ALTERNATIVE BETA STRATEGIES: THE ONLY FREE LUNCH IN FINANCE

Anastasia Santoreneos writes that investors seeking diversification should take hold of what's been coined the only free lunch in finance: alternative beta strategies.

BOTH ALTERNATIVE INVESTMENTS and strategies are vehicles for investors to improve portfolio construction by diversifying their portfolios, and they've been coined "the only free lunch in finance" for their benefits.

A SNAPSHOT OF ALTERNATIVES

Data from FE Analytics showed for the 12 months to 12 April, the alternatives sector average was 0.19 per cent, with the top fund being Macquarie's P/E Global FX Alpha, followed by Regal Australian Small Companies with 23.05 per cent and Enlihtan Global Opportunity with 21.83 per cent.

Looking a little more longer-term, the sector average was 6.29 per cent for the 10 years to 12 April, 4.46 per cent for the five years to 12 April and 3.12 per cent for the three years to 12 April.

It's difficult to derive the performance of alternatives from a few figures though. Given they should be held for a full market cycle, and we're sitting in the longest bull-market on record, alternatives have continued to outperform and underperform at certain times.

Philippe Jordan, president of Capital Funds Management (CFM) said CFM used an extensive scientific, research-based approach to identifying and implementing strategies that have proven to be robust, sustainable and scalable.

"Financial markets are constantly evolving and have a degree of predictability that we continue to explore through data. This creates a strong environment to create alternative strategies which provide risk-adjusted returns with a low correlation to traditional investment market benchmarks."

ALTERNATIVE BETA STRATEGIES

Alternative beta strategies are, according to Jordan, strategies that aim to offer absolute returns that are de-correlated from traditional equity and bond benchmarks.

These strategies, Jordan said, have historically been associated with hedge funds, which, 20 years ago, were the ultimate generators of alpha, but they're not simply hedge fund index replicators.

"Part of what makes alternative beta strategies attractive is that historically, just as hedge fund returns were frequently de-correlated from equity and bond benchmarks, so too returns generated through exposure to alternative risk premia have also exhibited little performance correlation to one another, or to traditional investments in global stock and bond markets," he said.

"This is important, because we know that combining non-correlated alternative strategies into a single portfolio helps diversify risk and generate more consistent returns over time."

So, ultimately, alternative beta strategies depend heavily on managers' understanding of strategies driving hedge fund returns.

While they sound complex and therefore expensive, Jordan said one of the reasons alternative beta strategies were gaining momentum was due to their transparency and low cost when compared to traditional alternative investments.

They sit somewhere between actively managed hedge funds that deliver pure alpha and traditional long-only beta products like index funds, so their cost, naturally, sits in the middle of the scale.

SEEKING DIVERSIFICATION? SEEK ALTERNATIVE BETA

Historically, alternatives have been used more frequently by institutional investors, simply because they're not well-known or understood, but they're being increasingly sought after by financial advisers and their clients given their diversification benefits as well as their liquidity, transparency and lower cost.

Jordan said any investor nowadays looking for diversification could opt for alternative beta strategies, which are specifically designed to add diversification to portfolios, regardless of whether the portfolio is held by retail or institutional investors.

And, not many people wouldn't be looking for diversification, given it helps manage downside risk, which subsequently improves portfolio returns over the long term. And this "long-term" aspect was driven home by Jordan, who said alternative beta strategies should ideally be held for a full economic cycle.

"Like any investment product they can underperform and outperform at certain time periods, so attempting to time them, by moving in and out frequently, is not ideal," he said.

Key to diversifying, according to Jordan, is reducing the correlation between the returns from different asset classes in a portfolio, and being mindful that correlations aren't static, particularly during corrections or crises.

"Assuming that historic correlations between asset classes will hold true in all market conditions is a risky assumption – and can have disastrous effects in serious market downturns," he said. "For example, historically investors have turned to fixed interest to diversify away from equity risk, but when the global financial crisis hit, equities and fixed income began to move together in lockstep, exacerbating portfolio losses at the worst possible time."

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Chart 1: Performance of the ACS – Alternatives Sector across the 10 years to 12 April.

Source: FE Analytics