



# IS ALTERNATIVE BETA DISRUPTING HEDGE FUNDS?

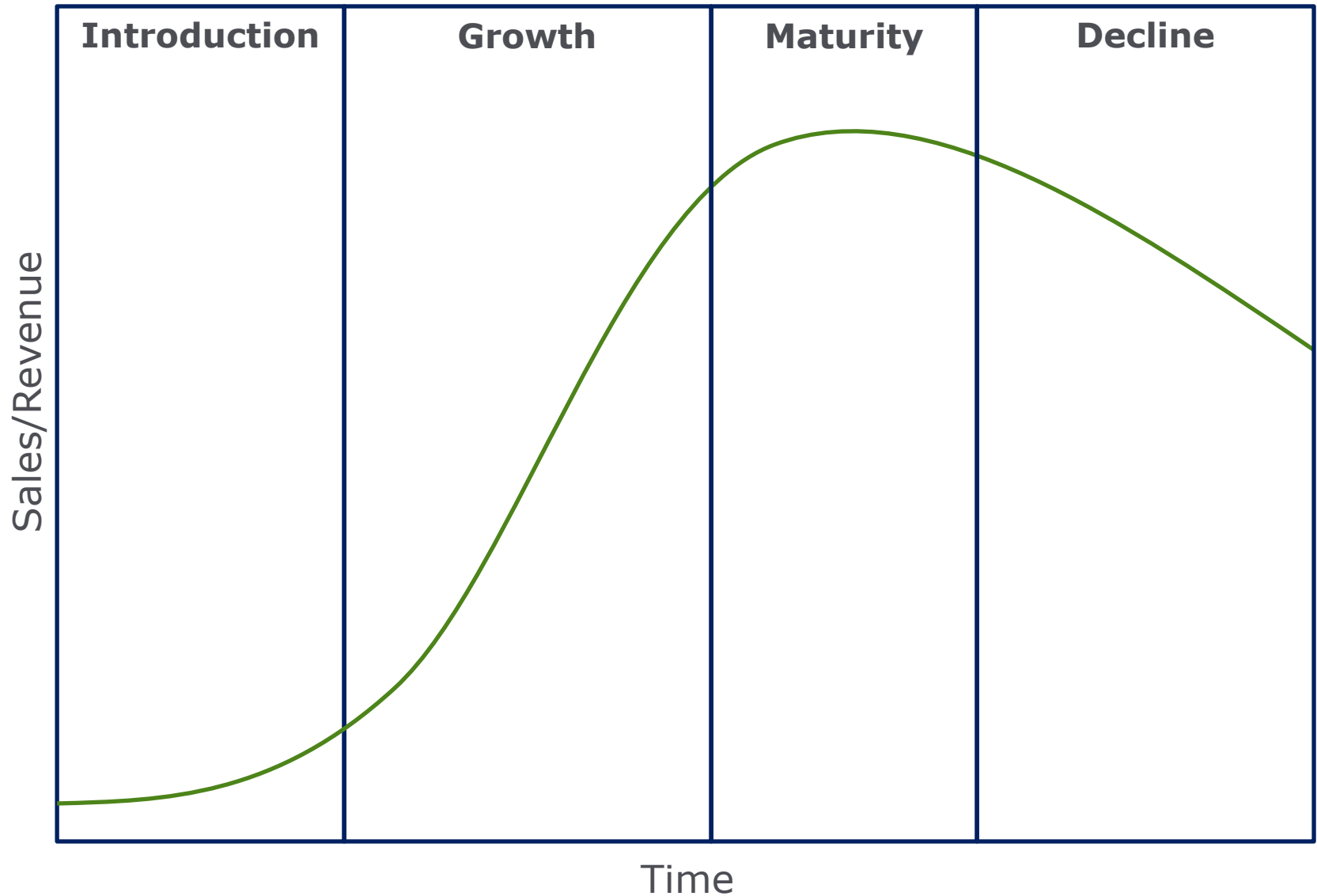
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**NEPC'S 23<sup>RD</sup> ANNUAL INVESTMENT CONFERENCE**

