January 2025

Enhancing portfolio resilience with diversifying liquid alternatives

Important Information:

- The value of investments and the income from them can go down as well as up and investors may not get back the amount invested.
- For funds that invest in overseas markets and the value of investments can be affected by changes in currency exchange rates.
- For funds that invest in emerging markets which can be more volatile than other more developed markets.
- For funds that use financial derivative instruments for investment purposes, which may expose the fund to a higher degree of risk and can cause investments to experience larger than average price fluctuations.
- For funds that may make increased and more complicated use of derivatives and this may result in leverage. In such situations performance may rise or fall more than it would have done otherwise. The fund may be exposed to the risk of financial loss if a counterparty used for derivative instruments subsequently defaults.
- Reference to specific securities should not be construed as a recommendation to buy or sell these securities and is included for the purposes of illustration only.
- Currency hedging may be used to substantially reduce the risk of losses from unfavourable exchange rate movements on holdings in currencies that differ from the dealing currency. Hedging also has the effect of limiting the potential for currency gains to be made.
- Investors should note that the views expressed may no longer be current and may have already been acted upon.
- Past performance is not a reliable indicator of future returns.

Last update: January 2025

Fidelity INTERNATIONAL

Rahul Srivatsa
Portfolio Manager

Stefan Rusev
Senior SAA Strategist

Isabella Labak
Director, Client Solutions

The years since the Covid pandemic have marked a significant departure in macroeconomic conditions from the preceding decade. In the period after the financial crisis, easy monetary policy helped to flatten macroeconomic volatility. However, today investors must grapple with greater uncertainty about inflation and central bank rates, as well as widening fiscal deficits, escalating protectionism, and more positive equity-bond correlations. We believe this marks the beginning of a new macroeconomic regime, and that building portfolios that are resilient to these new challenges will require a different approach to the one that was successful in the past. In particular, investors may need to look beyond traditional asset classes to achieve the diversification that they are used to.

Our research shows that diversifying liquid alternatives could have an important role to play in increasing the robustness of portfolios in this new environment. Liquid alternatives are assets and strategies that are both liquid and offer different risk and return characteristics to those of equities and bonds. The universe is highly diverse, ranging from gold to equity long-short strategies to put options. We think about liquid alternatives in three distinct groups - 'Carry', 'Diversifying' and 'Hedging'. Carry strategies tend to perform well in benign or 'risk on' markets, diversifying strategies have little or no correlation to broader markets, while hedging strategies are those that tend to perform well in 'risk off' markets.

Figure 1: How we define the liquid alternatives universe

Carry strategies	Diversifying strategies	Hedging strategies
Examples ▪ Short volatility strategies ▪ FX carry strategies ▪ Short skew strategies	**Examples** ▪ Commodity liquidity strategies ▪ Equity long-short strategies ▪ Global macro strategies	**Examples** ▪ Put options ▪ Rates volatility strategies ▪ VIX call replication strategies
Tend to perform well in 'risk on' markets	**Little – no correlation to broader markets**	**Tend to perform well in 'risk off' markets**

Source: Fidelity International, 2025. For illustrative purposes only.

In this paper, we will focus specifically on diversifying liquid alternatives and outline the strong medium-term case for allocating to this strategy group within a balanced portfolio. The first section sets out why we believe that the medium-term macroeconomic outlook of elevated inflation and volatility, higher equity-bond correlations, and higher bond valuations, means that investors might need to look beyond bonds alone for diversification when building robust portfolios. The second section details our research into the beneficial impact diversifying liquid alternatives can have on portfolio resilience and mitigating tail risks. The final section provides a summary of our approach to portfolio construction with this diverse asset class.

