Alternatives can elevate a good portfolio to greatness

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In a recent interview, **Som Seif**, CEO at Purpose Investments, navigated the current economic landscape marked by Federal Reserve policies and inflation. Seif underscored the necessity for a balanced approach in the bond market, taking into account both short- and long-term bonds, and keeping an eye on potential economic slowdowns. With a note of caution around the sustainability of the rally in ‘growthy’ tech stocks and cryptocurrencies, he spotlighted the importance of alternative investments as a crucial component of a well-rounded portfolio. He unveiled the Purpose Private Assets Platform, designed[1] to offer high-quality alternative investment and private market asset investment options to Canadians, and emphasized understanding both the opportunity set as well as recognizing how illiquidity structures inherent in diverse investment options should be weighted.

These issues are not unique to the banking sector; they can also occur in manufacturing or highly leveraged companies that made decisions based on interest rate projections but got caught on the wrong side of them.

AdvisorAnalyst.com: The past year has given us much to discuss, particularly in light of the recent quarter. The rapid pace of rate hikes has led to significant discussion around the Federal Reserve's actions, culminating in a banking debacle. Som, what are your thoughts on this?

Som Seif: This year has been marked by change, with a focus on inflation, Fed movements, and geopolitical risks—all of which affect investor and advisor portfolios. We've also seen a shift in market valuations and segments since the end of 2021, with rotations becoming necessary. The Fed's response to inflationary pressures and rate hikes has been the most significant development.

I recall a conversation with industry CEOs, who agreed that reaching 5% would be painful, but ultimately beneficial. I often remind my team and investors that we have just navigated that difficult path. Such a transition inevitably impacts both the economy and businesses, though the full effects of the Fed rate hikes may not be felt for about a year.

A year into these major changes, we should begin to see their consequences in the upcoming quarters. The recent issues faced by US banks, particularly regional banks, have been linked to the Fed's tightening of interest rates. While there may be some connection, I believe poor management is primarily to blame.

AA: There's been considerable debate about where the blame lies, but it seems like all parties share some responsibility, right?

Som Seif: Absolutely, it's a marriage of factors. We're looking at lax risk oversight, a lenient regulatory environment, and poor management decisions. It's crucial to question the board and management when a bank is funded by short-term funding and has such a mismatched liability scale. The changing business environment also plays a role in creating these challenges for the businesses involved.

These issues are not unique to the banking sector; they can also occur in manufacturing or highly leveraged companies that made decisions based on interest rate projections but got caught on the wrong side of them. Whether it's a gold company that did or didn't hedge against gold prices, these are management decisions that sometimes get attributed to failures related to the Federal Reserve or other external factors.

As Warren Buffett famously said, "When the tide goes out, you see who's been swimming naked."

AA: That's the perfect quote for our current times indeed.

Until the recent banking system issues, we mainly observed effects on wealth, stocks, and bonds. Now, with a 6-18 month lead time on policy rate hikes, we're witnessing the first signs of economic pressure.

What are your thoughts on the bond market and the opportunities you see, given that investors have been flocking to the short end of the yield curve?

Som Seif: The bond market has moved past the most painful part, creating an attractive environment with bond yields providing real returns relative to risk. We still have an uncertain path on where inflation will ultimately be, although, there is a consensus that inflation is softening and coming down. Whether that persists long term and we get back down to more reasonable inflation levels in the short term or if we still have some more upside on inflation risks, that's to be determined. Short duration can have benefits on that front.

The focus has shifted from inflation to the economic impact, potential slowdowns, and the possibility of a more severe recession. The bond market's current balance is questionable. While short duration trades were ideal a year ago, a more balanced perspective is needed now. Last year, we shortened our duration going into the rate hike environment; this year, we've lengthened it. Our multi-asset portfolio's average duration has increased significantly, to 5.1, suggesting a barbell approach is appropriate. If we face a more challenging economic environment with recession risks and slowing growth, bond yields may decline further.

AA: Is there a chance that investors might cling to the short end too long, given the 4-5% returns they're currently receiving?

Som Seif: While there's merit in adopting a barbell approach to the short end, given the uncertainties surrounding inflation and interest rate decisions, it's important to consider the other side of the trade. Bonds allow you to structure your portfolio for different scenarios, but focusing solely on short duration may cause you to miss opportunities based on the economic backdrop. For instance, if long-term interest rates decrease, it could have a positive impact on both short- and long-term bonds.

