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INVESTMENT MANAGEMENT

Alternative Risk Premia: Taking Control of Your Exposures

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Alternative risk premia (ARP) represent the potential reward to investors for taking on specific types of risk. As the name suggests, these risks are "alternative" to traditional market risks in the sense that they tend to be structured as long/short investments and, if carefully selected, tend not to correlate highly with traditional asset classes. In fact, many ARP seek to be market-neutral, while others seek to act as traditional market risk mitigators. Both may be appealing to investors concerned about the potential for a future market downturn.

AUTHORS

PATRICK REID, CFA
Managing Director

GARY CHAN
Executive Director

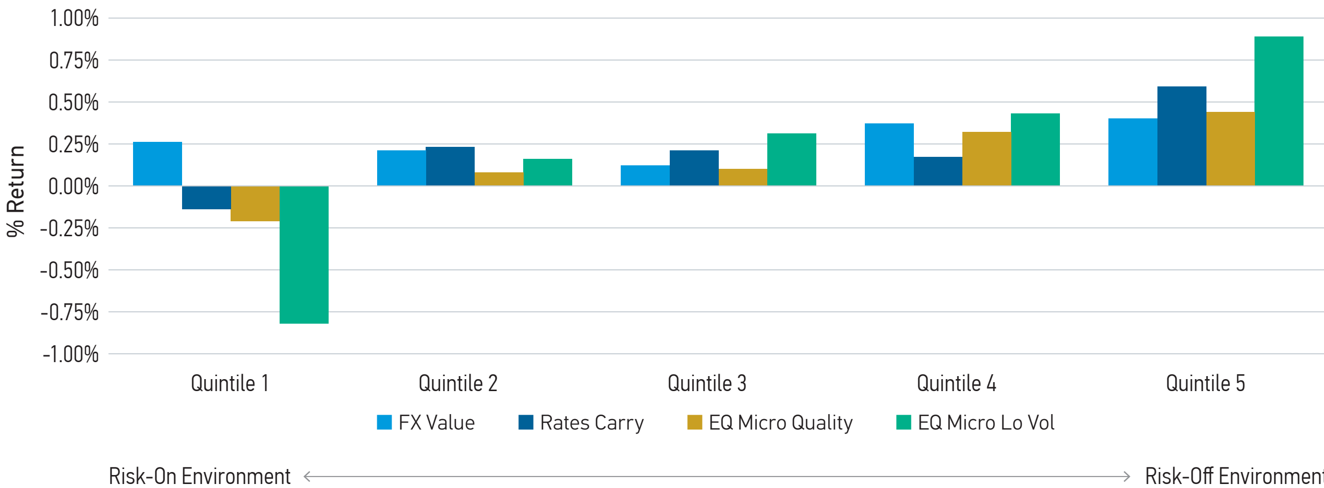
What Are ARP?

ARP are factor-based sources of return that are rules-based and systematically derived. By factor-based, we mean that ARP represent specific factor exposures, such as value, momentum, carry and volatility. They can be asset class-specific or multi-asset, and they can span geographies. ARP have the flexibility to invest long or short in instruments such as, but not limited to: stocks, bonds, money market, treasuries, currencies, commodities and options. By rules-based, we mean that ARP are designed with specific rules governing investment strategy—investment universe, frequency of trading and amounts traded, for example. Once these rules have been established, trading is done systematically without portfolio manager intervention. For all of these reasons, ARP, as a group, tend to exhibit heterogeneous characteristics.

DISPLAY 1

Performance of Representative ARP in a Range of Risk-On and Risk-Off Environments

Representative ARP Performance by RORO Quintile, 07/2001 - 08/2019



Source: AIP Hedge Fund Team and Bloomberg. Past performance is not a guarantee of future results.