Macro outlook highlights the benefits of alternative forms of diversification

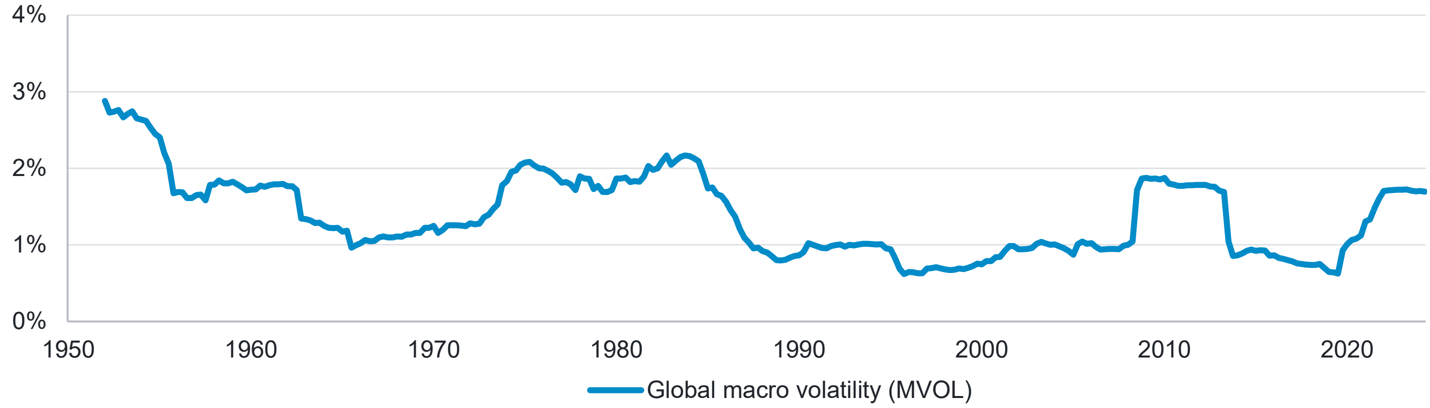
The global economy has faced a number of shocks since the onset of the Covid pandemic, from lockdowns to extraordinary government spending to runaway inflation in developed markets. We have entered a new macroeconomic regime of greater protectionism, more volatile inflation, and wider fiscal deficits. We believe that there are two key characteristics of this environment that could reduce the diversification benefits of bonds compared to the pre-pandemic era - higher and more volatile inflation and higher bond valuations.

Higher inflation volatility

The period between the financial crisis and the pandemic was marked by low inflation and broadly negative equity-bond correlations, which meant that investors could achieve relatively robust diversification with just equities and bonds.

However, as Figure 2 shows over the past four years, macroeconomic volatility, particularly inflation and inflation volatility, has risen substantially as a result of post-pandemic central bank monetary stimulus, supply chain disruptions, and de-globalisation. Given that this has taken place outside of a recession, we believe it signals a return to a higher volatility regime over the medium-term.

Figure 2: Macroeconomic and inflation volatility has risen since 2020



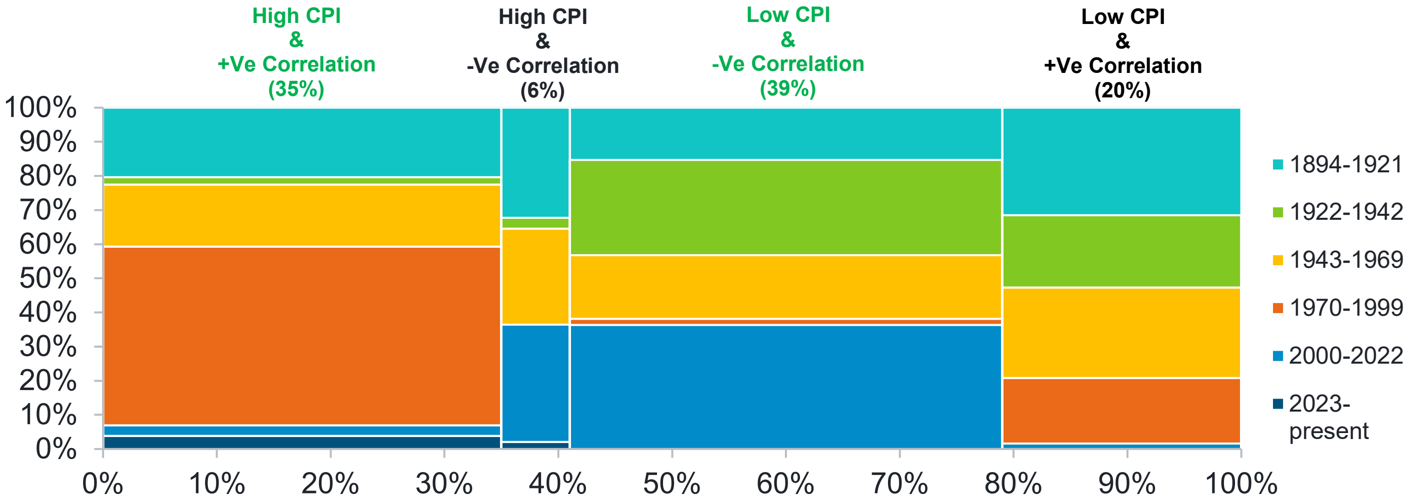
Source: Fidelity International, January 2025. MVOL is a proprietary metric and is defined as the average of 5-year rolling volatilities of quarter-on-quarter RGDP and inflation (March/June 2020 RGDP data is interpolated). Global MVOL: 75% US, 15% EU, 6% JP, 4% UK.