Additionally, entry price matters. If the 10-year bond is at 3.2% and short-term bonds are close to 5%, you should assess their relative performance. A 3.2% 10-year bond might be mispriced based on the risks. If it rises to 3.8% or 4%, a more aggressive entry position could be warranted. Trading around these perspectives and taking profits when the 10-year bond fluctuates can be a useful strategy for achieving balance.

AA: Investors and the Fed often overshoot expectations, whether it's concerns about volatility, downside, or fighting inflation. The bond market, particularly the 10-year, is sending signals that the Fed may have already gone too far. With short-term rates now offering a safe alternative, unlike when yields were at zero, investors might pay less attention to real return. However, if they stay too long in the short term, they're just treading water in terms of real rates, right?

Som Seif: That's correct. If inflation remains around 5-6%, then short-term rates result in negative real returns. However, it's not as bad as it was a few years ago when rates were much lower. I believe short-term inflation will drop below 5%, creating a positive spread. The balance between the economic impact of rate hikes and inflation is crucial.

Cash and short term rates are phenomenal today compared to three years ago when there was, effectively no reason to be sitting there. Therefore, all the money never really stayed in the cash or the side lines. It went into the markets. Today, with the amount of money that's going into deposits, of course, the regional bank issue was such a huge problem because so much money has been, going into deposits in the last year or so with rates going up. But so much money has gone from deposits to short term instruments, now, because people can see them as a good sort of sitting spot because you're getting paid at least while you sit and wait for more certainty. At some point, though, finding certainty in something and making a call is going to be a critical thing in asset mix.

AA: Recently, investors have been drawn to tech stocks and crypto, given the mixed monetary policy environment. Are lower rates benefiting high-duration tech stocks, and is this a sustainable bet? Additionally, the crypto community has been promoting decentralized finance as a solution to central bank chaos. What are your thoughts?

Some of the best asset managers and allocators globally, including large pension plans, understand the value of alternatives when used correctly. In this environment, having alternatives for greater diversification beyond bonds and equities is crucial.

Som Seif: At the end of 2021, asset prices were dislocated from their fundamental value, and 2022 was a year of adjustment. Interest rate increases impacted long-duration growth bets, with overvalued risky assets being corrected. As we entered 2023, the NASDAQ and crypto rebounded, partially due to fundamental changes in large tech companies and a shift in long-term inflation risk and Fed policy.

I do think what has happened in Q1 and a bit of Q2 here and the tech and growth space probably is a little bit ahead of itself. I do think that there's still lots of uncertainty, just like I think that the 10-year bond at 3.2 doesn't make a ton of sense. Maybe I like it at 3.8 and 3.9. At 3.2, I'm not as excited about it. I think that maybe some of these long duration tech bets have probably seen a little bit of a run and there's probably some path to give up some of that. But if you're investing for five years or longer, you may be a little bit less indifferent to that. It's a really important comment around what happened with the banking crisis.

At the end of the day, there's a part of it that's sensationalism, or the industry trying to highlight a use case that is critical, but actually, there's some practical, too. If you were a company during the few days surrounding the banking crisis when there was uncertainty, what were you going to do? You could take all your money out and go to JPMorgan. The process of opening up bank accounts is really hard, but I'm certain that some percentage of that capital would've been suggested by the board or other to put it into some form of crypto, whether it be a stable coin or some other crypto exposure.

The reality is that it is why decentralized finance is a unique proposition, because there is this constructive reduction of agency. The banking crisis or any banking crisis is ultimately a result of deep agency structures. I personally look at it and say I don't believe that's the reason why crypto is rallying. I think there's a lot of reasons and it is numerous factors, but I do think that crypto itself has to have real use cases. This is an example of a use case that is real, and and I think it would've had an impact.

AA: With the bench-clearing brawl that's taking place between market regulators and crypto intermediaries, it's interesting to see the crypto community promoting decentralized finance – as we're in the midst of central bank chaos. Regarding the way forward, we haven't seen the expected recessionary outlook, and the tilt toward quality, low-vol and value materialize meaningfully, in terms of returns. Do you think the market will turn, or are we in for more volatility?

Som Seif: The bond market is currently forecasting a recession, while the equity market seems to expect a soft landing or slowdown. The inverted yield curve impacts financial sectors and banks, causing slow lending and dampening the market. Though the bond market may indicate a near-term recession, I'm not certain I agree. Both equity and bond markets may experience continued short-term volatility, so investors should maintain a balanced approach.

Last year, value and quality performed well. This year's shift toward growth seems more like a rebound than a fundamental rotation. I believe we're still in a value and quality environment, favouring companies with good pricing power, strong balance sheets, and low leverage. If the next few years resemble the post-dotcom bubble period, cyclicals and value should do well. Companies that transition from unprofitable to profitable with strong business models may be the best performers over the next decade.

