Can alternative beta strategies help in a lower for longer environment?

Pensions Age explores the potential portfolio benefits of alternative beta in a challenging market environment

A recent report by *Institutional Investor* found that investors expect inflation to remain subdued, returns to remain low, and volatility to increase and all these factors are impacting chosen investment strategies. In this environment, two strategies are being favoured by investors – thematic active strategies and systematic/quantitative strategies.

In addition we are seeing investors becoming increasingly aware of being charged active fees for beta-driven returns dressed up as alpha strategies.

In this environment, for investors who realise how elusive and expensive chasing alpha has become, alternative beta can be appealing as a lower cost, uncorrelated and liquid strategy generating consistent returns.

Low correlation, high Sharpe ratio

"Our definition of alternative beta strategies refers to trading programmes that tend to have a low correlation to traditional markets, and a Sharpe ratio in excess of 0.3 or 0.4, similar to the historical Sharpe ratio of the stock market," says Philippe Jordan, president of Capital Fund Management International (CFMI), a quantitative asset manager founded in 1991.

An optimum strategy of this kind, Jordan explains, is one that blends negative and positive skew.

"Our alternative beta products combine multiple independent alternative beta strategies, providing a mix of positive and negative skew characteristics," says Jordan. "The result of our back tests is a portfolio with reduced overall negative skew producing a Sharpe ratio of 0.5 to 0.7 over time, versus a stock market Sharpe ratio of 0.3 to 0.4. This is also achieved with an average correlation to the major benchmarks of below 30 per cent and should be priced at below 100bp."

A compelling alternative for long-term investors

Alternative beta is compelling from a quantitative perspective, for investors maintaining a long-term exposure to the strategy.

"We work to deliver a steady return over the long term, within investors' chosen average volatility preferences, with the distribution of the underlying return varying each year depending on the risk constraint," Jordan explains.

"For example, if we run a portfolio with a 10 per cent average volatility and say it will deliver a Sharpe of 0.5, then returns could range from +15 per cent to -15 per cent in extreme years, with an average return of 5 per cent in a zero-rate environment. However, to earn an annual average return of 5 per cent, investors would need to maintain exposure to the strategy for a minimum of five to seven years."

"Whilst alternative beta delivers lower returns than alpha, it tends to generate a Sharpe ratio that is above the market metrics and it is beneficial in that it behaves differently over the long term," says Jordan.

Managing investors' expectations

"Alternative beta will never be as large as the beta market, because it requires a number of portfolio structuring techniques," Jordan concedes. "For example, it involves borrowing securities for shorting, meaning it will be inherently more expensive than pure equity beta."

Alternative beta therefore may be unattractive for investors looking for a similar return to that delivered by a portfolio of G7 government bonds, generating real annual returns of 3-4 per cent, with equity beta concurrently producing 7-8 per cent each year.

For investors who believe those sorts of return unlikely, alternative beta may become an appealing way of constructing a portfolio that balances a constant risk against a variable return.

Whilst alternative beta has become well understood by investors in the past 10 years, Jordan recognises that it can take a few more years before it will entrench itself fully as a core part of investors' portfolios.

"We find its appeal is universal, although to date investors that have been most attracted to it have been pension funds from the US, Canada, Europe, and Australia, which have long-dated liabilities," he says.

"Investors need to ensure that they maximise the portfolio benefits of reduced correlation with mainstream assets. They also need to ensure they understand the level of risk at which they're operating, and understand that the distribution of returns may be random within those risk parameters over the medium term."

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