The PODfolio Podcast Episode 20: Asset Class Mini-Series: Alt Beta

VICTORIA VODOLAZSCHI: : And in fact, the strategy is low volatility. Because volatility creates opportunities. It creates mispricings in the market that can be traded.
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SPEAKER 2: Welcome to the PODfolio, Willis Towers Watson's investment podcast series, where we'll give you an update on the latest developments across global markets and talk to expert guests on hot topics that matter to institutional investors and their portfolios.
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LOK MA: Hello, everyone. 20 episodes of the PODfolio podcast. I'm sorry, that's me applauding myself, which is, of course, very sad. Thank you. We're now at part four of our asset class mini series. So far we've looked at equities, bonds, and illiquid assets. So let's now continue on our journey with a look at some other maybe less mainstream ways for generating an investment return. And then the motivation for going further afield is, of course, to spread our investment risk exposures and reduce the chance of taking a big hit when the main markets get into trouble.
So to take us to these other places in the investment universe, we've got two of our experts in diversifying strategies joining us today. Sara Rejal, first of all. Thank you, and welcome to the show.
SARA REJAL: Thank you for having me.
LOK MA: And we also have Victoria Vodolazschi. So thank you very much for coming on.
VICTORIA VODOLAZSCHI I: Hi, Locke. It's great to be here.
LOK MA: Right, so in this episode, we're talking about using this idea of alternative beta to help us to diversify away from the mainstream market. Fancy name, I know, alternative beta. So we'll be sure to explain what we mean by that. And chances are that for our listeners, some of your investments should already fall within this category. So, Sara, let's just start with this concept of beta. Second letter of the Greek alphabet, I know. But what does beta mean in an investment context?
SARA REJAL: Yeah, beta's a widely used term in finance. It's mostly about the relationship of an asset to the overall market. So you'll say, you'll say, what's the beta of Apple to the S&P 500? I think realistically, people quite lazily just actually just mean, what's happening with the market? When they talk about beta. But yeah, it is very widely used, that term.
LOK MA: How then would you describe this idea of alternative beta?
SARA REJAL: Yeah. So alternative beta is actually trying to get away from the beta, it's almost like an anti-beta, and that it's trying to diversify and not move in step with the market. I'll come to this later, but the word anti might be a little bit misleading, you're not trying to go exactly the opposite way, but you get my drift here. We're trying to get away from market beta. So I wish I could also tell you that there's a really snappy definition of alternative beta, it didn't actually come from beta, we didn't go straight from beta to alternative beta, we had a little mini middle step, which was smart beta.
So smart beta was a way to access different parts of the market. So if you just wanted the value factor, or the quality factor, that's how you would access it. You would do smart beta strategies. Alternative beta

came as an extension to smart beta. So it was a way of going long and short, the smart betas. So you could make money if those smart betas were doing well or not doing well. So it's kind of long and short. Now today the way that we explain alternative beta products is that they are investment strategies that are well understood and widely recognized in investing. Now a bit of a wishy-washy way of explaining it, but if I get a bit more technical, these strategies are generally aiming to earn returns by exploiting market mispricings, which could arise say from behavioral effects, or you're trying to capture those risk premiums or those factors that I was talking about or both.

But anyway, maybe I haven't given the best answer, but hopefully today you'll get a better flavor when we talk about some of these strategies, because it's not a distinct or exact group,

LOK MA: And I think a good way of doing that is to go through a number of examples. Say, shall we start with what you call the risk premiums, what kind of strategies are these, and can you just give us some examples?

SARA REJAL: Yeah. And maybe what I should say is also that alternative beta is not a term that everybody uses, everyone calls these types of strategies different things. So actually risk premium funds is probably the first thing people think about when they think about alternative beta, but the way that we define it it's actually just a subsection of alternative beta. So risk premium funds, which have been popular in the past few years, they're a collection of different strategies.

As I mentioned before they tend to go long and short, certain factors. So those factors like carry or value and they do that across different asset classes, so we're not just talking about equities here, it's multiple asset classes. These products also tend to have trend following strategies, and they might have a few other strategies bucketed in too. But generally when we talk about risk premium funds as thinking about carry value and trend following. And they are quite topical at the moment, last year, 2020, they didn't perform particularly well.