While the explicit inflation targets of many developed market central banks will help combat this, we believe that structural trends including decarbonisation, de-globalisation, and widening fiscal deficits will cause inflation to be higher and more volatile in the coming years than in the post-financial crisis era. For further information on our inflation forecast, please refer to ***Insight into Fidelity's capital market assumptions***.

As Figure 3 shows, higher inflation implies equity-bond correlations will also be higher in the coming years. Higher correlations between the major asset classes means investors may need to consider other sources of diversification to achieve the same level of portfolio resilience as in the past.

Figure 3: Our expectation of higher inflation implies higher correlations

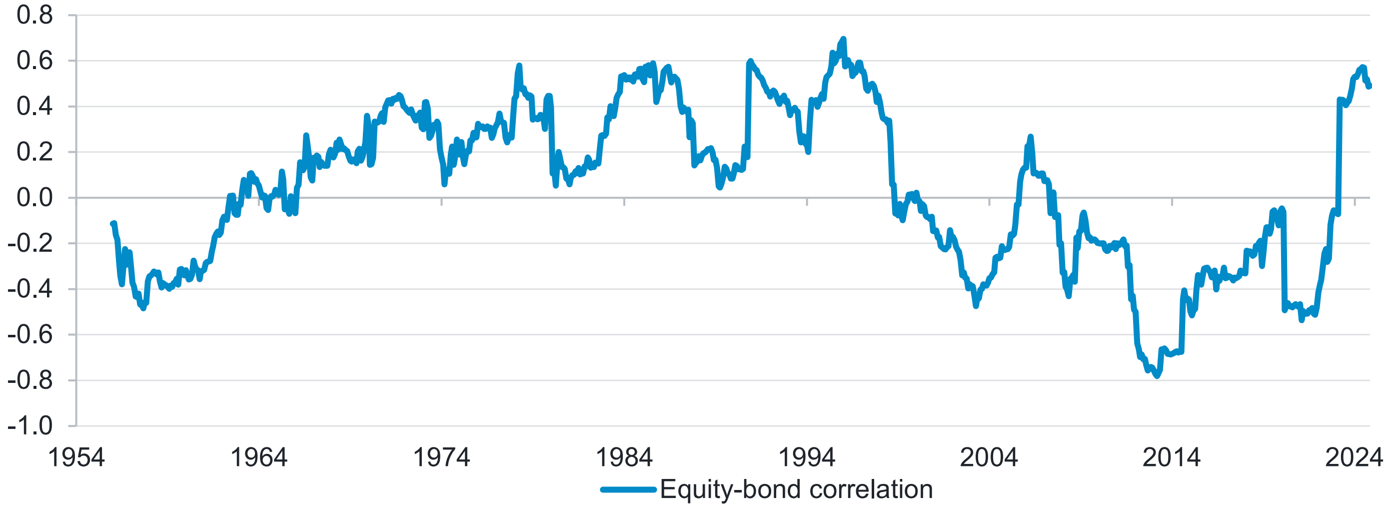
Positive relationship between equity-bond correlations and inflation levels for nearly 75% of cases



Source: Fidelity International, Robert Shiller Database, January 2025. Chart is showing annualised rolling 3-yr inflation vs rolling 3-yr equity bond correlation. Equity-bond correlation is calculated as the rolling annualised 3-year correlation between the S&P 500 index and the 10-year US Treasury Note. 'High CPI' is defined as >3% and 'Low CPI' is defined is < 3%. The chart above is a Marimekko chart. The chart's column widths are proportional to the total count of items in a category, while the segment heights within a column represent sub-category values, allowing for a combined view of absolute and relative size. For illustrative purposes only.

