CASE STUDY

The Case for Alternatives

SIMPLIFY

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INTRODUCTION

The 60/40 portfolio has been a staple for the wealth management industry for decades, and as Figure 1 illustrates, it has worked well over extended horizons. But there is more to investing than just equities and bonds, there is also a broad universe of alternative investment strategies that can complement the traditional equity/bond mix and potentially enhance risk-adjusted performance.

Figure 1: 60/40 Performance Over Long Periods

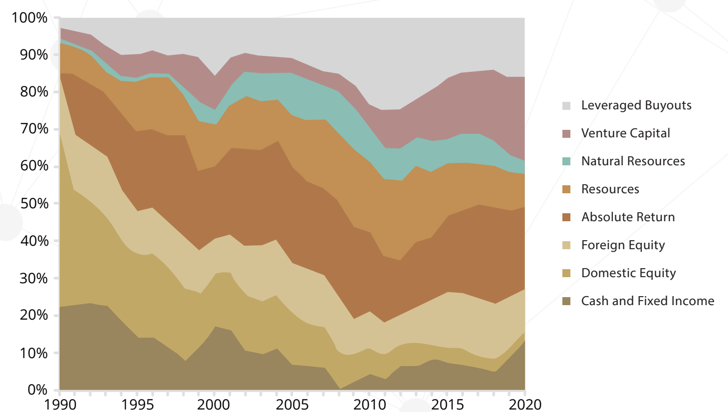
60/40 Average Annual Total Return	
10 Year	7.7%
20 Year	7.5%
30 Year	8.1%
40 Year	9.6%

Source: New York University. 60% S&P 500 Index, 40% 10-year US Treasury Bonds. The results are hypothetical (data ended 12/31/22), are not an indicator of future results, and do not represent returns that any investor actually attained. Hypothetical strategies and indices presented are unmanaged and do not reflect management or trading fees. One cannot invest directly in an index.

For decades, institutional investors have utilized significant allocations to alternatives to improve their performance. According to a 2023 Fidelity Investments survey, pension funds report a 22% allocation to alternatives, while endowments and foundations report a 32% allocation[1].

Perhaps the most well-known institutional portfolio is the Yale University Endowment. Over the past 30 years, they have taken their exposure to alternatives from under 20% to now over 77%[2], as seen in Figure 2. And indeed Yale has reaped the benefits of deploying alternatives. In the 20 years ending June 2022, their portfolio had an average annual total return of 11.3%, versus 7.2% for the 60/40 portfolio[3].

Figure 2: Yale's Asset Allocation in Time



Source: Yale Investments Office, 2023

In this report, we will review why most financial advisors have not historically allocated to alternatives and how many of the biggest historical roadblocks to adopting alternatives have now been removed. We will then show what to expect from investing a portion of your traditional balanced portfolio into a diversified sleeve of alternatives. Lastly, we'll discuss how investors can begin to build that alternatives sleeve with Simplify products.

THE CHALLENGE OF ALTERNATIVES FOR ADVISORS

If the world's most sophisticated investors have successfully embraced alternative investments, why have they gained such limited traction among financial advisors and individual investors? It's because most alternative strategies have been confined to the sphere of hedge funds and private equity funds. While institutional investors have access to these types of investments, they are difficult for most financial advisors to implement.

Obstacles for advisor use include:

- Qualified purchaser requirements (investor must have at least $5mm of net worth)
- High operational and legal complexity
- High minimum investment requirements
- Lack of liquidity (not traded on exchanges, typically have monthly redemption windows at best, can block redemptions at will)
- High fees (typically 2% management fee and 20% performance fee on gains)

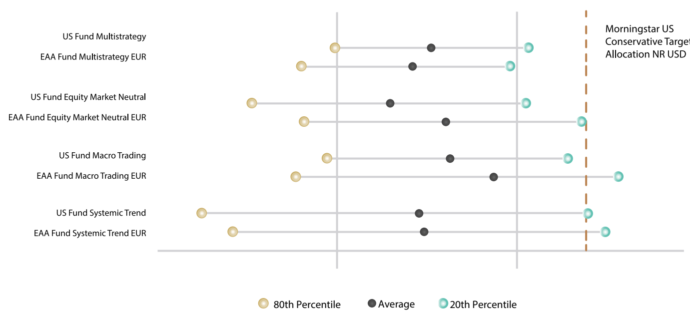
WHAT IS AN ALTERNATIVE INVESTMENT?