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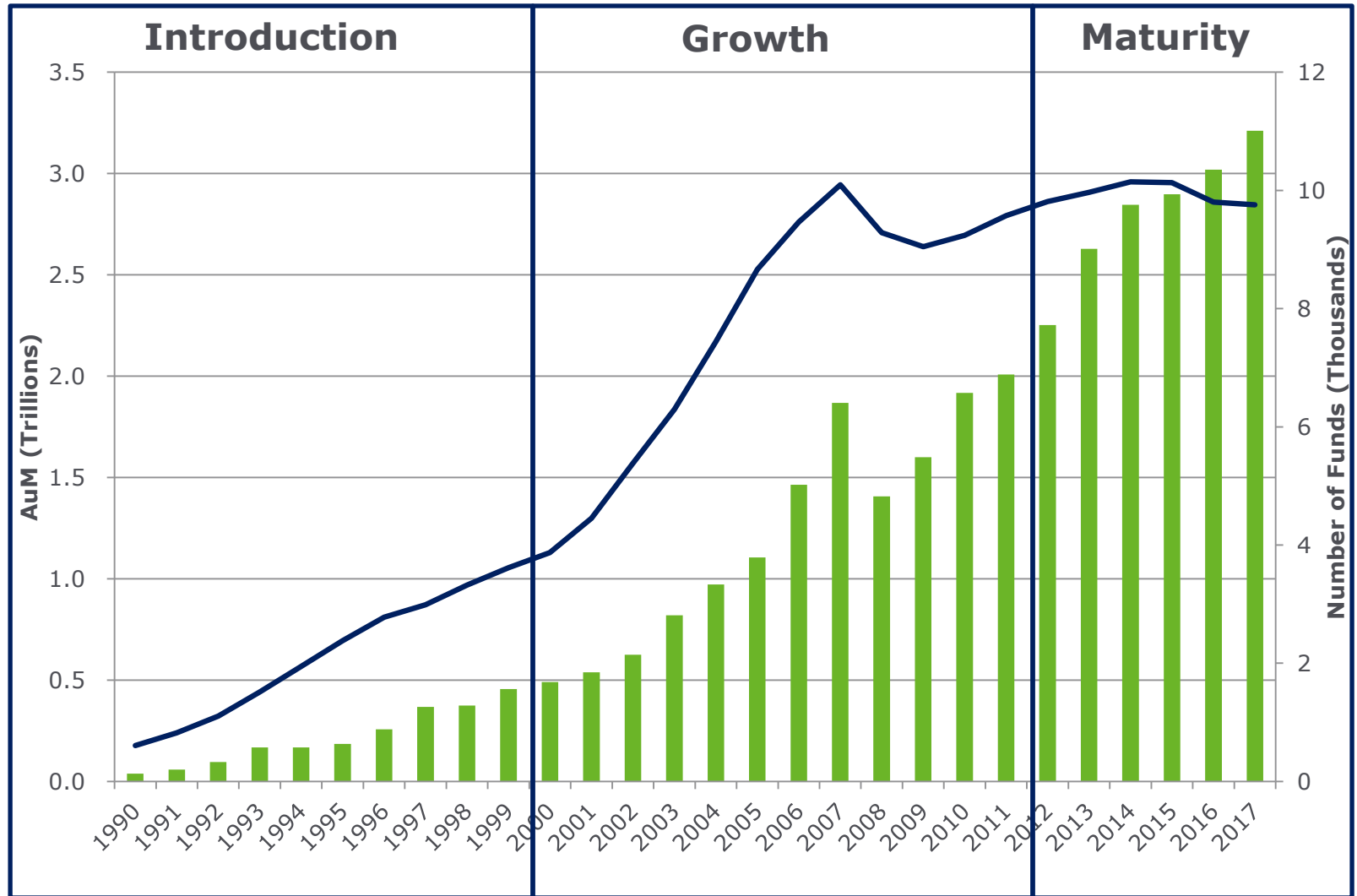
# INDUSTRY LIFECYCLES



# MATURITY BREEDS OPPORTUNITIES

- **Ridesharing (Uber/Lyft) versus taxi services**
  - Offering better pricing, faster on-demand service, seamless payment
- **AirBNB versus traditional hotel chains**
- **eCommerce (Amazon) versus brick-and-mortar retail**
- **Streaming entertainment (Netflix, Hulu, Spotify) versus traditional distribution channels**

# WHERE IS THE HEDGE FUND INDUSTRY?



Source: HFR

# SOWING THE SEEDS FOR NEW ENTRANTS

- **Maturation of the hedge fund industry corresponded with challenges for hedge fund managers**
  - Lower absolute and relative returns
  - Increased correlation to traditional assets
- **And frustrations for investors**
  - High fees
  - Reduced liquidity
  - Lacking transparency

**“Are there options that can alleviate investor’s frustrations with hedge funds while delivering hedge-fund-like returns?”**

