classes, performance figures above represent those of the portfolio (USD performance, net of estimated fees and expenses); please consult SEI directly for specific share class returns. We have chosen to compare the fund to major equity, fixed income, and commodity indices to give a sense for the macroeconomic picture. For illustrative purposes only. Past performance does not predict future returns.

Index returns are for illustrative purposes only and do not represent actual fund performance. Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index.

2023 then saw the macroeconomic environment take something of a U-turn. Equities recouped much of their losses from the previous year, but bonds only partially recovered.

Here, the fund's multi-strategy sleeve captured a portion of the gains made by the equity markets, meaning the losses incurred by the multi-strategy sleeve in 2022 were more than recovered. Meanwhile, the managed futures sleeve experienced a moderate loss, but net returns for the fund were still positive.

Chart 3 – In a sea of green, the fund was positioned to take advantage of equity market gains in 2023



Source: Bloomberg, DBI. For the period 1 January 2023 to 31 December 2023. 'SEI Portfolio' refers to the SEI Liquid Alternative Fund. 'SEI Target' refers to the hedge fund portfolio our quantitative model looks to replicate. Given differences among share classes, performance figures above represent those of the portfolio (USD performance, net of estimated fees and expenses); please consult SEI directly for specific share class returns. We have chosen to compare the fund to major equity, fixed income, and commodity indices to give a sense for the macroeconomic picture. For illustrative purposes only. Past performance does not predict future returns.

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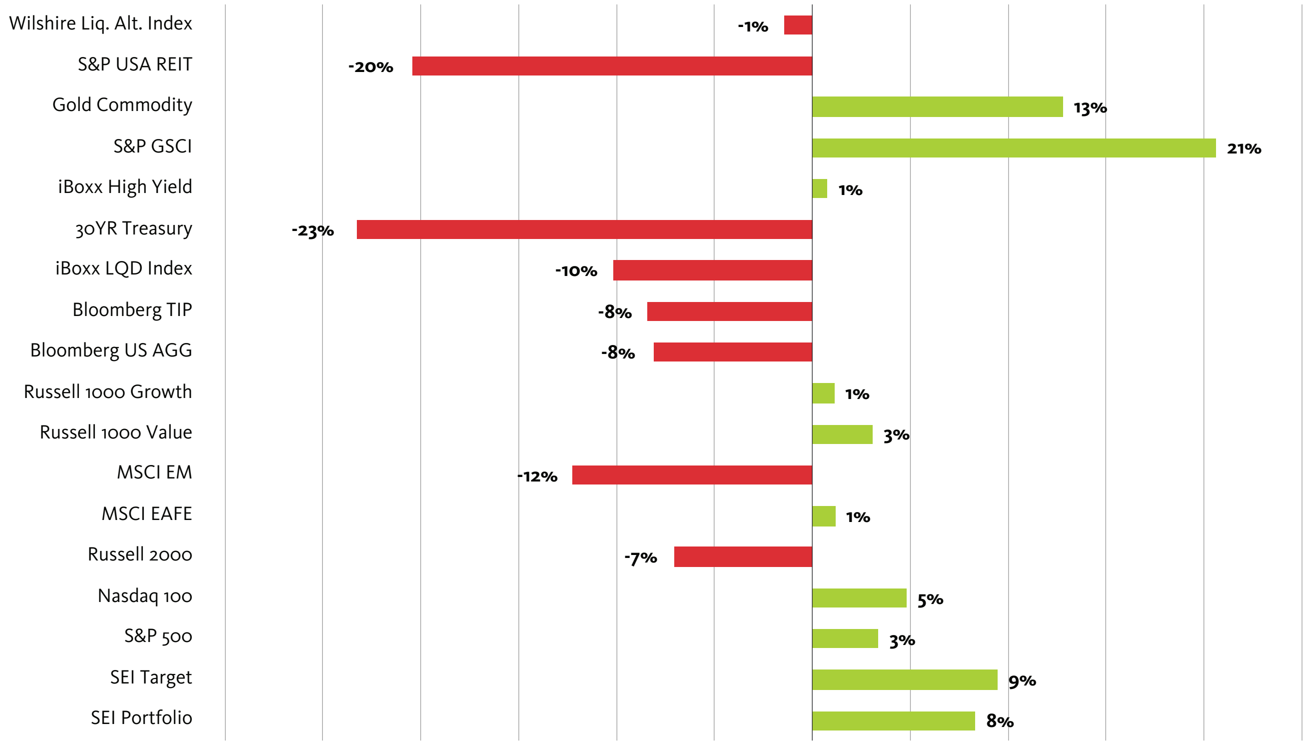
What's important to note here is that taken together, 2022 and 2023 illustrated how the two sides of the fund work together.

The fund's sleeves are different, but complement one another, allowing the fund to target outperformance in different market environments.

Chart 4 – Cumulative performance for 2022-23 was positive, thanks to the funds complementary sleeves



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SEI Liquid Alternative Fund (% performance)

	Multi-strategy sleeve	Managed futures sleeve
2022	-3.0	15.6
2023	9.7	-3.3
2022-23 (cumulative)	6.4	11.8

Calendar year returns (%)

	SEI Liquid Alternative Fund	Eurekahedge Institutional Multi-Strategy Hedge Fund Index	ICE BofA US 3-Month Treasury Bill Index
2016	8.6	4.0	0.3
2017	4.5	6.5	0.9
2018	-0.6	-1.9	1.9
2019	8.7	6.9	2.3
2020	8.9	4.8	0.7
2021	10.0	7.0	0.1
2022	4.1	-2.2	1.5
2023	4.3	4.2	5.0

Source: SEI, DBi. Annualised returns are shown net, as at 31 December for each calendar year, respectively, using the USD Institutional Distributing share class. This share class is not available to retail investors and is only included for reference purposes to demonstrate longer term performance patterns. The fund's inception date was 13 November 2015. Past performance does not predict future returns.

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What's next?

To best manage risk, an investor needs to be dynamic. And with 60/40 portfolios struggling, now's the time to think differently about the problem at hand.

Whilst we believe adding liquid alts to a portfolio comprised of more traditional investments can provide diversification—something many investors today feel they're lacking—this is far from the only benefit. The SEI Liquid Alternative Fund certainly offers a different way to diversify, as this paper has demonstrated. But it also provides a potential source of 'crisis alpha', as well as a cost-effective way to access the best macro ideas from an array of top-performing hedge fund managers. In other words, the fund's role within a portfolio isn't predetermined, which is one reason it appeals to institutional investors, wealth managers, financial advisers, and family office alike.

Interested in finding out what the SEI Liquid Alternative Fund could help you achieve?

Contact the team today.

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