So there's a lot of people questioning whether they can still survive, but we would say that's a bit short-sighted, but in any case, they've been popular in the past few years.

LOK MA: And I think you also mentioned another category of these alternative beta strategies based around behavioral effects, and maybe let's bring you into this conversation Victoria, what are these kind of behavioral effect type strategies and again can you give us some examples of those?

VICTORIA VODOLAZSCHI: Sure. So trend following is a classic one, and this strategy basically work when trends exist, and when price trends continue. And why should they continue? Because of investors herding behavior, when they basically chase winners and sell losers, which creates further momentum. There's also another strategy example called low volatility, which is based on the observation that market participants tend to like to buy safer low volatility assets, especially in times of market stress.

So this strategy would buy those assets which don't move up or down in price too much, and then, they would sell or go short, the high volatility assets.

LOK MA: But I think the idea of these strategies is, you're deliberately trying to generate a return in a way that's not correlated to the main market. So doing specific things within parts of the market in a way that the outcome is not the same as the overall thing. So how is that actually possible? Especially, you mentioned trend following strategies, if you're following a trend aren't you just basically moving in the direction of the market anyway?

VICTORIA VODOLASZSCHI : Well you're right. Alternative beta strategies are interesting to investors, because they're generally unrelated to broader macro fundamentals like stocks and bonds, and they're structured as long/short investments as Sara mentioned. So to use a trend following example, the strategy can be long, a market that is in an uptrend, say US equity market. And/or Japan or Europe or it could be any market. And sure the market that's in the downtrend, like say a bond market in the US today.

So in this example it happens to be correlated to the stock market at the time, because it happens to be trending up. But we're talking about sometimes more than 100 markets the strategists typically trade at any given time. So you get the overall outcome where you could be long dozens of markets, and you could be short thousands more. So over time you should get, I would say, a triple benefit of one, downside protection, because of the ability to short.

Two, differentiated exposure, because of the breadth of the markets, and truly uncorrelated sources of returns, because of low sensitivity to traditional markets.

LOK MA: So I think by design, with all this shorting and other techniques yield, you're not trying to get the market return, but what's the size of return that you might expect from these investments?

VICTORIA VODOLAZSCHI: So we believe that over the medium to long-term, performance can be attractive. Particularly if investors are worried about potential wobbles in traditional markets. And in fact the strategy is low volatility, because volatility creates opportunities, it creates mispricing in the market that can be traded. But these strategies also tend to be multi assets, so you're not just relying on equities. So we would say return expectations should be mid single digits, depending also on what cash rates are at the moment.

But to be clear, when equity markets are very strong, you would not expect alternative beta strategies to be outperforming equities because of the lower beta.

LOK MA: Understood. So OK. We've talked about some examples of the strategies. And I now just want to take a step back, because these ideas to me sound a little bit like hedge funds, which I know we'll be talking about in the next episode. Hopefully both of you will join me again for that discussion as well. But for now, what are the differences Sara, between what we're talking about today, alternative beta, and hedge funds?

SARA REJAL: You're absolutely correct. Look a lot of these ideas are coming from hedge funds, and it's really because when we would be looking at hedge funds and trying to figure out how they're generating their returns, we'd actually observe the, hang on, some of these strategies are what we would classify as well understood, or widely recognized. Going back to that definition that I had earlier on.

And so what we try to do is when we're looking at hedge funds, we're trying to split them out and try and extract some of the elements that we think would classify as alternative beta. Now a lot of the hedge funds may disagree with us because they're not so familiar with this definition, it's not a universal definition. But yeah, you're absolutely right. We're trying to get ideas from hedge funds.

I would say the big difference is that on alternative beta we're not relying on the unique skill of the managers, or their flair for example. But at the same time we're not dumbing down what they do, we still actually need the experience of the managers, we need their strong infrastructure. So all of that is really important. It's just that we're trying to make them justifiably more simple.

So some of the time we're taking some of their strategies, and saying, could we actually put some rules around it? Can we make it mechanistic? Some people call that. The other thing we're really trying to do here as well is trying to improve the transparency. So that's one thing that hedge funds are not particularly well known for, is being very open with how they trade.

