INVESTMENT INSIGHTS

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Alternative Beta: A strategy that hits the portfolio sweet spot

Institutional investors are increasingly concerned that they are paying for alpha but receiving beta. One strategy that can offer diversification and exposure to alternative strategies without the cost of supposed alpha is alternative beta. Alternative beta strategies aim to provide investors with absolute returns with low correlation to traditional markets.

"What we've done is to clearly separate alpha, beta and alternative beta," said Philippe Jordan, president of CFM (Capital Fund Management) International, the global quantitative asset management firm that has pioneered alternative beta strategies.

According to Jordan, alpha — or the return above the market — is transient, capacity constrained and the result of intensive research. Traditional beta is systematic exposure on the long-only side to a diversified portfolio of equities that are constituents of an index

And then there is alternative beta. Unlike beta and so-called smart beta, alternative beta encompasses multiple asset classes and strategies well beyond long-only equities. These strategies are well researched and understood and, over the years, have formed the core of many hedge funds. They combine equities and other asset classes in strategies "in a manner that has low correlation to benchmarks, or beta, because of the construction of the portfolio that's equity-market neutral," Jordan said.

Additionally, alternative beta strategies don't have the same capacity constraints as alpha strategies. And unlike the fleeting returns of alpha strategies, alternative beta returns tend to be more persistent and last through time. Expected returns stem from both risk premia and market anomalies.

DO YOU KNOW WHAT YOU ARE PAYING FOR?

Jordan's classification of these strategies ultimately is quantitative. For him, alpha strategies are those that produce, net of fees, a Sharpe ratio greater than one and with no or low correlation to the benchmark. Alternative beta strategies produce a Sharpe ratio between 0.5-0.7, with only approximately 30% correlation to benchmarks. Beta, on the other hand, has a Sharpe ratio of about 0.3-0.4.

These distinctions should be extremely important to institutional investors, who should be seeking to pay the appropriate price for the value they receive. Hedge fund strategies — those that deliver pure alpha — cost "2 and 20" (2% of assets under management and 20% of returns). Alternative beta is appropriately priced, while providing attractive Sharpe ratios and diversification. Beta is cheaper still, with fees under 10 basis points.

However, many hedge funds have historically provided either alternative beta or worse but charged for alpha. "Unfortunately," Jordan said, "some hedge funds have historically exposed investors to the worst of both worlds, which has led to a result that has been disappointing in aggregate."

If some hedge funds have offered the worst of both worlds, alternative beta strategies could provide the best of both worlds: diversification and exposure to alternatives at a reasonable price point.

> "Alternative beta offers a price point that's appropriate and it resonates with investors."

Investors increasingly view their portfolio as made up of exposures to factors and strategies. As such, alternative beta can be used in portfolio construction as replacement strategies for premium-fee hedge funds that haven't delivered, as a completion component to an existing factor portfolio, "and as a diversifying strategy for traditional large exposures to equity and fixed income markets" Jordan said.

In all these cases, "investors should be looking for strategies that are truly persistent, that are well constructed, by firms that know how to control costs, which is a big part of being able to deliver this."

That's all well and good, but given all the headwinds facing financial markets today, investors could be forgiven for wondering whether now is the right time to add an alternative beta strategy to an existing asset allocation.

"We are not in the market-timing business," Jordan said. "You need to define an amount of risk that you want to allocate to alternative beta and then you should own it." That is, alternative beta should be a strategic rather than a tactical allocation. It is designed to be held for the long term.

Alternative beta is not meant to be an instantaneous hedge against risk; rather a long-term protection through diversification. "Alternative beta is a portfolio tool that will diversify your returns in a bear market," Jordan said.

GETTING COMFORTABLE

It took investors 50 years or so to become comfortable with beta and implement it widely. Alternative beta is following that trajectory but at an accelerated pace.

Alternative beta is now being demystified and asset managers "are innovating to respond to investor needs," Jordan said. Investors understand the portfolio proposition of alternative beta, which includes low correlations and higher Sharpe ratios compared with beta strategies, and without the capacity constraints and transience of alpha strategies.

Indeed, "what resonates is diversification and transparency," Jordan said.

And finally, there are the fees.

"I think we're moving into era where people are going to be able to price appropriately what they are paying for," Jordan said. And by this metric, alternative beta strategies hit investors' sweet spot. For a third of hedge fund fees, these strategies can offer Sharpe ratios of 0.5-0.7 or above and diversification away from traditional asset classes such as equities or fixed income.

Investors are taking notice. "Alternative beta offers a price point that's appropriate and it resonates with investors," Jordan said. ■

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