A Complementary, All-Weather Portfolio Allocation

Introducing alternative risk premia to a portfolio that includes traditional market betas and/or other relative return-based strategies could offer a number of potential benefits:

1. **DIVERSIFICATION:**[1] Source of absolute return with potential for low correlation to stocks, bonds and other assets
2. **CONTROL:** Transparent and targeted means of addressing gaps and concentrations in existing factor exposures
3. **LIQUIDITY:** With daily liquidity, potential to increase a portfolio's ability to adapt to changing markets without significant cost
4. **FEE OPTIMIZATION:** Systematic exposure to alternative strategies at potentially lower cost than available through active managers

Considering the above characteristics, one can see that ARP strategies have the potential to be powerful portfolio construction and optimization tools.

Performance During Sideways and Down Markets

If included as part of a broader asset allocation, we believe ARP strategies have the potential to play a valuable role over the long term, removing some of the path dependency to which a portfolio comprised solely of traditional asset classes can be exposed. ARP have the potential to generate returns that are unaffected by market movements and, in some cases, actually move counter to traditional markets. An analysis of ARP strategy behavior in different market scenarios explains why this is the case.

We can assess the historical behavior of various ARPs using a measure that is based on the differential between equity and rates performance. Higher historical equity performance suggests a "risk-on" environment, while higher fixed income returns reflect "risk-off" sentiment. *(Display 1)* With this data, we can compare how various ARPs behave in different circumstances, with those most closely related to higher equity returns being more risk-seeking and those with more contrarian characteristics being potentially more defensive. Understanding these dynamics may allow investors to make decisions about how to incorporate complementary allocations of ARP to portfolios that are heavily allocated to traditional asset classes.

[1] Diversification does not eliminate the risk of loss.

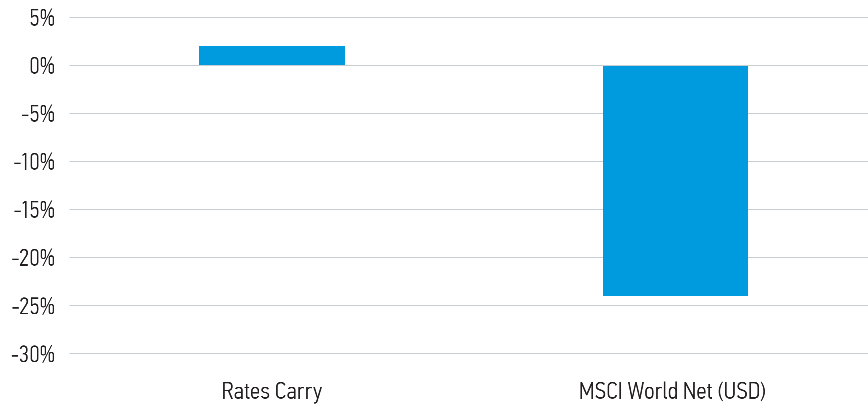
Below, we highlight a small subset of these strategies that may be attractive as we face the increased risk of flat markets or market declines:

- A **Market Neutral Rates Carry** risk premia strategy invests long in bonds with the highest yields and short bonds with the lowest yields. Designed appropriately, the excess returns from interest rate carry are countercyclical in nature, with excess returns of deferred money market futures contracts approximately three to five times higher in recessions than the non-recession average.
- An **Equity Quality** risk premia strategy invests in stocks with the highest profitability and earnings efficiency in a given category while shorting the least profitable and least efficient stocks in that same category. Here, the idea is to buy assets that show strong earnings certainty and sell assets that appear less profitable.

  Quality is a relatively new risk premia factor, but it has been incorporated in ARP portfolios for its defensive positioning characteristics. The countercyclical nature of quality factors means that they can be used to hedge broad equity exposure.

