

MyConsultant

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Consultant

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Smart betas, alternative betas and risk premia

'Smart beta' has been a hot topic in investment circles in recent years, and before there was 'smart beta' there was 'alternative beta'. So just what are these betas, and do they have a role to play in institutional portfolios?

What is 'beta'?

Investors are used to thinking about beta in the context of traditional asset classes, such as equities and bonds. In a technical sense, the term beta refers to the systematic risk exposure of a security to a particular market, such as equities, as distinct from idiosyncratic, or 'stock specific' risk. We most commonly refer to beta when considering the behaviour of stocks or investment managers. For example, an investment manager may be labelled as having a 'defensive' style if their portfolio typically displays a beta of less than 1.0. If a manager has a beta of 0.9, then based purely on the manager's style and systematic risk profile, we would theoretically see their portfolio generate a return of 9% when the market rose by 10%, and to fall by 9% when the market fell by 10%. This assumes no return contribution from the manager's specific stock and sector positioning decisions.

Investors expect to be compensated for taking on the risks associated with a particular market or asset class. The Capital Asset Pricing Model (see separate box) labels this compensation the 'risk premium', representing the expected rate of return over and above a 'risk free' rate of return that investors require to be willing to invest their money. The equity market is expected to have an attractive risk premium associated with it over the long term and, as such, investors generally want to invest in assets that have a positive beta to the equity market in order to capture that risk premium (at least within their equity portfolios).

So what are these other 'betas'?

The term 'alternative beta' was first used within the alternative investment space to refer to the returns that were captured by hedge fund strategies. Hedge funds use a range of alternative investment techniques, such as short selling and leverage, which result in a return stream that often has little or no relationship to the traditional asset classes. As these could be demonstrated to have little or no beta to markets, hedge fund managers referred to their excess returns as 'alpha'.

This view has been widely challenged in both academic and investment circles. Early academic studies and industry research identified a broad range of factors, or 'alternative betas', that they believe drive a large portion of hedge fund returns. For example, research has shown that much of the returns achieved by hedge funds that operate a merger arbitrage strategy can be explained by a naïve approach that replicates the basic merger arbitrage trade, taking a long position in the acquiree company and a short position in the acquirer company for all announced mergers. An active merger arbitrage manager may add value over and above the simple replication strategy, but one could consider the naïve strategy to be the equivalent of a traditional asset class benchmark and view the managers' returns relative to the simple replication strategy.

Just as the equity market has a risk premium to compensate for the possibility that companies will not perform well, the merger arbitrage strategy should have a risk premium associated

with it to compensate investors for taking on the risk that the acquisitions may not occur. In this regard, the merger arbitrage risk premium is likely to be the primary driver of the managers' returns, compensating investors for deal risk taken.

What is 'Smart Beta'?

Early smart beta approaches were focused on providing alternatives to the dominant, market capitalisation weighted approach to capturing the equity market risk premium from a long only perspective (equity market indices such as the S&P/ASX 300 and the MSCI World Index are calculated by weighting each stock based on their market capitalisation). First generation smart beta products typically gained exposure to the equity market by weighting stocks by certain characteristics, such as their price to book value, earnings growth or volatility characteristics. Like alternative beta strategies, smart beta strategies were seeking to capture risk premia that active, style based managers have previously provided exposure to, but with the promise of lower fees. With no live track record at the time of launch, these products generally had stellar 'back tests' and have garnered a lot of criticism for being overly simplistic and giving insufficient consideration to risk. Criticism has been such that many now cynically label them 'dumb beta', or as an often quoted asset manager says, "dumb beta, smart marketing".

After a shaky start, the term 'smart beta' has increasingly evolved to refer to a broad range of systematic strategies that seek to capture specific equity market risk premia. While many still focus on capturing style factors that have historically been available through active managers, the 'smart beta' strategies are becoming increasingly more sophisticated in construction, with more focus on traditional risk management considerations in particular. In some cases, the term 'smart beta' has also been applied to other asset classes, and is increasingly being used interchangeably with 'alternative beta' to refer to any risk premium that can be systematically exploited.

Evolution of Risk Premia Approaches

JANA has been investing in alternative beta strategies since 2007, and much has changed since then. Early alternative beta strategies were primarily focused on providing a low cost, liquid means of accessing hedge fund returns. These products generally delivered a diversified portfolio of risk premia that could be considered the equivalent to investing in the HFRI Fund Weighted Index, a benchmark that seeks to capture hedge fund manager returns that is similar in construct to a market cap weighted index. These strategies gave little or no consideration to the risk and return characteristics that may arise from the collection of risk premia, and whether these were actually desirable in the context of a typical institutional portfolio. Alternative beta strategy products

were often taken up by investors seeking a liquid, transparent and cost effective alternative to fund of hedge fund strategies.

A lot has changed in recent years. Those seeking to identify and capture risk premia have shifted their focus from seeking to replicate hedge fund strategies, to isolating the specific risk premia that underpin those strategies. This has resulted in an explosion in the number of risk premia that have been isolated, with investment bank providers of these products numbering in the thousands. This has led to a better understanding of what these risk premia are and what they can bring to portfolios.

Product Evolution

The manner in which investment managers combine risk premia has also evolved. A greater understanding of risk premia has led managers to place greater emphasis on risk and diversification when combining these factors in a product solution. This has resulted in more robust product offerings.

While most products continue to focus primarily on holding low exposure to traditional market betas in recognition that these are well represented in institutional client portfolios, others are becoming more tailored by considering which risk premia may be attractive in the context of the institutional client portfolio.

Are these useful for building portfolios?

JANA continues to see value in active management in hedge fund and other strategies, particularly for strategies that are harder to replicate systematically. However, as risk premia strategies have become more sophisticated and with greater focus on investment costs, their relevance to institutional investors has increased. Of particular interest will be the development of strategies that focus not just on how risk premia can be better combined in a product context but that start with the perspective of an institutional investor and ask what risk premia can provide the most benefit to the client's overall portfolio. JANA expects to see further evolution in these strategies in coming years.

The Capital Asset Pricing Model describes the relationship between the expected return of a security and its relationship to the overall market.

$$E(R_i) = R_f + \beta_i(R_m - R_f)$$

Where:

E(R_i) is the expected return of the security

R_f is the risk free rate (generally the cash rate)

β_i is the beta of the security to the reference market

R_m is the expected return of the market

(R_m – R_f) is the risk premium for exposure to the market return

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