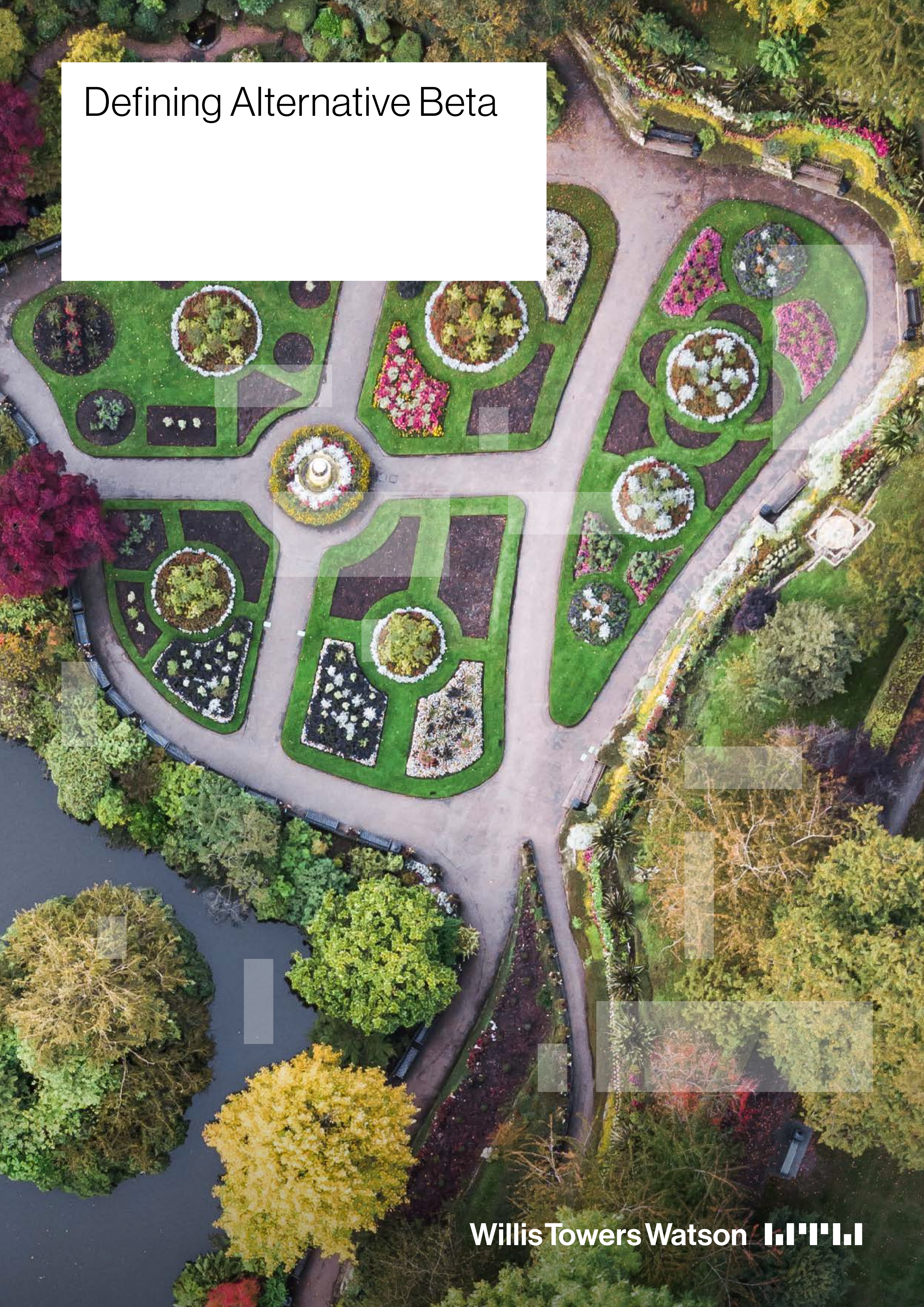
Defining Alternative Beta



Willis Towers Watson

Well-known investment strategies that exploit mispricing in securities markets

The investment industry loves jargon. Rather than communicating ideas in a succinct manner, jargon is instead used to create a roadblock to understanding, often to disguise the value or uniqueness (or lack thereof) of a strategy. Unfortunately, the "Alternative Beta" space is particularly rife. And somewhat perversely, we believe the increasing acceptance of alternative beta investment strategies is leading to a worsening of the situation.

A clear and concise definition of Alternative Beta is required, put simply we define Alternative Beta as: **Products that invest in well-understood, diversifying long/short investment strategies that seek to exploit behavioural effects and risk premiums.**

These products (or funds) will have low exposure to traditional markets by the long/short nature of the implementation of the underlying strategies. As such we believe these products are, in general, excellent diversifiers to existing market exposures in a portfolio.

The products contain investment strategies that are well understood and widely recognised by investment professionals. These strategies aim to earn returns by exploiting market mispricings arising from behavioural effects, capturing risk premiums, or both.

