The greatest innovation of the 21st century?

Pensions Age speaks to CFM's Philippe Jordan about alternative beta and how pension funds can incorporate it into their portfolios

The greatest innovation in asset management of the 20th century? Systematic beta, so says CFM president Philippe Jordan. He acknowledges that active, discretionary management still holds the lion's share in portfolios, but "nonetheless, systematic beta really is one of the big innovations of the last century, due to it delivering on its promise of a decent Sharpe ratio of about 0.3-0.4 at very reasonable costs, and with relatively simple systematic implementation".

So while the greatest innovation of the 20th century is now widely adopted, what of the greatest innovation (so far) of the 21st century? For Jordan, this century's greatest development in asset management is alternative beta, which is the quantitative and systematic management of liquid alternative assets, sometimes referred to as alternative risk premia or hedge fund beta.

According to Jordan, there is a whole battery of alternative beta investment strategies that have made their way in the past 15 or 20 years from academia, into asset management and more recently into the public consciousness. They are scalable, persistent strategies delivering a significant Sharpe ratio between 0.5-0.7.

Its these characteristics, together with the industry's need for decorrelated returns to systematic beta but with greater capacity than pure alpha, which Jordan believes continues to make alternative beta attractive to pension funds. "I think it is going to continue to grow and become an increasingly significant component of pension fund portfolios. They either are using it to complement their exposures to traditional betas or they are using it as a completion strategy for their existing factor portfolios. Finally they are implementing them as a replacement strategy for hedge funds that are providing less value at a higher fee." Jordan explains.

The idea of using current alternative betas as a replacement for less efficient hedge funds is significant. "A lot of what we call alternative betas today was packaged as hedge funds 15, 20 years ago at a cost level and with governance structures that were unacceptable to many pension boards," Jordan says.

In contrast, since the mid-2000s, alternative beta has become available in a format that is now acceptable in terms of costs and governance package, he explains.

This change to an 'acceptable format' accelerated post-financial crisis. But while alternative betas would still be affected from a massive instantaneous shock such as another financial crisis, just as all investment products would be, they can protect investors against a protracted downturn in the equity and bond markets. This is due to the decorrelation benefits and diversifying effects alternative betas provide, Jordan explains.

However, the tricky part with achieving this is finding alternative betas that are truly persistent, "something we have committed decades of research to, as there are a lot to choose from, and within that there is a lot of noise", Jordan says.

There are certain factors that truly deliver exposures that are persistent over time and are decorrelated from traditional equity and fixed income markets, he assures, such as long-term trend following, or factor exposures such as value, momentum, quality, or risk premia.

So, in order to effectively implement alternative beta, a couple of ingredients are key. "One is being able to distinguish between persistent alternative beta from non-persistent," Jordan says, "and two, you need to be able to implement it in a fashion where you can control execution cost and control risk. Those two are particularly intertwined, in that the better you can control execution cost, the more you can risk manage, and vice versa – the less you can control execution cost, the less you can risk manage because you need to trade in order to risk manage and the more you trade the more cost you generate."

According to Jordan, to implement alternative beta into a pension fund portfolio properly, "you need to utilise technology globally and you need to accumulate a lot of know-how for how to use that technology to your benefit" – something that individual pension funds are generally reluctant to do alone.

This will lead investors to fewer than 20 firms worldwide that have the combination of rigorous, statistical science in order to distinguish what is the persistent from the non-persistent, coupled with implementation technology and know-how.

"So talking to firms that have these skillsets and have had these deployed in excess of a decade is probably the right thing to do," he concludes.