

Understanding alternative beta

The global financial crisis forced many investors to rethink what constitutes a well-diversified portfolio after 'uncorrelated assets' reacted the same way to the market shock. GREG HICKLING explains the role of alternative sources of beta in a portfolio.

Since the Global Financial Crisis (GFC), investors have been left thinking that their portfolios lack sufficient downside protection and need greater diversity. Indeed allocations to alternative investments like private equity, infrastructure and the broad universe of hedge funds did not provide the level of protection that investors desired.

Questions have quite fairly been raised about the extent to which some of these alternatives were able to provide the expected diversification benefits and whether some simply represented a "repack" of traditional market exposures (or "betas") with some added bells and whistles such as leverage. Of course not all alternatives performed in line with traditional assets during the GFC but it is fair to say expectations were sorely tested.

There is a body of work that identifies the main drivers of return to the main asset classes – both traditional and alternative – and argues that the level of diversity in a multi asset portfolio is not nearly sufficient. With a reasonable level of confidence, we can set out those key factors, which influence the bulk of returns to the main asset class groups. See Table 1.

This suggests there is significant commonality across some of the primary drivers of return to the most widely used asset classes. A paper published by the Centre for Financial Studies in 2009 titled "The Levered Equity Risk Premium and Credit Spreads: A Unified Framework" found evidence to support this argument in building a common framework to value credit and equity. This thesis goes some way to explaining the sharp increase in the correlation of returns through the GFC.

There is, however, a group of investible assets whose returns are more substantially driven by risk premia that do not drive the returns of traditional assets, or indeed the alpha strategies of widely used alternatives such as hedge funds and absolute return strategies. These assets provide diversification to portfolios through sources of alternative beta. See Table 2.

Table 1. Factors affecting various asset classes

Asset	Equity risk premium	Interest rates	Credit spreads	Inflation	Economic growth	Liquidity premium
Equities (listed and private)	✓	✓	✓	✓	✓	✓
Bonds	✓	✓	✓	✓	✓	✓
Property	✓	✓	✓	✓	✓	✓
Infrastructure	✓	✓	✓	✓	✓	✓
Absolute return	✓	✓	✓	✓	✓	✓
Cash		✓		✓		

Our research has identified a number of assets, which look to have characteristics which fit the definition of alternative beta assets with return drivers that are fundamentally different to traditional risk premia. Our particular focus has been on those assets that display the key features of institutional investability including: liquidity, sustainable risk premia, identifiable and functioning markets and institutional grade execution structures.

Taking the period 2007–2009 ("The GFC") as a window which displayed the old adage; "In times of crisis, all correlations turn to one," the divergence of returns of those assets comprised of Common Risk Premia (CRP) and Alternative Risk Premia (ARP) establishes a prima facie case for the existence of such an asset class.

Further investigation of the correlation coefficients of CRP and ARP assets, together with the inclusion of a moderate allocation to ARP assets in a back-tested average Australian balanced portfolio, provides further evidence of the diversification benefits of a new and emerging group of assets.

There is a strong case for identifying that particular group of assets whose risk premia are so fundamentally different to traditional assets, that creating an asset allocation specifically for "alternative beta" would produce a positive impact on the diversification of multi asset portfolios.

While new alternative beta investments such as Insurance Linked Securities and Water Entitlements present a new set of risks and challenges, and require a more specialised level of due diligence and enquiry, capacity is often in short supply and there is strong evidence now that Australian investors are beginning to embrace them. **FS**



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Greg Hickling is a director of consulting firm Brookvine and is a member of IMCA.



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Table 2. Examples of alternative beta assets may include:

Asset	Common risk premia	Alternative risk premia
Insurance linked strategies	– Interest rates – Credit spreads – Economic growth	– Natural catastrophe risk – Longevity risk
Australian water entitlements	Economic growth	– Climatic conditions – Consumptive demand for water

Figure 1. Performance of asset classes during the GFC (Jul-07 to Dec-09)