DISPLAY 2

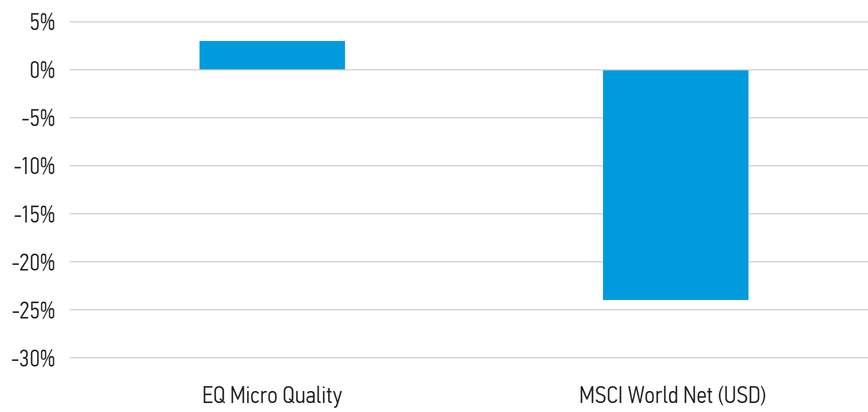
Market-Neutral Rates Carry
Annualized Return 07/2001 – 08/2019
Downside Capture = -8%



Source: AIP Hedge Fund Team and Bloomberg. Past performance is not a guarantee of future results.

DISPLAY 3

Equity Quality
Annualized Return 07/2001 – 08/2019
Downside Capture = -13%



Source: AIP Hedge Fund Team and Bloomberg. Past performance is not a guarantee of future results.

- An **Equity Low Volatility** risk premia strategy invests in stocks with the lowest volatility in a given group and shorts those stocks with highest volatility in the same group. Low volatility has produced significant alpha over the past few decades. And historically, the performance of low volatility has declined less than the market during downturns.[2]

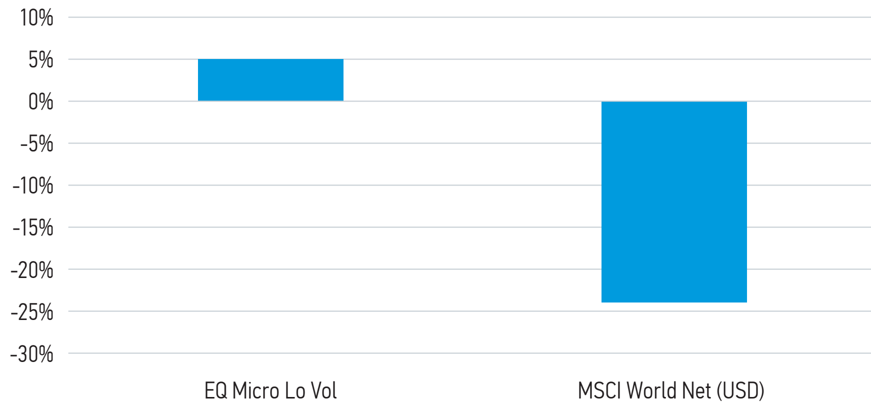
  The outperformance of low volatility stocks somewhat contradicts the Capital Asset Pricing Model's assumption that higher risk is compensated with higher return, leading people to refer to this trend as the "Low Volatility Anomaly." The return associated with this risk premium has been explained as follows: "Many investors seek to outperform benchmarks through holding higher risk stocks, resulting in relatively underpriced low volatility stocks."[3] As such, we would define this strategy as somewhat contrarian.

- An **FX Value** risk premia strategy seeks to capitalize on the mean reversion of prices to their "equilibrium price," based on the premise that prices temporarily deviate because of investor behavior (e.g., overreaction or herding mentality) or liquidity effects (e.g., temporary market shocks or supply/demand friction).[4] With regard to currencies, the idea is that misaligned exchange rates should adjust to their equilibrium rates over the long term. That is, exchange rates that are overvalued relative to equilibrium will depreciate and vice versa. The correlation between FX value and equity/bond betas have historically been either negative or close to zero, suggesting the strategy may provide some useful diversification benefits to a portfolio largely comprised of traditional asset classes.