Alternative investments can be defined as assets outside of traditional stocks or bonds. Managed futures, long/short strategies, quantitative investment strategies, and derivatives-based strategies are examples of alternative investments.

Against this backdrop, many advisors are limited to "liquid" alternatives, which are alternative investments in mutual fund or ETF format. Liquid alternatives solve many of the issues associated with hedge funds, as they have low or no minimums, allow for daily liquidity, and are easily managed through the advisor's trading and accounting systems.

Liquid alternatives have been around for over a decade, but for reasons we will jump into shortly, these investments have been underwhelming. Figure 3 shows that from January 2011 to March 2021 the annual excess return for liquid alternatives has averaged less than 1%.

Figure 3: Average Rolling 3-Year Excess Returns of Selected Alternative Categories Between January 2011 and March 2021



Source: Morningstar 2021 Global Liquid Alternatives Landscape

There are a couple reasons for this lackluster performance. First, alternative investments frequently require the use of derivatives and leverage, but funds subject to the SEC's 1940 Investment Company Act have been limited in their use of derivatives and leverage. Additionally, the first generation of alternative managers have generally erred on the side of lower, more conservative use of leverage and derivatives to play it safe for new users of alternatives. As a result, liquid alternatives to date have often been managed to excessively low volatility levels, with uninspiring returns being the result.

Fortunately, there is new life for liquid alternatives, on the heels of a recent regulatory shift by the SEC.

A NEW DAY FOR LIQUID ALTERNATIVES

The SEC's recent Rule 18f-4 has modernized the rules around derivatives and leverage usage in ETFs and has helped create increased regulatory clarity[4]. This has already led to the launch of innovative new alternative products (some from us here at Simplify) that are seeking to level the playing field between illiquid alternatives and ETFs.

Given that our definition of an "alt" is anything other than standard equities and bonds, the category is enormous, but can broadly be broken down into the following large categories:

- Private Equity
- Private Real Estate
- Private Credit
- Managed Futures
- Long/Short Equity
- Cash-Plus

Private equity, private real estate, and private credit are not accessible in liquid formats by definition. But these strategies are also very exposed to traditional equity and credit risk, so they wouldn't be our first choice to add to an equity/bond portfolio even if they were easily available in an ETF.

We believe there are three primary categories of funds that work well in a liquid wrapper that can help maximize risk-adjusted returns when added to a traditional balanced portfolio:

- **Managed Futures:** a fully systematic trend-following strategy that can go long or short a diversified basket of futures, has historically exhibited near zero correlations to stocks and bonds, and has generally outperformed during risk-off events.

- **Equity Market Neutral:** a fully quantitative strategy that goes long or short stocks with total net equity exposure near zero, allowing access to multiple factor-based alpha sources while keeping low correlations to equities. With typical factor tilts towards quality and away from junk, these strategies also typically perform well during risk off events.

RULE 18F-4

- Effective February 19, 2021
- Eliminated need for exemptive relief to launch derivatives-based products
- Set clear limits on allowable leverage based on "value at risk"
- Requires managers utilizing derivatives to set risk management procedures

- **Cash-Plus:** a broad category of absolute return strategies designed to provide treasury bill returns plus an additional stream of low-risk returns. A common strategy here is treasuries plus a diversified basket of Quantitative Investment Strategies (QIS), whereby rules-based quantitative strategies that capture various risk premia are combined in an effort to create a high Sharpe Ratio, high yielding overlay that outperforms during risk-off events with little correlation to equity or bond markets. One can also have simpler versions that focus on singular QIS, still designed to offer a smooth return stream on top of T-Bills, but with significantly less holdings and complexity.

