

PERSPECTIVES

Shifting volatility, sentiment and alternative investment allocations

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Changing economic and market conditions this year and the threat of renewed volatility are impacting both investor sentiment and allocations to alternative sources of return.

Shifting stock and bond valuations. Rising interest rates. Escalating trade tensions. These are just a few of this year's ever-increasing sources of market uncertainty, which are upping the potential for heightened volatility and causing a downturn in investor confidence around achieving their investment objectives.

So far this year investors have witnessed multiple Fed interest rate hikes, with the expectation of more through 2019, plus heightened geopolitical tensions on the heels of global trade and economic strains. A highly public and tense trade battle was kicked off with China and other countries, which also has exacerbated the U.S.-Russia showdown.

Given these developments and 2018's overall economic and market uncertainties, it's no wonder investors continue to report changing sentiment in connection with outlook for market gains in the months ahead.

What's impacting sentiment?

Shifting levels of investor caution and overall uncertainty have pervaded 2018 as mixed economic signals have clouded investor conviction regarding the market outlook. Bullish investor sentiment — expectations that stock prices will rise over the next six months — has dropped in recent months in the closely watched AAI Investor Sentiment Survey. A sharp plunge of 10.1% as of September 13 ended a three-week streak where optimism held above its historical average of 38.5%.¹ Then, with the Dow suddenly achieving record highs, investor sentiment seesawed — bullish sentiment jumped over 14% to 45.7% as of October 4.

Bearish sentiment — expectations that stock prices will fall over the next six months — jumped 6.5% to 32.8% in mid-September, putting pessimism back above its historical average of 30.5% for the first time in five weeks, only to reverse course in October amid the climbing Dow.¹

Despite fluctuations in the short-term direction of the stock market, decidedly lower levels of investor confidence are trending internationally. Mounting trade tensions throughout the world, growing protectionism and deviating monetary policies among major central banks are all triggering more guarded investor positioning. These global economic developments are translating deeply into investor sentiment as reflected in the State Street Investor Confidence Index (ICI), which dropped in August by 7.4 points to its lowest level in 18 months.²

Market observers are witnessing changing investor views not only with individual investors, but also with institutional investors. While individual investors reported a rise in bullishness in the short-term direction of the market, institutional investors are becoming increasingly cautious amid high stock valuations and worries regarding a slowdown in corporate earnings growth.³

Sentiment among many money managers has declined in 2018. Marking the most negative outlook from managers on the global economy since December 2011, a net 24% of managers surveyed in September expect global growth to slow in the next 12 months—a huge jump from only net 7% in August. A further signal of manager bearishness is the rise in their average cash balance to an 18-month high of 5.1% in September.⁴

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What’s lifting alternative investment inflows?

Recognizing the potential for increased volatility and amid declining sentiment, some investors are turning their attention and portfolio allocations to alternative sources of income and growth. This trend isn’t surprising. Uncertain market environments can create an atmosphere where investors seek out investments designed to provide greater diversification, lower volatility, low correlation to traditional markets or potential downside mitigation if sharp declines or dislocations are triggered by geopolitical or other events.

Why do we believe interest in liquid alternatives is growing? One reason relates to how their strategy and structure may align with certain investors’ goals and interests. These funds can go both long and short on their investments, which has the potential to lower volatility and mitigate downside risk.

The maturity of the investment category may also contribute to the increased interest. While still young when compared to their more-traditional equity and fixed income brethren, liquid alternatives now comprise a diverse body of funds with enough longevity to enable thorough evaluation. Investors and their financial advisors simply have more options with track records in this segment to choose from.

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Investing smartly amid market uncertainty

Given the Fed’s rate hike trajectory and current geopolitical tensions, we believe there’s no reason to expect market volatility to lessen materially in the near term. This means there could be ongoing—and possibly increasing—uncertainty and caution among investors, managers and analysts, which can exacerbate the volatility problem.

The performance of alternatives relies heavily on market conditions, the expertise of the manager and the strategy they implement. Alternatives may also have higher expenses than traditional investments. However, within this environment, and with portfolio diversification at a premium, allocations beyond traditional stocks and bonds are likely to remain a viable consideration for investors.



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Greg serves as Managing Director and Head of Liquid Alternative Strategies, overseeing the development and management of the firm’s liquid alternatives platform. As a pioneer and thought leader in this space, he looks to the future of investing trends with a focus on creating access to alternative strategies that can help investors design better, more diversified portfolios. Greg has been recognized for leadership and innovation in financial services and asset management and has been honored for his longtime civic work. He continues to give back to the community through board service and leadership at several local and national civic organizations.

1 American Association of Individual Investors, Investor Sentiment Survey. Historical average based on data from January 1, 1987–September 13, 2018, <https://www.aaii.com/o/sentimentsurvey>.

2 State Street Investor Confidence Index, August 2018.

3 State Street Investor Confidence Index, September 2018.

4 Bank of America Merrill Lynch Global Fund Manager Survey, September 13, 2018. The survey of 244 money managers representing a total of \$742 billion in assets under management was conducted September 7–13, 2018.

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