

Alternatives Pre-Flight Checklist

Most investors believe that uncorrelated investments are good to own because they help to diversify risk. But an uncorrelated investment doesn't help unless it's profitable as well. Many managers claim that their investments are uncorrelated and profitable. But as an educated investor, how can you verify or sense check these claims? Here's a simple four point pre-flight checklist for anyone who is contemplating an allocation to an uncorrelated asset class.

01

Intuitively uncorrelated.

When examining the correlation between investments, the reason for low correlation should be clear and intuitive. Don't just trust a historical test—it's better if there is a simple explanation for why the risks of an investment are uncorrelated. A good example of this is reinsurance, where common sense suggests that there is no relationship between natural disasters and financial markets.

02

Uncorrelated even in financial crises.

We now have two major financial crises during which we can check the correlation of investments—the Financial Crisis of 2007-08, and the COVID-19 Crisis of 2020. Since an important part of the value of uncorrelated investments is weathering the storm during crises, it's useful to check how alternative investments performed during these periods.

03

Good reason to be profitable.

It's good to understand who is setting the prices for taking on risk and why they have both the incentive and discipline to ensure profitability over time. For example, the profitability of co-investing in reinsurance contracts is driven by a small number of large reinsurers, who have priced these contracts with the goal of earning an equity-like return on capital.

04

Profitable over cycles.

Any asset that earns a return over the risk-free rate will have the risk of occasional drawdowns. If you want to get an idea of the long-run average profitability of an investment, then you need to look at profitability over a long period—ideally a period that captures more than one or two periods of stress.



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