So the way that we like to call it is we're trying to bring honesty to this industry, and we're just trying to separate out the high skill stuff that should charge high fees, and the more well understood stuff that we think should be priced lower. So the fees are a big difference between hedge funds and alternative beta, as you know hedge funds have fairly high fees, they charge a management fee and the performance fee. In alternative beta the average management fee is probably about less than half of a hedge fund, and there's no performance fee. So that's a significant difference. But I will also say, your return expectations should also be different, as Victoria was saying. For alternative beta it's a lower return expectation, but that's also understandable, right? If there's more skill and flair, or something unique that a hedge fund is doing, they should generate more returns.

LOK MA: And just maybe for a bit of gossip really. How are the hedge fund managers reacting to this idea then? That you can distill their magic into this kind of more mechanistic approach? I mean, in their eyes are you kind of disrespecting their craft in some way?

SARA REJAL: Yeah. I mean, it's an education process, let's put it that way. We're really excited, because we think this is a really interesting universe and it's an interesting way to tap into it. But it's taken time to get the hedge funds comfortable with it. Maybe a great example is that about seven years ago, we did our own research into a strategy called merger arbitrage, and that's been a very popular hedge fund strategy, where every time a merger deal is announced in the markets, hedge fund traders would get in on it and start trading around those deals in the stock markets.

Now we looked at the data and we questioned whether instead of doing all of that trading, you could just buy the deal. So when I said buy the deal you could, for example, go long the target company stock, and you could go short the acquiring company stock. But ultimately, what you're doing is you're waiting for those two stocks to converge in prices as the two companies merge.

And when we looked at the data, we thought, actually if you just held onto that deal from the day it gets announced, to when it closes, that's quite an attractive strategy. So we presented that to some of these hedge funds and a lot of them told us to get out the door, there was a lot of value in them having lots of lawyers, and lots of traders. But the reality was, that we stuck to our guns on the research, we still appreciated that all of that does add value.

But we thought, actually, there's a different way you can do this, there's a more simple way. It may not generate as high returns, but it's still really attractive. And we found actually a couple of hedge funds who agreed with us, and then we created this program with them, and made it sort of more rules based as I was saying before. And I know Victoria's got a couple of good examples that she's been working on, maybe Victoria, why don't you talk about yours?

VICTORIA VODOLAZSCHI: Sure so as you're saying Sara, it's an evolution, and I think part of any evolution is disrupting the incumbents a little bit, right? So I think-- Yeah. I'll try to give you some other examples of strategies where we essentially replicated a hedge fund skilled strategy into a more mechanical alternative beta strategy. So recently we launched a strategy, which is basically investing in initial public offerings and secondaries. So this was at a time when hedge funds were launching dedicated equity capital market strategies and charging high fees, because the equity issuance market was very, very active.

In our view it's a fairly well understood strategy, it's about getting access to the allocations, which requires some contacts and capital, obviously. But otherwise the level of skill required is fairly low, because you're essentially trying to access the market, whether it's the IPO market or the secondary market. So you're buying all the deals, right? Rather than trying to pick like 10 or 20 best deals, which would be more of an alpha type return, because there is selection skill involved.

Yes. Well let's just say a lot of hedge funds disagreed with us, because they tried to raise assets, obviously, in their new hedge fund fees-- hedge funds at higher fees. another strategy we extracted from hedge funds was index rebalancing. Most indices are relatively clear about what criteria they have to include, or exclude the particular stock, typically as a result of an M&A deal, a spinoff or other corporate action. It will also tell you how often they apply this criteria. But what they don't tell you is exactly when and how they make those changes.

So a classic hedge fund strategy was to predict which stocks are added to the index, and which would fall out. And hedge fund managers would trade around those events. So again, we consider this a fairly well understood strategy and we essentially lifted it out as an alternative beta strategy. So [INAUDIBLE].

SARA REJAL: Yeah. Those are great examples. And I would say, look back to your original question. I think the biggest fear for a hedge fund is being exposed, is that if there's a more simple version of what they do and it performs better, then their investors are going to move from the more expensive product to the cheaper product, and that's not good for their revenues. So that's the cannibalizing of the business that they worry about.