The new reality of higher inflation and the subsequent impact to equity-bond correlations was apparent in 2022, when surging inflation in developed markets caused correlations to spike. The failure of bonds to offset equity losses that year caught many investors off guard. A sustained period of positive correlations would be a significant change from the 20-year period between 2000-2020 of broadly negative correlations that many of today's investment strategies are based on. As Figure 4 shows, equity-bond correlations tend to fluctuate, and persistent negative correlations are in fact rare rather than the norm.

Figure 4: Persistently negative correlations are rare



Source: Fidelity International, Robert Shiller Database, January 2025. Equity-bond correlation is calculated as the rolling annualised 3-year correlation between the S&P 500 index and the 10-year US Treasury Note. For illustrative purposes only.

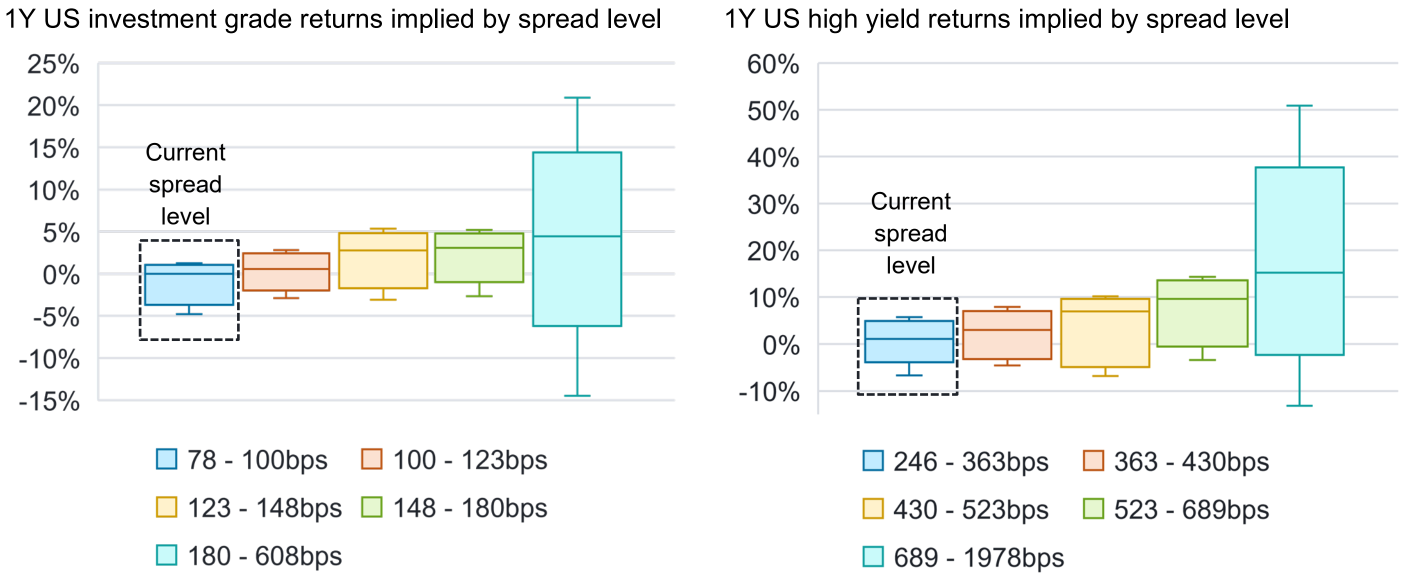
A further consequence of higher and more volatile inflation is higher bond volatility. The relative calm of the pre-pandemic era made bonds a stable investment. However the more uncertain future means that investors will not be able to depend on bonds in the same way they did in the past for diversification.

We believe this further increases the attractiveness of other assets that can provide additional diversification and return benefits to portfolios alongside bonds. This is especially true for certain diversifying liquid alternatives, such as hedge funds and absolute return strategies, which generally benefit from more trading opportunities when volatility and dispersion are elevated, allowing them to achieve higher levels of return at a time when traditional asset classes may struggle.