DISPLAY 4

Equity Low Volatility
Annualized Return 07/2001 – 08/2019

Downside Capture = -20%

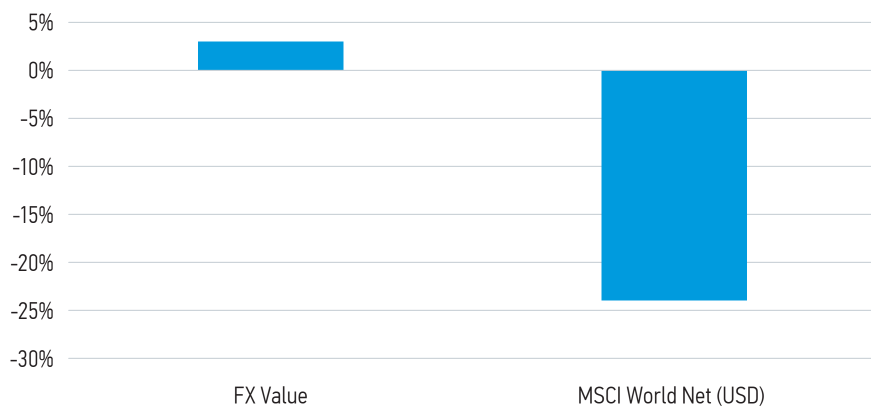


Source: AIP Hedge Fund Team and Bloomberg. Past performance is not a guarantee of future results.

DISPLAY 5

FX Value
Annualized Return 07/2001 – 08/2019

Downside Capture = -12%



Source: AIP Hedge Fund Team and Bloomberg. Past performance is not a guarantee of future results.

[2] Alighanbari, Doole and Shankar. *Journal of Index Investing* 7(3):21-33, November 2016

[3] Frazzini and Pederson "Betting Against Beta" *Journal of Financial Economics* Volume 111, Issue 1, January 2014

[4] Kolanovic, M., Wei, Z. "Systematic Strategies across Asset Classes". J.P. Morgan, December 2013

It Can Be Complicated

Interestingly, some of the same characteristics that make it compelling to invest in ARP strategies also make it more challenging to do so. For instance, since ARP do not track conventional market movements, which have generally been upward-sloping, they can generate lower absolute returns than traditional markets in some scenarios. It is worth highlighting, however, that unlike pure alternative hedging strategies, for which you pay a premium for insurance that translates to negative carry, ARP have the potential to generate positive carry even when markets are going up. ARP returns are not normally distributed and have the potential to provide returns complementary to traditional markets—providing hedging and diversification benefits when implemented appropriately. However, this also means that it can be challenging to apply conventional asset allocation methodologies to these ARP strategies without requisite expertise.

Another consideration is that there are no set industry rules governing how ARP are designed. In other words, ARPs with similar names, such as "Equity Quality," may have been designed very differently by different providers and thus may have dramatically different return profiles. For this reason, ARP investing requires extensive evaluation, record-keeping and coverage, things not all investors may wish to carry out on their own.

These are just two examples of why we believe it's important for investors to consider partnering with a fiduciary who can help them evaluate ARP strategies for inclusion in a broader asset allocation mix effectively.

Conclusion

Investors' search for differentiated exposures and uncorrelated sources of return takes on new urgency against a backdrop of potentially weaker future market returns. Bonds have historically been a safe haven of positive yield in times of negative equity returns. However, with rates decreasing globally, and in many cases turning negative, bonds are not generating much, if any, yield. In other words, bonds may not be able to generate sufficient returns and the same level of portfolio protection today that they have historically. As such, it may be worth considering ARP, which have the potential to mitigate downside risk while in many cases still generating positive returns in a liquid and cost-efficient way.

GLOSSARY AND INDEX DESCRIPTIONS

Backwardation: Market condition in which futures prices decline in the future; roll yield is positive on long positions

Contango: Market condition in which futures prices increase in the future; roll yield is negative on long positions

MSCI World Index Net (USD): A market cap weighted stock market index that represents large and mid-cap equity performance across 23 developed markets countries with net dividends reinvested in U.S. dollars.

Net market exposure: Takes into account the benefits of offsetting long and short positions; is calculated by subtracting the percentage of the fund's equity capital invested in short sales from the percentage of equity capital used for long positions.

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