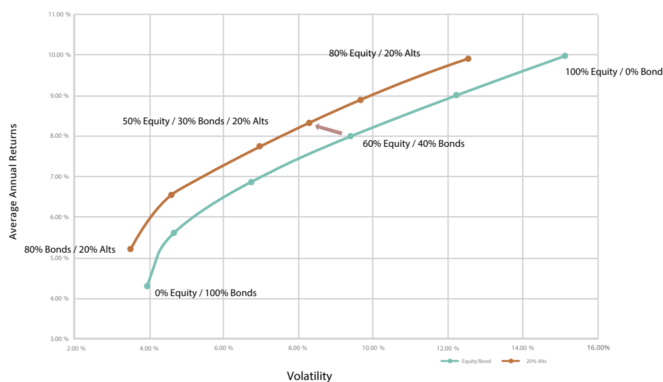
As you can see, there are three unifying investment mandates underlying each of these alternative strategies:

1. Provide a source of returns that is distinct from traditional equity and bond risk premia
2. Have minimal or even negative correlations to both stocks and bonds
3. Be flat to positive during risk-off events

THE PORTFOLIO BENEFITS OF ALTERNATIVES

Figure 4 shows how adding a 20% allocation to alternatives, equally weighted to proxy indices for the three strategies just discussed, may improve the risk-return profile of traditional balanced portfolios. We see that the portfolios including a 20% alternatives allocation (copper) are all up and to the left of the equity/bond-only portfolios (teal), which means that the portfolio with alternatives is either delivering the same amount of return with less volatility, a higher return with the same level of volatility, or a combination of both higher return and lower volatility.

Figure 4: Benefit of Adding Alternatives to Traditional Balanced Portfolios



Source: Bloomberg. Data from 8/31/93 through 6/30/23. Stocks: S&P 500 Index. Bonds: Bloomberg Aggregate Bond Index. Alts: SG CTA Index, HFRI Macro (US) Systematic Macro Index scaled to 8% volatility (proxy for Cash-Plus), HFRI (US) EH: Equity Market Neutral Index scaled to 10% volatility. The results are hypothetical, are not an indicator of future results, and do not represent returns that any investor actually attained. Hypothetical strategies and indices presented are unmanaged and do not reflect management or trading fees. One cannot invest directly in an index.

Figure 5 highlights some other key improvements as we move the 60/40 to 50/30/20 (50% equity, 30% bonds, 20% alts). We see an improved Sharpe Ratio from both enhanced returns and reduced volatility, but we also see lower maximum drawdown, stemming from both lower volatility and strong performance during risk-off events.

Figure 5: From 60/40 to 50/30/20

Indicator	60% Equities / 40% Bonds	50% Equities / 30% Bonds / 20% Alternatives
Avg. Annual Return	8.0%	8.3%
Annual Volatility	9.4%	8.3%
Sharpe Ratio	0.9	1.0
Maximum Drawdown	-32.5%	-27.0%

Source: Bloomberg. Stocks: S&P 500 Index. Bonds: Bloomberg Aggregate Bond Index. Alts: SG CTA Index, HFRI Macro (US) Systematic Macro Index scaled to 8% volatility (proxy for Cash-Plus), HFRI (US) EH: Equity Market Neutral Index scaled to 10% volatility. The results are hypothetical (based on data from 8/31/93-6/30/23), are not an indicator of future results and do not represent returns that any investor actually attained. Hypothetical strategies and indices presented are unmanaged and do not reflect management or trading fees. One cannot invest directly in an index.

BUILDING A SIMPLIFY ALTERNATIVES SLEEVE

The alts sleeve discussed above can be represented by an equally weighted portfolio of the following Simplify funds:

- Simplify Managed Futures Strategy ETF (CTA)
- Simplify Multi-QIS Alternative ETF (QIS) or Simplify Enhanced Income ETF (HIGH)
- Simplify Market Neutral Equity Long/Short ETF (EQLS)

Let's now discuss these funds in more detail.

CTA | Simplify Managed Futures Strategy ETF

CTA is a systematic, model-driven strategy that will take long or short positions across interest rates and commodities. Managed futures have historically exhibited low correlations with both equities and bonds, making them an ideal portfolio diversifier. They have been particularly effective during periods of extreme stock market drawdowns and inflationary periods (see Figure 6).

