Back to the Future

'The risks of overdoing it seem, for now, to be smaller.' Jerome Powell

'The smartest thing we can do is act big.' Janet Yellen

'This is heavy.' Marty McFly – Back to the Future

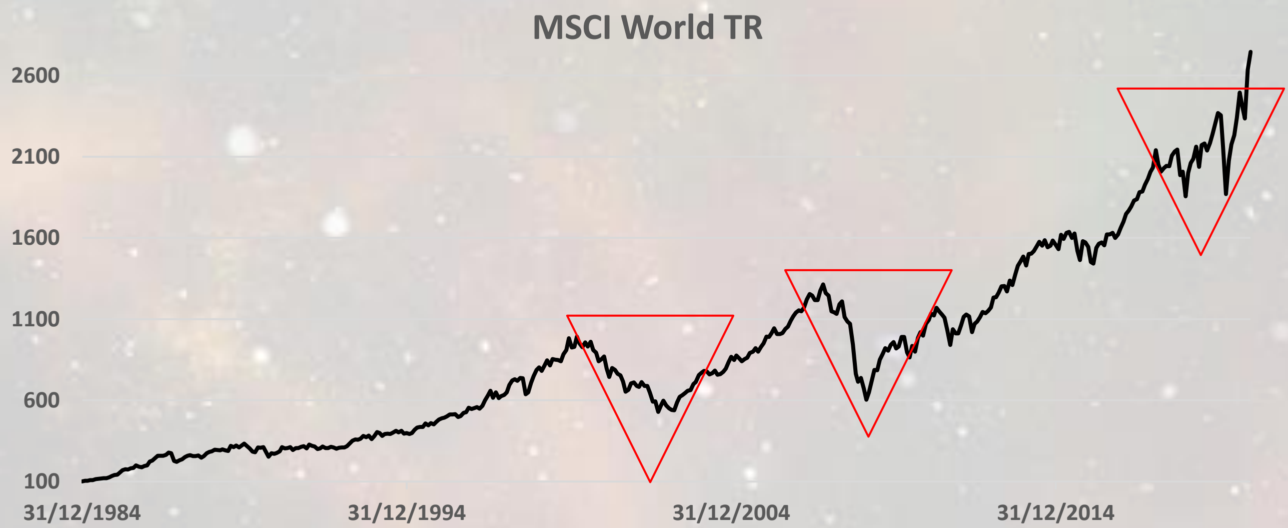
'I guess you guys aren't ready for that yet, but your kids are gonna love it.' Marty McFly – Back to the Future

Alternative Beta, Risk Premia, Factor Investing are nomenclature that have been gaining in prominence in the financial media for a number of years, and have also been growing in popularity amongst institutional investors. They are once again coming to the fore and gaining traction within the industry; as they should be.

What is Alternative Beta/Risk Premia/Factor Investing?

Beta or factor investing has always underpinned the investment management industry. A factor or type of beta are simply ways of referencing a specific driver of risk and return. Historically, portfolios have been anchored in a single factor; the growth factor or what has come to be known as beta.

The most obvious manifestation of the growth factor is with regards to companies that extract growth from the economy and return it to shareholders in the form of dividends and capital appreciation of the share price. The fundamental pillar around which the investment management industry is based is the notion that if one is long equity for long enough, then positive returns should be made to some degree or other. This leads to the typical portfolio having 60% allocated to equity or the growth factor. This factor has been both persistent and rewarding over time:



31.12.1984 – 31/12.2020
Source: Bloomberg, Fortem Capital

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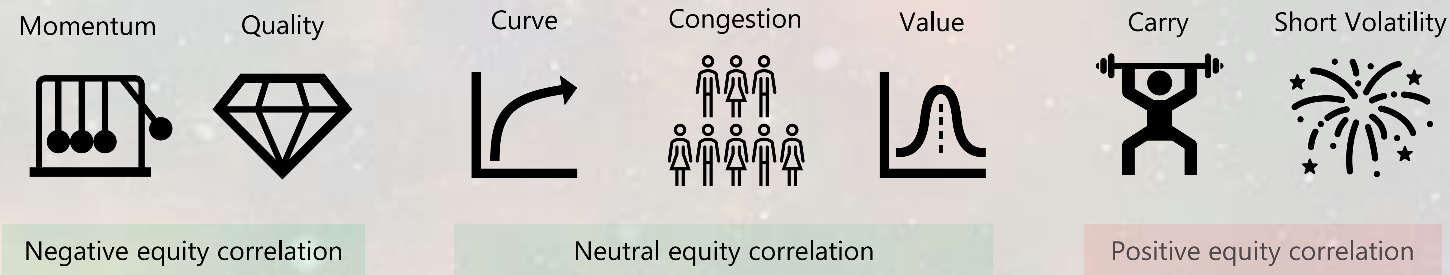
However, in addition to the growth factor's undeniably attractive trait of persistent positive returns over time, it does have some less desirable attributes. Firstly, it is a volatile factor in isolation; an annualised volatility of 20% over that period is too rich for the vast majority of investors. Secondly, its returns are negatively skewed; it tends to crash, and those crashes tend to be short, sharp and very painful, whereas its recoveries tend to be more gradual and measured relatively speaking. This leads to decision risk for investors; many would have decided enough was enough and crystallised huge losses in 2008 and 2020 if invested purely in equity. And an unfortunate trait of human nature is that those same investors would likely finally succumb to re-entering the market at much higher levels - nobody likes seeing their neighbour getting rich while they are not.