Higher credit valuations

Current credit valuations indicate that returns are likely to be lower over the coming years. Unlike equities, credit valuations, in the form of credit spreads, are a relatively reliable indicator of medium-term returns. Spreads today are amongst the lowest since records began, resulting in a pronounced negative return asymmetry, particularly for investment grade bonds. Replacing some fixed income exposure with alternative forms of diversification could help offset this risk.

Figure 5: Current spreads indicate low future bond returns, boosting the case for alternative forms of diversification



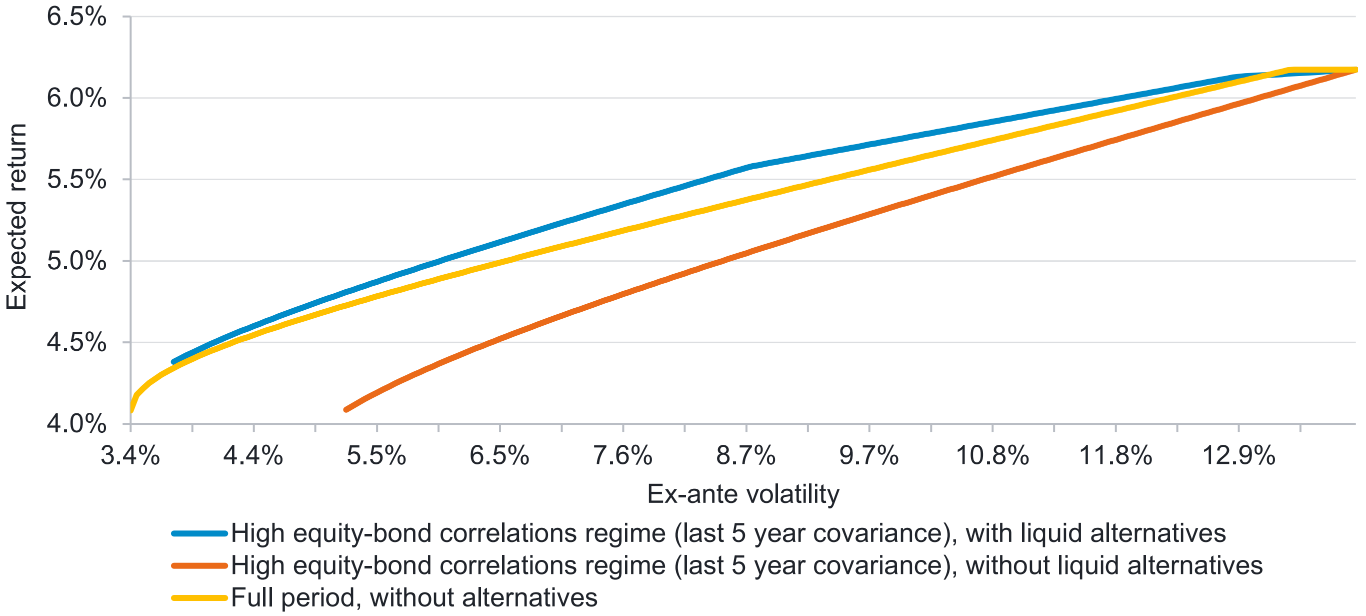
Source: Fidelity International, ICE BofA, January 2025. Analysis conducted from: January 1999 - September 2024. OAS: Option Adjusted Spread. Ranges above represent the starting OAS for US investment grade bonds and US high yield bonds. US IG Index: C0A0, US HY Index: H0A0. For illustrative purposes only. The charts above are known as box and whisker plots. They display the distribution of credit returns from different starting OAS. They consist of a rectangular "box" that represents the interquartile range of the data, with a line inside marking the median. "Whiskers" extend from the hox to the 10th percentile and 90th percentile values (excluding outliers). This visualisation provides a summary of the data's central tendency and spread.

Diversifying liquid alternatives can enhance long-term portfolio outcomes

Our research suggests that allocating to diversifying liquid alternatives can enhance long-term investment outcomes. Investors must decide whether this fits with their own objectives and preferences, but for those willing and able to access this strategy group, their use can shift the efficient frontier upwards and to the left - offering higher returns for a given level of risk or lower risk for a given return.