Figure 6: Managed Futures During Stock Market Drawdowns

	Stocks	Bonds	Managed Futures
Dot.com Bust 3/24/00 – 10/9/02	-47.4%	29.1%	29.0%
Global Financial Crisis 10/9/07 – 3/9/09	-55.3%	7.2%	19.2%
Interest Rate Shock 1/3/22 – 10/12/22	-24.5%	-14.4%	27.7%

Source: Barclays, Ycharts. Stocks: S&P 500 Index, bonds: Bloomberg Aggregate Bond Index, managed futures: SG CTA Index. For illustrated purposes only. Past performance is not a guarantee of future results. Index performance is not representative of fund performance.

The two core models used to trade both commodities and interest rates are Trend Following and Fundamental Reversion:

Trend Following	• Uses momentum to forecast short term returns • Combines multiple time horizon forecasts
Fundamental Reversion	• Uses a fundamentals model to complement trend-based forecasts • Often helps smooth risk of extended trends

The interest rate positions are managed with two additional models:

Intermarket Factor	• Uses equity markets to cue long rates positions • Designed to reduce drawdowns in a risk-off event
Carry Factor	• Positions rates on the optimal point of the yield curve • A high carry factor can enhance returns in a period of flat or falling rates

Unlike many managed futures products, CTA will not take positions in equities or currencies, seeking to ensure minimum correlations to equities and to maximize risk-adjusted returns. Because of its naturally low correlations with both equities and bonds, CTA makes an ideal anchor in an alternative investments sleeve.

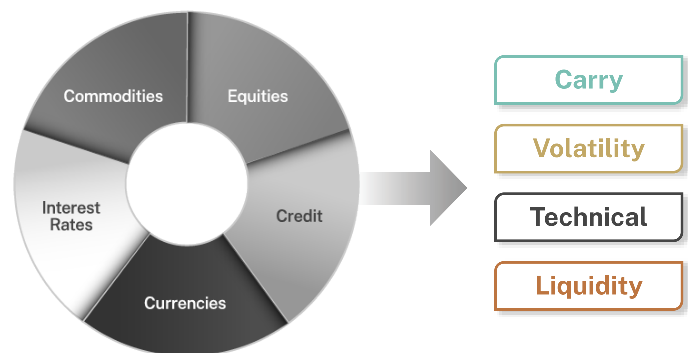
Learn more about **CTA** with detailed explainer videos and much more.

QIS Simplify Multi-QIS Alternative ETF

Quantitative investment strategies are systematic, rules-based strategies that are each designed to capture proven market return premia. The fund invests in a diversified portfolio of third-party quantitative investment strategies across equities, interest rates, credit, commodities, and currencies. By using a multi-strategy approach, Simplify seeks to identify the optimal allocation among 10 to 20 strategies to achieve positive returns and mitigate asset-class and single-strategy risks.

The five asset classes may be further divided into four types of strategies: carry, volatility, technical and liquidity (see Figure 7). Each strategy type offers a distinct return driver, which when combined, can maximize diversification benefits. QIS won't necessarily have strategies representing all 20 possible combinations, but it will typically have at least one strategy per asset class and one strategy per return driver.

Figure 7: Taxonomy of QIS Strategies



Source: Simplify

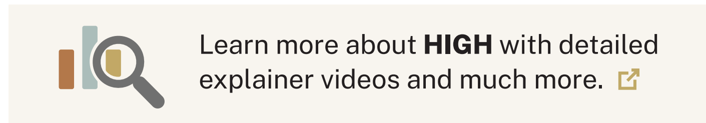
The goal of the fund is to have positive absolute returns across most market environments, making QIS a nice diversifier to CTA, and another anchor in the three fund alternative sleeve.

Learn more about **QIS** with detailed explainer videos and much more.