Therefore, an element of diversification is required away from the growth factor in portfolios – the 40 of the 60/40. Historically the bond market has been the go to tool in order to achieve this. However, in a post QE / Modern Monetary Theory World bonds no longer function as a diversifier to the growth factor in portfolios; this is an objective truth.

NB This does not necessarily mean that bonds are going down, up or sideways over the next 1/3/5 years, just that they no longer diversify exposure to the growth factor in portfolios.

This has left the industry desperately searching for ways to meaningfully diversify its exposure to equity beta / the growth factor. There are alternative sources of beta and other factors that share that same persistence as the growth factor, but that are also completely uncorrelated to it, or indeed to each other, leading to portfolios with lower overall volatility and higher Sharpe Ratios. There are also a number of these other factors that have positively skewed returns, so whereas equity beta tends to crash downwards, they crash upwards, an incredibly useful characteristic when looking to insulate portfolios to some degree from the worst of equity market downturns.

What are these other factors or alternative betas?



If one is looking to alternative sources of beta to diversify exposure to equity market beta or the growth factor, then two clearly stick out as inappropriate from the above. They happen to be two of the most popular factors within the space. If one is short volatility, or betting that implied volatility will be lower than realised volatility, it can be thought of as being short the VIX index, also known as the 'fear gauge'. To be short fear is to be long confidence, and that is of course going to be correlated to equity market returns. The classic carry trade of borrowing in DM currency in order to invest in EM currency for a yield pick up will perform particularly well in an environment in which the EM currency appreciates against the DM currency, likely concurrent with strong global growth and a supportive environment for equity beta and the growth factor.

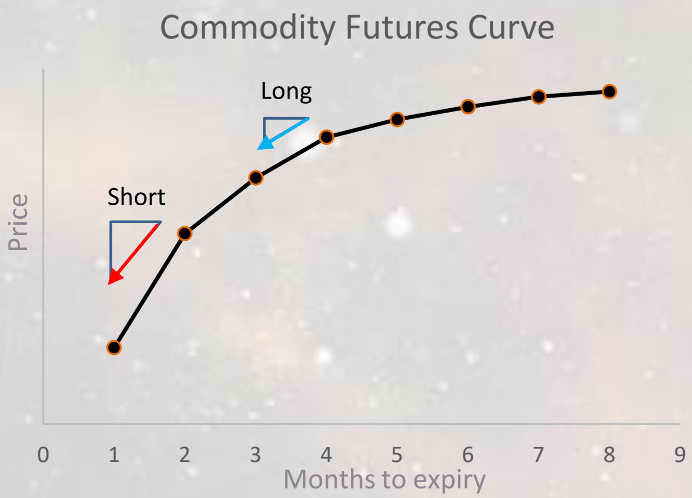
It would therefore make sense that any strategy that looks to diversify away from the growth factor or equity market beta in portfolios, should not be heavily exposed to factors that are correlated to it. However, due to the rewards that have historically been available in short vol and carry strategies, they are two of the most popular within the alternative beta fund space. This is likely fine if the objective is purely to produce positive returns, but is definitely not if it is to diversify. Screening those strategies from the core of any strategy should ensure that the strategy is statistically uncorrelated to the growth factor.

It can be taken further

In addition to there being a number of alternative sources of beta or factors, available across most asset classes, which share in the growth factor's persistence, while being completely uncorrelated to it, there is another layer that can be added to increase confidence in a strategy's persistence of return. If the very reason that a persistent return exists is due to the fundamental make-up of a market, rather than any macroeconomic influence over it, then one can reasonably draw a conclusion over that return continuing into the future while any structural anomaly exists. These structural returns arise as a result of an idiosyncratic risk that is independent of traditional macroeconomics, and therefore independent of the risks driving the rest of a multi-asset portfolio, as well as independent of each other. Examples of these types of risk can be seen below.