As Figure 6 illustrates, this can be particularly important in regimes with higher bond volatility and high equity-bond correlations, such as we expect in the coming years. These conditions increase portfolio risk, which materially lowers the efficient frontier. The sample analysis in Figure 6 uses the realised covariances of the last five years, a snapshot of a period with much higher equity-bond correlations than the preceding 20 years, demonstrating that diversifying liquid alternatives can help keep the frontier closer to equilibrium expectations - helping provide better risk-adjusted investment outcomes.

Figure 6: Diversifying liquid alternatives can improve investment outcomes, especially in high correlation regimes



Source: Fidelity International, January 2025. Currency: USD. For illustrative purposes only. Expected risk and returns for asset classes are based on Fidelity International's proprietary capital market assumptions (beta only and do not include added value from active management and risk) as at H2 2024. Efficient frontier based on 20% allocation to diversifying liquid alternatives: 4% volatility; 0.5 Sharpe Ratio.

The diversification benefits of liquid alternatives come from their low correlations with traditional asset classes. In general, we look for an asset class to fall within a correlation range +/-0.25 to be considered as having a low or uncorrelated risk and return profile.

Figure 7: Liquid alternatives can be powerful diversifiers due to their low correlations to traditional asset classes

Correlation matrix	Diversifying liquid alternatives	US Treasuries	US High Yield	DM Equities
Diversifying liquid alternatives	1.0	-0.2	0.1	0.2
US Treasuries	-0.2	1.0	-0.3	0.0
US High Yield	0.1	-0.3	1.0	0.8
DM Equities	0.2	0.0	0.8	1.0

Source: Fidelity International, January 2025. Time horizon: Feb-08 - Sep-24. Treasuries: ICE BofA US Treasury Index; Credit: ICE BofA US High Yield Index Total Return Index returns above US Treasuries; Equities: MSCI World Index; Diversifying liquid alternatives is represented by an HFR custom index, which includes HFRX Systematic Diversified, HFR Macro Discretionary Thematic, HFR RV Volatility, HFR Macro Commodity, HFRX EQ Market Neutral, and CTA.

In addition, the slightly negative correlation between diversifying liquid alternatives and US Treasuries is advantageous in portfolio design because investors often seek out diversifying exposures for returns and protection when risks increase in traditionally defensive market areas.

While informative, these numbers can mask prolonged periods of instability. Regime analysis can provide a deeper understanding of how asset classes might behave under different conditions and over time. Figure 8 reveals the average expected performance of diversifying liquid alternatives, US Treasuries, and developed market equities across six distinct growth and inflation regimes.

Figure 8: Diversifying liquid alternatives exhibit stable performance across most regimes

Average returns in regime (%)

Growth conditions	**Rising**	**Rising**	**Rising**	**Falling**	**Falling**	**Falling**
Inflation	**Low**	**Normal**	**High**	**Low**	**Normal**	**High**
Diversifying liquid alternatives	2.1	2.3	4.5	1.8	-2.0	1.4
US Treasuries	-2.6	0.2	-5.5	6.8	4.1	-0.2
Global equities	29.1	15.8	1.9	9.7	-21.4	-2.2