So we spend a lot of time trying to give them comfort, and a big part of the way we do that is showing them that there's a different type of client that you can attract to these products. There are some clients that just cannot invest in hedge funds. It might be because it's not liquid enough or because they are not allowed to pay performance fees, or they might be just a particular reason they're never going to invest in a hedge fund. But they would in their alternative beta product.

So that's one way we're trying to give them comfort. But ultimately, if their magic is justified, then the investors are going to stay in the high fee product.

LOK MA: Yeah. And of course these alternative beta investments designed to sit alongside your main beta investments. So how big an allocation to these alternative sources of return do you think is sensible next to the more mainstream stuff?

VICTORIA VODOLAZSCHI: So the reason you would invest in alternative beta is if you want to diversify away from your traditional equity and bond allocations, but particularly in strategies that are liquid, that are transparent and cheaper relative to the hedge funds. Their size really depends on what else you have in your portfolio, your risk appetite, your return objectives. If you can't or don't want, for example, a lot of liquid investments, say like private equity, then you'd probably want to do more in alternative beta.

If you already have a fully multi-asset portfolio with the whole spectrum of strategies and liquidities, maybe 15% to 20% allocation in alternative beta makes sense, but it really depends on each investor specific needs.

LOK MA: And that's a useful step Victoria. I think sometimes I come across portfolios where a lot less than 20% of your returns seeking portfolio in these alternatives, and it just makes me wonder if that's enough to be doing the job of diversifying the portfolio, if you haven't got enough of these diversifying assets. So as a way of wrapping up, this is something that I've been asking all of our various expert guests, because I think it's really important.

How much does an institutional investor-- So we're not talking about an asset manager we're talking about an institutional investor. How much do you need to understand about these potentially highly technical strategies before you have the confidence to invest in them?

SARA REJAL: Yeah. That's a good question. I think let's first touch on the making sure that the allocator, the investor understands the why. Why are they actually investing in the first place? So we think it's a very robust tool for your portfolio, to diversify away from equities and bonds, and their liquid as well. So that's the way bit, it's the simple strategies, the liquid there's value for money, they're cheaper than hedge funds, for example.

The why can actually be different, sometimes the why is that investors are thinking about hedge funds, they're not quite comfortable with hedge funds and they use this as a stepping stone. But the why is actually I think, very important. And then the expectations are really important here. We've talked about them diversifying and protecting, but they're not necessarily negatively correlated.

You'll remember right at the beginning, I said, I shouldn't use the word anti, they're not anti equity markets, but they will protect. They're just not going to fall as much as equity markets, they can be up when equity markets are down, so they're still very valuable to have in your portfolio, and they can smooth out return profiles as well. And then on the expectations, just carrying on with that, you've got to be sensible about the returns as well, don't expect double digit returns every day.

I think Victoria laid it out nicely earlier as more like mid single digits. The really important final bit about this is that you really shouldn't just settle for one or two strategies, that's I think one of the mistakes that a lot of investors have made, is that they bought that one risk premier fund, and I mentioned earlier that risk premium funds didn't do very well in 2020, and so now everyone's what, giving up?

Well we think that's the wrong way to do it, is that you've got to have a robust portfolio and you need to have to different return drivers, and you need to have a wide range of different strategies. So we think you just need to do that in the most efficient implementation. So going back in terms of how do you understand these technical strategies, especially when you got a portfolio of lots of them. I would say the best way is to partner with someone who you trust, who knows these strategies very well, who has got experience in running them, and who can explain them to you in a way that you're going to understand as well.

So Yeah. If we genuinely really like these strategies, we think they're really valuable in portfolios and we're really excited by a couple of new projects we're doing as well to expand that universe.

LOK MA: Right. So thank you very much, both for telling us all about alternative beta investment strategies, I really appreciate your time Sara.

SARA REJAL: Thank you so much.

LOK MA: And also thanks for coming on the show Victoria.

VICTORIA VODOLAZSCHI: Thank you for having me.

LOK MA: So I think the plan is for you both to come back for our next episode to talk about hedge funds, and for those tuning in, we hope you enjoyed our discussion, and do please join us for the next one. In the meantime, do take care.

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