Smart Alpha: Looking beyond stocks and bonds to find return

Setting aside volatility – or potential volatility – from rising interest rates and an unsettled political climate in both the U.S. and Europe, returns on stocks and bonds are not likely to reach levels that investors have become accustomed to, particularly in the early days of the Trump Administration.

In fact, Eric Stein, co-director of global income at Eaton Vance Management, said institutional investors need to set their return sights lower. And then think creatively about finding return.

"Fixed income returns are going to be very challenged going forward," he said. "At best the equity market is fairly valued. It could keep going but it's getting ahead of itself."

While the discussion with investment committees and boards around lowering return expectations might be difficult, "that's just reality," Stein said. "You can't create returns out of thin air."

The investment universe, however, is big enough for investors to find sources of alpha that don't move in lockstep with U.S. equities or fixed income instruments.

"For some investors, that's going international, into emerging markets," he explained. "For others, it's looking for alternative, unconstrained, noncorrelated sources of return. Assets that don't move with traditional asset markets and that sometimes use shorting, sometimes use derivatives."

In other words, global macro absolute return strategies that take into consideration economic and political fundamentals of countries around the world and then take positions based on those views.

"Global macro is sometimes defined differently by different people. I would define it as investing in sovereign assets — currencies, bonds, some equities (indexes, not companies) — driven by macroeconomic and political fundamentals," Stein explained. "You're studying macroeconomics and politics and you're making investment decisions that are either going to do well or do poorly based on that analysis."

LONG AND SHORT

By definition, the strategy must be long and short "and hopefully will have done well if done in a way that's uncorrelated to traditional equities and fixed income," he added. As there can be different definitions of global macro, money managers focus on different sectors, giving each strategy a unique tilt.

"Different global macro strategies have different risk/return targets," Stein said. "Some that are on the lower (return) end are more fixed income substitutes and some that are on the higher (return) end are more equity substitutes."

Given this range of options — and potential outcomes — how should asset owners think about building a global macro allocation into their existing asset mix?

"The number one consideration is if you can provide a noncorrelated return stream to whatever else is in that institutional investor's portfolio," he said. "But as someone told me, you can't eat Sharpe ratio and you can't eat noncorrelation with no returns, so it really depends on what that institutional investor is replacing. It may be both equity and fixed income. It depends on the manager" and the investor's goals.

From there, the investor can figure out a funding source for an allocation to global macro. If the investor is using it as more of a fixed income-like allocation, funding would come out of the traditional fixed income bucket, and likewise for equities.

Stein added that some institutional investors drop global macro into their alternatives bucket and would fund an allocation from both equities and fixed income depending on valuation levels in those markets, which can help determine which positions to trim to fund the global macro allocation.

BOTTOM UP APPROACH

At Eaton Vance, Stein and his team follow a bottom up, country-by-country approach to their global macro absolute return strategy, which means they don't allocate assets to any particular region or asset class. So what is looking attractive today?

"There are pockets of value in local interest rates in places like Russia, Serbia, Indonesia and New Zealand, so it really varies from a geographic perspective," he said. There opportunities around the world in the currency markets, too, such as longs in Iceland and Sri Lanka as well as shorts in China and Gulf Cooperation Council (GCC) countries such as Oman.

"We try to do things bottom up, country-by-country, looking for specific asset classes or risk factors," he said. "Some of the emerging market risk factors are less attractive than they were a year ago."

Eric Stein, CFA
Co-Director of Global Income
Eaton Vance Management

Positions in the portfolio do change but Stein said the strategy takes a medium to long-term approach.

"Investors can see that our holdings by and large are the same but that doesn't mean we don't change," he said. "If you go back five years ago, we were long the Chinese currency and now we're short. If you go back three, four years ago, we had some short positions in Russia and now we have some long positions."

Looking around the world, Stein said the biggest risk factor to the Eaton Vance global macro strategy revolves around Europe.

"Europe keeps me up a lot at night," he said, explaining that the risk is mainly around how strongly the European Union holds together, particularly given elections in Germany in the fall, when Chancellor Angela Merkel will be up for reelection.

In addition, the U.S. relationship with Europe is something Stein is keeping an eye on. Specifically, how much or how little the U.S. Treasury under a Trump administration would go to support keeping the European Union together.

So between these risks and the specter of lower returns from traditional stock and bond investments, global macro absolute return is a timely strategy for institutional investors that may help make up ground that stocks and bonds could lose. ❖

For more insight from Stein on global fixed income absolute return, go to **pionline.com/EatonVance_Global**

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