Curve | Weather | Seasonality | Taxation | Rebalancing | Congestion

Commodity Curve



Commodities are accessed through futures. The shape of the futures curve tends to be upward sloping as a reflection of the cost of owning physical commodities, mainly storage. The further out on the curve one goes, the more cost is being transferred onto somebody else; a cost that must be paid. Like most rents, short term rent is more expensive, so the curve is concave. Since there are contracts with higher rent to be paid than others, an investor can short the contract on which the most rent must be paid, and go long that with the lowest risk-adjusted rent and make the difference while being insulated from parallel shifts in the curve i.e. not taking a view on the commodity itself. This return is structural and uncorrelated, occurring only as a result of the physical make-up of the market.

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Equity Congestion

Congestion strategies take advantage of price pressures driven by passive market participants. In equity markets, equity indices rebalance periodically and some companies drop out of the index while others are added. This is all telegraphed and so strategies can be constructed that short those companies leaving the index, while going long new entrants ahead of ETF and tracker funds' forced rebalances. This source of return is driven by the structural make-up of the equity market and has little to do with the general direction of travel for the asset class; it is uncorrelated.

These types of strategies are by no means riskless, but their risk drivers are idiosyncratic; separate and different to the risk drivers of the 60 & the 40 of the traditional multi-asset portfolio (the 60 & the 40 which now have the same overarching risk driver in the Fed), meaning that they can provide uncorrelated returns and therefore genuine diversification.

Does it work?

Yes. The Fortem Capital Alternative Growth Fund is composed of a number of strategies investing in alternative sources of beta or factors to the growth factor. The Fund is designed to produce positive returns, with low volatility, and most crucially with negligible correlation to the growth factor that dominates investment portfolios. The Fund launched into the most remarkable market on record, but it launched into a raging liquidity driven bull market, only with a huge bout of volatility in the middle:

10.05.2019 – 22.01.2021
Source: Bloomberg, Fortem Capital

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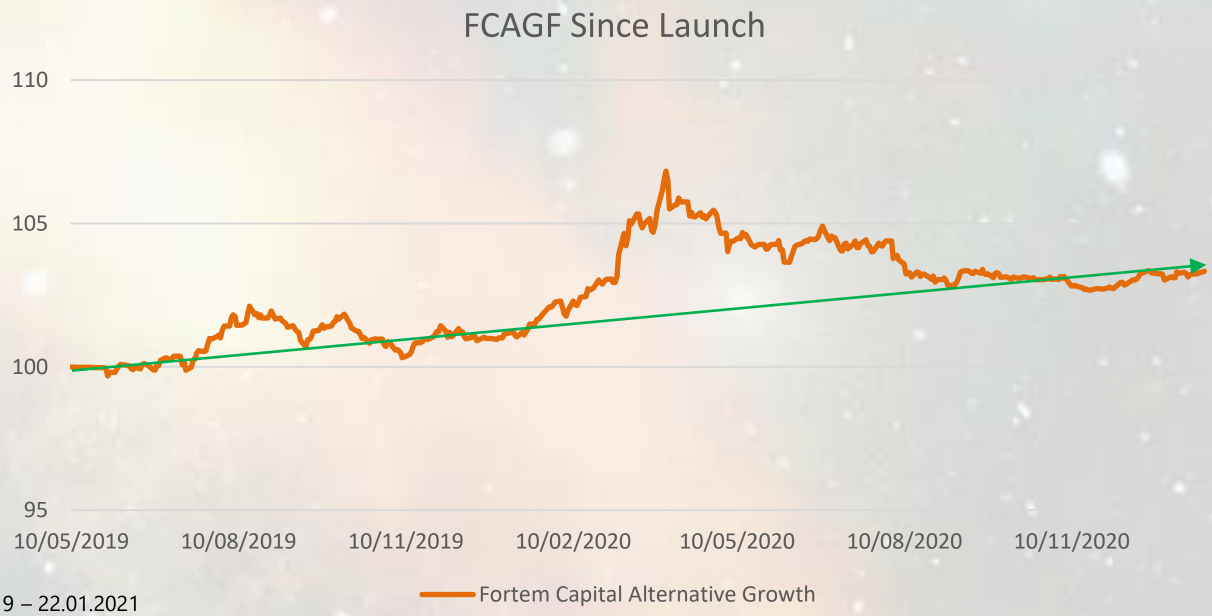
And in that environment, how might one hope an alternative might perform?

Ideally it should produce positive returns, with low volatility, in a completely uncorrelated fashion. If one were being greedy, possibly with some positive skew so that it crashes upwards at the same time that the growth factor in portfolios crashes downwards:



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You never change things by fighting the existing reality. To change something, build a new model that makes the existing model obsolete. – Buckminster Fuller

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