HIGH Simplify Enhanced Income ETF

If advisors or their clients find QIS a bit too complicated, going across so many asset classes and strategy types, a similar but significantly more straightforward product to use in the Cash-Plus sleeve is HIGH. This fund only uses a single QIS strategy in the overlay on top of T-Bills, an equity volatility algorithm. This overlay sells a diversified basket of put or call spreads on major indices with the same goals as QIS: consistent returns, low volatility, and minimized drawdown risk. Though the strategy is less diversified than QIS, its has a number of risk management procedures that help minimize drawdown, including diversification across option trades with minimal simultaneous risk, tight stop-losses to avoid even marginal

losses, and exposure reduction after losses to minimize overlay drawdowns. The main benefits of this strategy vs. QIS are that the position list shrinks from hundreds to around 10 and the source of returns is a single strategy that is easy to explain.

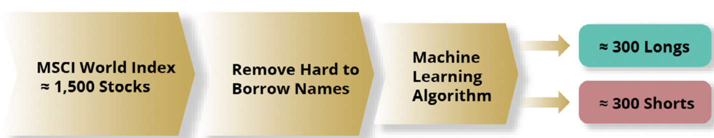


EQLS Simplify Market Neutral Equity Long/Short ETF

A market-neutral strategy is one that seeks to profit during both rising and falling equity markets. By potentially profiting in either market environment, EQLS can provide significant 60/40 diversification benefits while maintaining a return stream that is independent of traditional return premia.

The portfolio construction process begins with the approximate 1,500 stocks in the MSCI World Index. From there, hard to borrow names are removed before a machine-learning algorithm is applied. The 300 stocks with the highest expected return rankings are purchased as longs (with 200% gross exposure) while the 300 stocks with the lowest expected return rankings are shorted (with 200% gross exposure), resulting in approximately 0% net exposure to stocks. This process is outlined in Figure 8.

Figure 8: EQLS Investment Process



Source: Simplify

The machine learning algorithm is comprised of four underlying models:

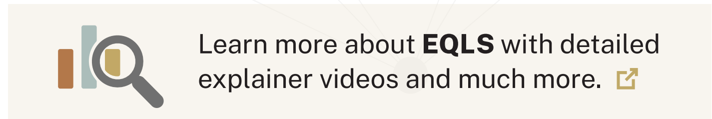
- **Short Term Model** utilizes prior month trend data
- **Medium Term Model** utilizes prior 12 months of trend data
- **Seasonal Model** utilizes trailing 10 years of trend data
- **Hedging Model** is used to support the fund's returns when the other three models are performing poorly

Finally, a dynamic risk-management process is applied to lower gross exposure during drawdowns and renew exposure when positive performance returns. Market neutral strategies have significant utility within an alternatives sleeve due to their historically low correlations with stocks and bonds, as shown in Figure 9.

Figure 9: Market Neutral Equity Correlations

MSCI World Index	Bloomberg Aggregate Bond Index
0.286	0.007

Source: Bloomberg. HFRI EH: Equity Market Neutral Index correlation versus MSCI World Index and Bloomberg Aggregate Bond Index. Data from 5/31/03 through 5/31/23. For illustrated purposes only. Past performance is not a guarantee of future results. Index performance is not representative of fund performance.



HOW MUCH SHOULD INVESTORS ALLOCATE TO ALTERNATIVES?

Now that we know what should go into our three fund alternatives sleeve, the big question is this: how much should be allocated to that sleeve?

The answer is going to depend on the investor's objective. If the goal is to build a portfolio that optimizes risk-adjusted returns, then a surprisingly large percentage of a portfolio can be allocated to alternatives (see Figure 10). For example, just looking at managed futures alone, a 40% allocation maximizes risk-adjusted returns when compared to the 60/40 portfolio.