Examples of widely recognised investment strategies

Over time investment strategies migrate from being known by a few investment professionals to being widely understood and used. As this happens a product containing these strategies becomes an Alternative Beta product.

Figure 1 shows a number of investment strategies that we believe are widely recognised in the investment industry and thus there is scope for alternative beta products to capture them; of course for the majority that is already the case.

Figure 1. **Examples of widely recognised investment strategies**

Investment strategy	Underlying concept	Simple version
Carry (cross-asset)	Capture yield difference without market risk	Buy relatively high yielding assets and sell relatively low yielding assets
Convertible Bond Arbitrage	The effective option embedded in a convertible bond is not always correctly priced	Buy convertible bond and hedge with bond/option components if the convertible bond trades at a premium to those components, or vice versa
Curve Carry	Capture roll yield without asset price risk	Buy high yield future and sell low yield future in each asset
Directional Carry	Assets with positive (negative) carry are expected to increase (decrease) in price	Buy assets with positive carry and sell assets with negative carry
Index Arbitrage	Capital flows due to index tracking move underlying asset prices	Buy assets that will be included in the index after rebalance and sell existing index constituents
Low Volatility	Investors prefer volatile assets resulting in an asset mis-pricing	Buy assets with low volatility and sell assets with high volatility
Merger Arbitrage	Insufficient capital willing to be exposed to the losses in the event of deal failure results in an expected positive risk-adjusted return spread between asset prices and deal terms	Buy companies being acquired and sell the acquiring companies
Momentum	Asset prices that have risen (fallen) in the past relative to peers are more likely continue rising (falling) relative to peers	Buy assets with relatively strong past performance and sell assets with relatively weak past performance
Quality	Investors underappreciate the return persistence of high quality assets	Buy high quality assets and sell low quality assets
Statistical Arbitrage	Asset prices exhibit mean-reversion in the short-term	Sell assets that have appreciated in recent days and vice versa
Trend-following	Asset prices that have risen in the past are more likely to rise in the future, and vice versa	Buy assets with positive past performance and sell assets with negative past performance
Value	Asset prices deviate from long-term fair value in the short to medium-term	Buy assets priced at below fair-value and sell assets priced above fair-value
Volatility Arbitrage	Investor demand and supply for options results in volatility (and other higher distribution moments) being mispriced in various assets	Buy asset where volatility (or correlation etc) is undervalued and sell asset where it is overvalued, or use other asset to hedge volatility (or correlation etc) exposures.
Volatility Selling	Investors overpay for exposure to assets via options	Sell options and hedge market exposure

The list of strategies in *Figure 1* is not exhaustive. Even so, we expect not everyone will agree these are all strategies that belong in alternative beta products. While we seek, and have offered, a clear and concise definition, we are just one participant in a fragmented market littered with jargon.

Some asset managers will argue that strategies in *Figure 1* require the unique insight of a skilled investor to make discretionary judgments about the implementation of the strategy or that insight is required to build a better more sophisticated quantitative strategy to safely implement the strategy.

We do not disagree with the point that it is possible to improve on a generic version of a strategy. We merely ask to be shown the evidence that this additional input from an asset manager is both insightful (adds value sustainably), unique (not available elsewhere) and represents good value for money for an investor after all costs and expenses. Often, we find that the benefit of "active management" that asset managers advocate (for example on-going rebalancing or managing a portfolio's risk exposures over time) would be better described as executing the investment strategy in a sensible manner addressing the issues that arise in the real world. We agree that these features are important, but as any credible asset manager undertakes them anyway, we do not consider them unique insights, frankly these features are what we expect an asset manager to be doing.

Strategies migrate to alternative beta

We believe it is irrefutable that the list of alternative beta strategies is longer than most market participants believe, furthermore we expect this list to keep growing as investment strategies that today are used by only a few asset managers will be adopted by more asset managers over time; and that as more asset managers begin using the strategy it stops being a unique investment insight and becomes an alternative beta.

We believe the following features of the investment ecosystem are likely to be key causes of this evolution:

1. **Learning new strategies** – Investors are always looking for new strategies to exploit inefficiencies in prices. With a finite amount of data to use we expect investors to independently identify similar strategies, albeit at different rates, over time.
2. **Investors moving organisations** – As investors move between organisations or start new organisations the knowledge of those investors spreads through the market.
3. **Capital movement** – As investment strategies are successful or not capital is reallocated between funds. As this happens funds that use a certain strategy (deemed unlikely to work in the future by allocators) will shut down while others will grow. This growth will encourage funds using similar strategies to be launched.

We feel this activity will result in strategies that were unique to become commonplace throughout the investment industry and as more investors use a strategy, or knowledge/understanding of it spreads to market participants, we believe these strategies stop being the unique insights of a few asset managers and therefore is no longer an alpha strategy.

This continual evolution of strategies moving from being rare to widely-known is a process we expect will continue in the future and result in an increasing number of strategies being added to *Figure 1* as they become Alternative Betas.

Further information

For more information, please contact your usual Willis Towers Watson consultant.

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