Diversifying alpha with alternative beta

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Finding alternative sources of returns that are uncorrelated to equity and bond markets is a key objective for institutional investors seeking to construct robust portfolios of investments. The growth of investments in hedge funds is a reflection of this. Their attractiveness lies in their ability to harness returns from alternative sources of risk premia that traditional managers have not been able to offer and this has justified a higher fee structure. But are institutional investors really receiving value for money? Idiosyncratic sources of risks and returns such as bets on mergers and acquisitions or arbitraging a specific convertible against a company's equity and bonds require specific expertise that can justify the hedge fund fees. But other sources of hedge fund returns are systematic and accessible via approaches that are best regarded as tapping alternative sources of beta. Investors should not be asked to pay extra for gaining systematic access to sources of risk premia that are not true "alpha".

Investment in the traditional assets classes of equities, bonds and property is a way of gaining systematic access to different types of risk premia, each of which produces an associated return. Equities have a well-known equity risk premium, which also includes outperformance arising from the small cap and value risk premia that have been well documented in the academic literature; bonds have an interest rate risk premium arising from the term of the bond in a normally upward sloping yield curve, together with credit/default risk premia for lower rated sovereign, corporate and securitised bonds; real estate, whether direct or through REITs, has risks associated with factors such as natural hazards, economic dislocations etc; and in all asset classes, there is an illiquidity risk premium relative to liquid government bond markets.

Metzler Asset Management's experience has shown that outside traditional equity and bond investments there are additional attractive sources of systematic risk premia that investors should consider accessing that are distinct from idiosyncratic risks. For example, "carry", momentum and volatility are sources of alternative risk premia that are systematically captured in Metzler's Systematic Diversified Alpha (SDA) strategy. Each is harvested using a number of different strategies, with the SDA strategy as a whole having exposure to 15 or more separate systematic trading strategies using liquid markets that capture risk premia in different ways.

The simplest of Metzler's choice of investable alternative risk premia to understand is the one associated with carry trades, which rely on borrowing at a low rate and lending at a higher rate. This can be undertaken both in a single currency through borrowing for short terms and investing for longer terms, as well as through the popular cross-currency trades, borrowing in low interest currencies and investing in higher interest currencies. The risk in the latter, of course, is a sudden currency depreciation, while in the former, it is changes in the yield curve. However, over the long term, a diversified portfolio of carry strategies can produce a sustainable return.

Momentum is a popular hedge fund strategy that relies on the fact that the behaviour of market participants does not follow the rational-expectations approach beloved of economic theory. Behavioural factors, such as investors following trends, can often override fundamentals until the gap becomes unsustainable. Metzler combines a number of such models with option replication models that mimic straddles, i.e. the simultaneous purchase of calls and puts such that the positions benefit when the underlying markets are trending either up or down. By diversifying across a range of momentum strategies, downside risk is controlled.

Volatility is a risk factor that can provide a systematic return because, like insurance, one class of investors is prepared to pay a price to reduce the volatility in specific asset classes. By selling options and hedging the option deltas via futures contracts, Metzler systematically captures the volatility premium in equity, fixed income and foreign exchange markets. Volatility harvesting strategies earn stable premiums during normal times but in a crisis with fast moving markets, such positions can be loss making. Investors are compensated for this by the fact that over the long term, like an insurance company's business model, the positions will be profitable if systematically applied. On the portfolio level, volatility and momentum strategies ideally complement each other due to their different behaviour in specific market environments.

It is perhaps not surprising that, given Metzler's German heritage, the SDA strategy uses a precisely engineered approach to simultaneously combine the three alternative systematic risk premia harvesting strategies without relying on opportunistic re-balancing. Moreover, the low correlation of the strategies to each other leads to a high degree of diversification.

For example, trend-following models capitalise on market phases with pronounced trends, while, conversely, certain option strategies benefit from markets with no trends. The diverse collection of models systematically trade bond, equity and foreign exchange derivative contracts to produce returns that are independent of market returns. Combining a number of such models results in more stable returns for the SDA strategy as a whole. The SDA strategy can also be adapted to individual investor requirements. An important characteristic of the returns generated by SDA is scalability; the investor is able to choose the target volatility and hence the risk of the strategy. The SDA strategy can also be tailored to reflect the risk profile in an institutional portfolio as a whole, thereby maximising the diversification benefits obtained from exposure to the three alternative risk premia. In the absence of any preference, Metzler would equally weight exposures to the three risk premia – but these can be adjusted to reflect the risk characteristics of the rest of the portfolio.

There is much academic literature surrounding the persistence of these three sources of alternative risk premia. They are different to conventional risk premia associated with equities, bonds and real estate in that they require more than a buy-and-hold strategy to capture them. However, as they can be captured by purely systematic approaches, they are more akin to alternative sources of market returns rather than skill-based outperformance of market returns. But as the returns have low correlations to traditional risk premia, they can be regarded as a source of diversified alpha. The Metzler SDA strategy gives access to risk premia that have traditionally been the preserve of hedge funds, but using systematic approaches that we see as akin to harvesting market returns. Some would refer to this as alternative beta; we prefer to call it diversified alpha. For institutional investors the nomenclature may not be important, but rather the ability to gain exposure to alternative risk premia at standard rather than hedge fund fee levels.