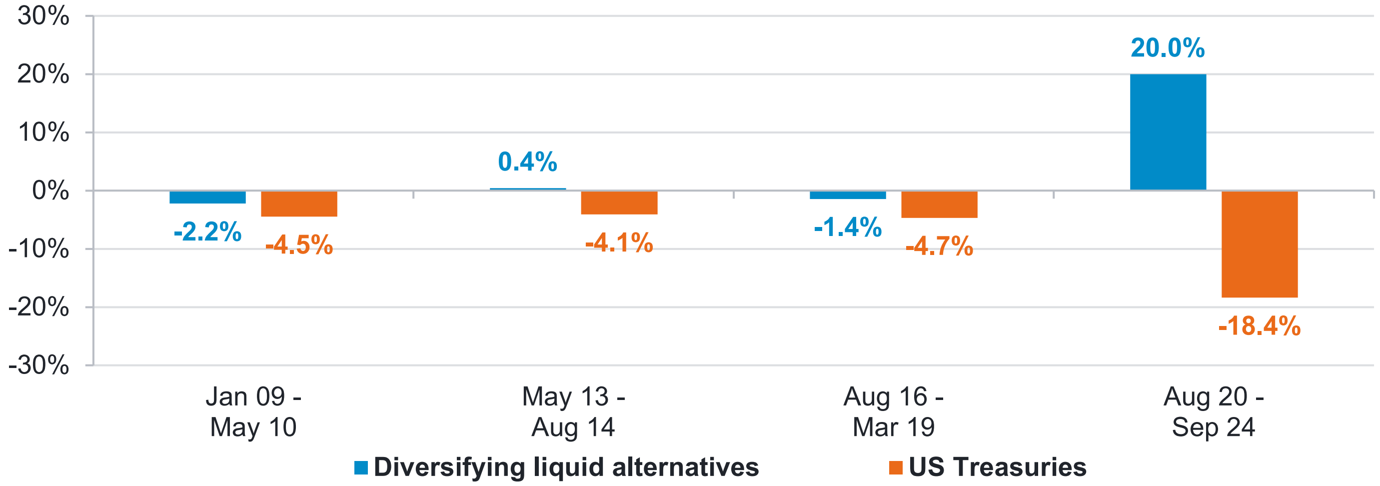
Source: Fidelity International, January 2025. Time horizon: Feb-08 - Sep-24. 'Growth conditions' are assessed using our Fidelity Leading Indicator. This is a proprietary cycle tracker based on calculations of FIL Global Macro Team calculations, Haver Analytics. The Indicator shows whether growth is accelerating or decelerating. Inflation is a proprietary measure of inflation expectations, expressed in Z-scores and is classed as follows: low (<-0.4), normal (-0.4;0.4) or high (>0.4). Diversifying liquid alternatives is represented by an HFR custom index, which includes HFRX Systematic Diversified, HFR Macro Discretionary Thematic, HFR RV Volatility, HFR Macro Commodity, HFRX EQ Market Neutral, and CTA. Treasuries: ICE BofA US Treasury Index; Equities: MSCI World Index.

Generally speaking, diversifying liquid alternatives exhibit broadly stable performance across different regimes, including in high inflation regimes when equities and bonds tend to perform poorly. This is noteworthy given our expectation of higher macroeconomic and inflation volatility. A bearish environment, where growth is falling and inflation normal, is the regime that the asset group performs the worst in, but even here the negative performance is reasonably contained and can be mitigated by appropriately sized allocations and selection of the optimal strategies.

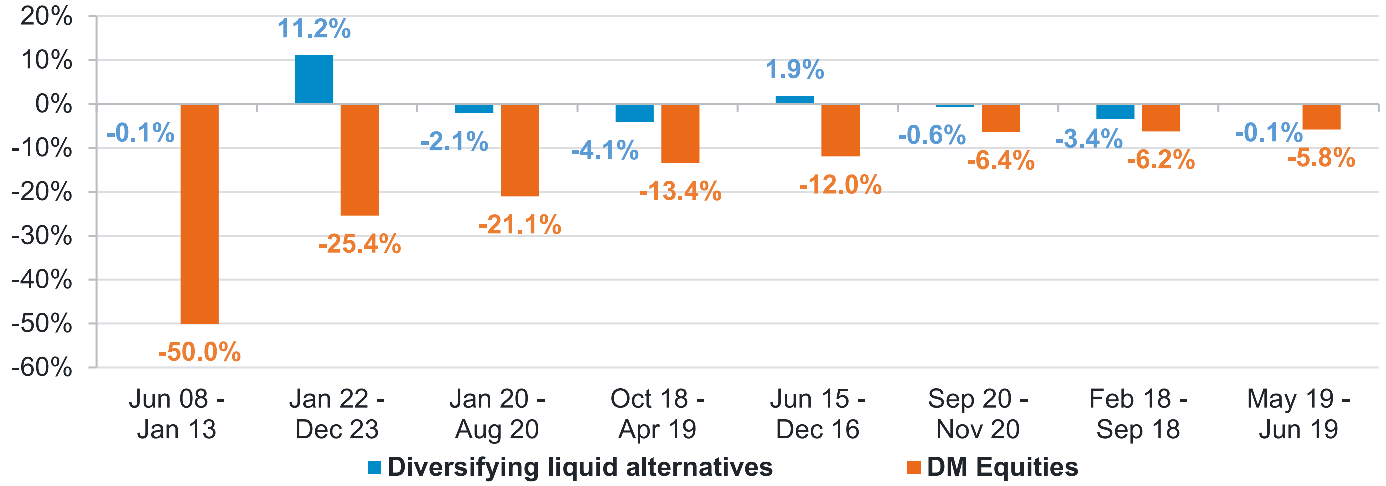
Drawdowns are also an important part of diversification. It's crucial to understand whether drawdowns in diversifying liquid alternatives coincide with drawdowns in equities and bonds - in other words, are the diversification benefits there when they are needed most? Our analysis shows that the strategy group does indeed tend to offer support when traditional assets come under pressure.