Figure 10: Adding Managed Futures to the 60/40 Portfolio

	60% S&P 500 Price Index 40% Bond Agg	54% S&P 500 Price Index 36% Bond Agg 10% SG CTA	48% S&P 500 Price Index 32% Bond Agg 20% SG CTA	42% S&P 500 Price Index 28% Bond Agg 30% SG CTA	40% 36% S&P 500 Price Index 24% Bond Agg 40% SG CTA	30% S&P 500 Price Index 20% Bond Agg 50% SG CTA
CAGR	4.9%	5.1%	5.4%	5.6%	5.8%	5.9%
Annual Volatility	11.2%	9.7%	9.0%	8.5%	8.5%	8.8%
CAGR / Volatility	43.4%	52.8%	60.1%	65.8%	68.5%	67.7%

Sources: Simplify Asset Management, Bloomberg. The results are hypothetical (based on data from 12/31/99 - 6/30/22), are not an indicator of future results, and do not represent returns that any investor actually attained. Hypothetical strategies and indices presented are unmanaged and do not reflect management or trading fees. One cannot invest directly in an index.

However, many investors have considerations beyond mean-variance portfolio optimization. Investment professionals are often especially cognizant of tracking error. If tracking error is a concern, a 20% allocation is a reasonable allocation. As previously shown, it should improve results while at the same time keeping tracking error to a reasonable level.

HOW TO MAKE ROOM FOR ALTERNATIVES

If an investor allocates 20% to an alternatives sleeve, from where should the assets be sourced? There are many ways that investors can choose to source assets, but here are two reasonable ideas:

1. **Add the desired allocation to alternatives, invest the remaining assets in a portfolio's original proportions.** Suppose an investor starts with a 60/40 portfolio. They allocate 20% to an alternatives sleeve. The remaining 80% would be allocated in the original 60/40 proportions, resulting in an allocation of 48% equities, 32% bonds and 20% alternatives.

2. **Take the assets equally from equities and bonds.** Investors can sometimes be guilty of trying to over-optimize their portfolios. A simple alternative is to source the alternatives sleeve equally from equities and bonds. The 60/40 portfolio becomes 50/30/20. Simple and potentially effective.

CONCLUSION

While top institutional investors have enjoyed the benefits of investing in alternatives for years, financial advisors and individual investors have not had access to alternatives of the same quality. With the recent modernization of regulatory rules around derivatives and leverage, ETFs are now much closer to parity with their less liquid (and more expensive) hedge fund counterparts.

We conclude that adding a 20% allocation to a diversified sleeve of alternatives is likely to improve investment results over time in nearly every respect: higher returns, lower volatility and lower drawdowns.

REFERENCES

[1]Fidelity Investments, “Alternative Investments and Their Roles in Multi-Asset Class Portfolios”, 2023

[2]Yale Investments Office website, 2023

[3]Yale Investments Office press release, October 2022

[4]SEC.gov. Use of Derivatives by Registered Investment Companies and Business Development Companies. [Release No. IC-34084; File No. S7-24-15]

DEFINITIONS

Alpha: An investment strategy’s ability to beat the market, or its “edge.” Alpha is thus also often referred to as “excess return” or the “abnormal rate of return” in relation to a benchmark, when adjusted for risk.

Compound Annual Growth Rate (CAGR): The rate of return (RoR) that would be required for an investment to grow from its beginning balance to its ending balance, assuming the profits were reinvested at the end of each period of the investment’s life span.

Derivative: A type of financial contract whose value is dependent on an underlying asset, group of assets, or benchmark.

Leveraged Buyout (LBO): The acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition.

Maximum Drawdown: The maximum observed loss from a peak to a trough of a portfolio, before a new peak is attained. Maximum drawdown is an indicator of downside risk over a specified time period.

Option: An option is a contract that gives the buyer the right to either buy (in the case of a call option) or sell (in the case of a put option) an underlying asset at a pre-determined price (“strike”) by a specific date (“expiry”). An “outright” is another name for a single option leg. A “spread” is when options are bought at one strike and an equal amount of options are sold at a different strike, all at the same expiry.

Sharpe Ratio: The ratio compares the return of an investment with its risk. It’s a mathematical expression of the insight that excess returns over a period of time may signify more volatility and risk, rather than investing skill.

Tracking Error: The divergence between the price behavior of a position or a portfolio and the price behavior of a benchmark.

Venture Capital (VC): A form of private equity and a type of financing that investors provide to startup companies and small businesses that are believed to have long-term growth potential.

Volatility: A measure of how much and how quickly prices move over a given span of time.

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