AA: Given the current policy climate, navigating the bond and equity markets is challenging. Alternatives seem underappreciated by investors. Are you seeing more interest in alternatives, and which ones would you recommend for portfolio allocations?

Som Seif: Alternatives play a crucial role in well-constructed portfolios. They include liquid alternative strategies, which hedge or participate in specific risks, and illiquid strategies like private equity, private credit, infrastructure, real estate, and real assets. A sound portfolio should contain equities, bonds, and alternatives.

However, alternatives come in various forms and may not work equally well for everyone. Some alternatives, like highly leveraged private equity or long-duration infrastructure, can be severely impacted by interest rate and inflation changes.

In Canada, investors have been burned by poorly run or fraudulent alternative businesses, like Bridging Finance, which may discourage them from considering alternatives in the future. However, high-quality alternatives are essential for a well-constructed portfolio. Some of the best asset managers and allocators globally, including large pension plans, understand the value of alternatives when used correctly. In this environment, having alternatives for greater diversification beyond bonds and equities is crucial.

AA: Alternatives play a crucial role in building a strong defensive line in a portfolio, which many portfolios currently lack. You recently launched the Purpose Private Assets Platform. Can you discuss why it matters now and the reasoning behind the decision to create this platform?

Som Seif: A well-constructed portfolio should have a balanced offense and defense, with each component contributing to its overall success. In terms of our private assets platform, we recognized that Canada needed a well-structured platform for accessing high-quality alternative managers and strategies. Canadians often find themselves investing in low-quality money managers like Bridging Finance, and we wanted to offer a better experience.

Our platform improves the purchasing and redeeming process for alternatives, offers transparency around offering memorandums, and provides access to some of the world's best managers with proven long-term track records and institutional-grade quality. Names like Apollo and Pantheon, which are trustworthy and unlikely to risk their reputation.

Partnering with Mercer for due diligence, we offer transparency around our managers and strategies.

The last thing is around education. We believe that a well-educated investor is going to understand how alternatives will fit into a portfolio, but importantly will work over time and through market cycles. What we've done is we've optimized a platform that engages all of these things from transparency, onboarding quality managers, diligence, and education, and put it into the marketplace. We can help Canadians and advisors, in the truest sense, to construct better portfolios, accessing some of the best return streams by some of the best managers in the world with a really elegant and delightful experience, and with confidence.

AA: Where can investors find more information on the Private Assets Platform?

Som Seif: So on our website at PurposeInvest.com, you can find it right on the homepage under 'platforms' and we have a full build on the three products that we did launch and also, the platform's vision and goals.

It's really critical that not only do you have a good strategy, but you also think about how it fits into the overall portfolio and the dynamics of you as an individual, and how you need to access your money at any point in time.

AA: Your company isn't the only one to launch alternatives, but what's unique about your platform?

Som Seif: What sets us apart is our comprehensive approach, bringing together education, diligence, quality of managers, transparency, reporting, and a low-friction onboarding experience. This combination is unique for Canadians, and we're proud of our achievements. We've partnered with a U.S. firm called CAIS (Capital Integration Systems, LLC), which has been providing attractive technology, infrastructure, and access for regional managers over the years, resulting in a premium platform in Canada. It's not just about the products; it's about how customers engage with them, use them, and gain confidence in them going forward.

AA: Helping advisors understand how alternatives can work in a portfolio setting and effectively communicate this to their clients is crucial. Many investors and advisors often make the mistake of viewing alternatives as standalone investments, or in a vacuum, but they're meant to be complementary holdings in a portfolio, and should be assessed in the context of a portfolio, not on a one-off basis. How do you address this issue?

Som Seif: Oftentimes, they have illiquidity structures. I think most investors—if you're not in retirement—ultimately can tolerate some illiquidity, but you can't tolerate a ton of illiquidity. You can't be sitting there in a private equity fund or a private credit fund that has a multi-year lockup and you can't get access to your money if you thought you could. So you have to really understand the product and the terms of it. We've focused on products that adopt the US' interval fund structure, which generally aims to provide 5% quarterly liquidity at the underlying fund level.

We think it's really critical that not only do you have a good strategy, but you also think about how it fits into the overall portfolio and the dynamics of you as an individual, and how you need to access your money at any point in time. We think that most people can tolerate 10%, 15%, 20% of illiquidity, in some cases even more, but not 80%.

AA: Som, thank you for being so generous with your incredibly valuable time. It's always a pleasure to catch up with you.