Figure 9: Diversifying liquid alternatives can offer support when most needed

Bond drawdown analysis



Equity drawdown analysis



Source: Fidelity International, January 2025. Currency: USD. Drawdown periods for Treasuries and DM equities with maximum drawdowns of at least 4% for Treasuries and 5% for equities selected. Diversifying liquid alternatives is represented by an HFR custom index, which includes HFRX Systematic Diversified, HFR Macro Discretionary Thematic, HFR RV Volatility, HFR Macro Commodity, HFRX EQ Market Neutral, and CTA. Treasuries: ICE BofA US Treasury Index; Equities: MSCI World Index.

Constructing portfolios with liquid alternatives

The idiosyncratic nature of the liquid alternatives universe makes it crucial to understand the risk and return characteristics of each strategy. Our approach involves categorising the liquid alternatives universe in such a way to allow us to construct portfolios that align with our clients' diverse objectives, ensuring precise and consistent exposure tailored to various risk and return requirements.

Figure 10: How we define the liquid alternatives universe

Source: Fidelity International, 2025. For illustrative purposes only. Carry: Positive strategy performance when benchmark delivers average returns. Convexity: Positive strategy performance when benchmark delivers weak returns. Benchmark: 60% global equities; 40% global aggregate bonds.

For example, investors seeking diversification and growth could consider allocating to ‘carry’ and ‘diversifying’ strategies, whereas those looking for defensive diversifying exposure could consider a ‘hedging’ portfolio alongside ‘diversifying’ strategies. When creating a balanced allocation to diversifying liquid alternatives by blending together complementary strategies, the resulting volatility profile means that the allocation is typically funded by reducing the proportion of bonds in a portfolio. As an asset allocation’s expected volatility increases, the exposure can also be funded from higher-risk assets, however further adjustments to the asset allocation will be needed to keep the overall risk profile constant.

Researching individual strategies is an important part of building portfolios with liquid alternatives. Splitting the universe into three broad strategy groups is helpful, but there are still significant differences between strategies in each category due to the large range of sub-style and implementation choices available. Selecting the appropriate strategies helps maximise returns and minimise risks, while the inclusions of inappropriate and under researched strategies could lead to missed opportunities or unexpected risks. As such, a robust strategy research and portfolio construction framework is needed. Our approach emphasises accountability and specialism alongside ongoing monitoring and review to ensure any selection delivers outcomes consistent with objectives.

Our portfolio construction process for the diversifying liquid alternatives building block avoids statistical optimisation and is designed with a focus on first principles of diversification and tail risk assessment to capture the idiosyncratic nature of the strategies being invested in. More specifically, when constructing an allocation, we use an equal volatility weighting as our neutral starting point. From there we amend exposures to individual strategies in order to maximise risk-adjusted return while factoring in convictions, tail risk, and diversification properties to mitigate drawdowns. More specifically, we assess the distribution of returns, maximum drawdowns, and qualitatively assess the correlation of drawdowns when further amending allocations.

Diversifying liquid alternatives can enhance portfolio outcomes

We believe that the current economic landscape, characterised by wider fiscal deficits, increasing protectionism, and unstable inflation, marks the start of a new macroeconomic regime of higher volatility and higher equity-bond correlations. Investors who adapt to these new conditions rather than stick to what worked in the past are likely to be rewarded with portfolios that are more resilient in the future.

We believe that diversifying liquid alternatives have an important role to play in building robust portfolios in the coming years, offering diversification benefits and having shown resilience in high inflation regimes. Our approach to portfolio construction allows us to help clients get the most out of this strategy group by creating tailored allocations that align with their specific needs.

Important information

Fidelity INTERNATIONAL

Important information

Fidelity INTERNATIONAL