-Enterprising Product Development Professional

# WHAT'S IN A NAME?

HEDGE FUND REPLICATION

FACTOR RISK PREMIA

ALTERNATIVE RISK PREMIA

FACTOR INVESTING

**ALTERNATIVE BETA**

RISK PREMIA

HEDGE FUND RISK PREMIA

SMART BETA

LIQUID ALTERNATIVES

EXOTIC BETA

# TWO BRANCHES OF THE TREE



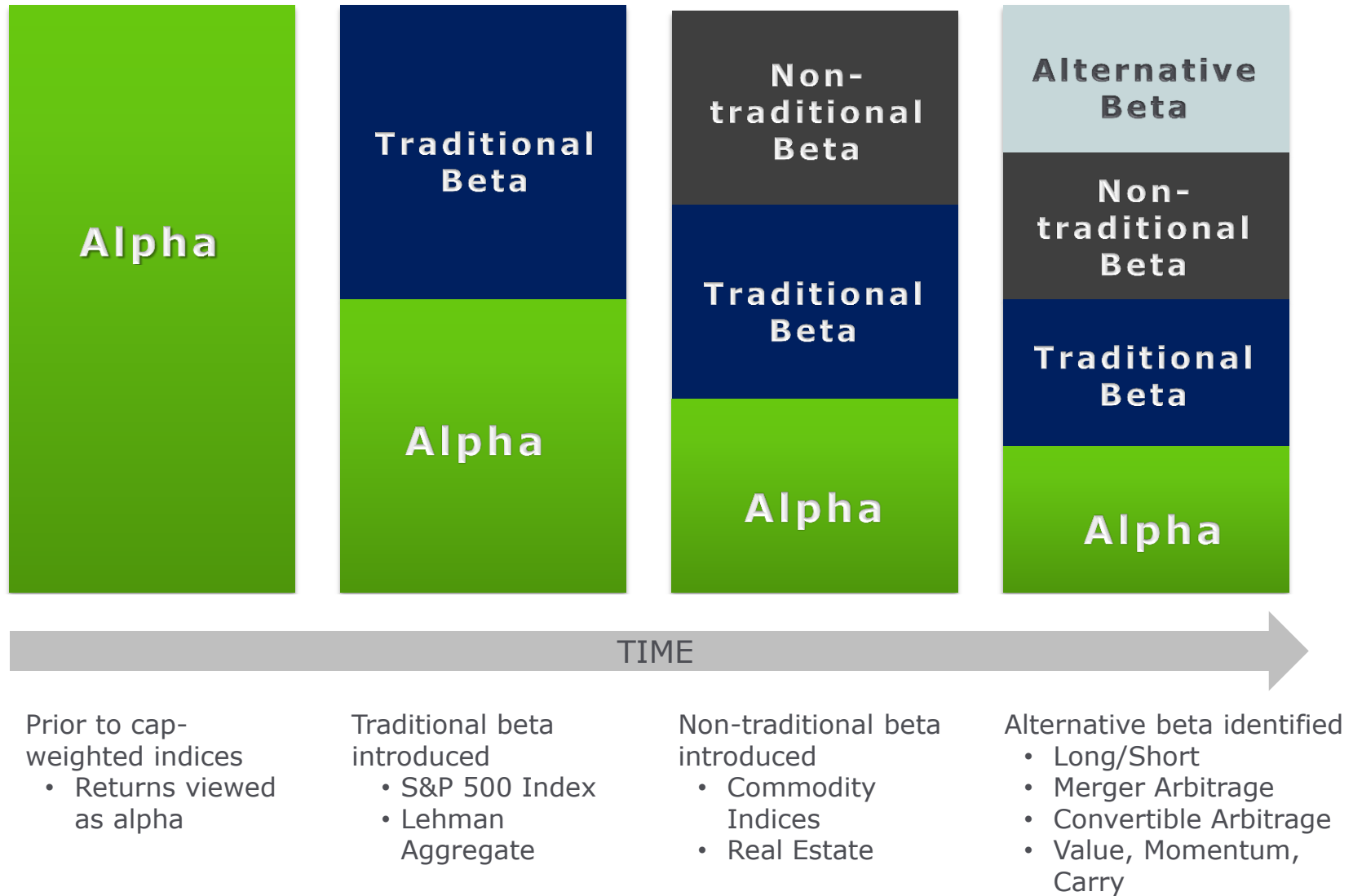
- **Build product structure to solve client frustrations first**
- **Invest within those constraints**
- **Examples:**
  - Hedge Fund Replication
  - Alternative mutual funds

**LIQUID ALTERNATIVES**

- **Access to diversifying investment strategies or non-traditional risk-return factors**
- **Design appropriate product**
- **Examples:**
  - Alternative risk premia
  - Hedge fund /strategy risk premia
  - Smart beta

**ALTERNATIVE BETA**

# BETA – THE OLD ALPHA





# WHAT ARE ALTERNATIVE BETAS?

- **Alternative betas are distinct, empirically-evidenced risk-return factors/premia**
  - Market risks
  - Non-traditional strategy returns
  - Behavioral anomalies

## Alternative Beta

Factor/Risk Premia

Strategy Premia

Value

Carry

Momentum

Volatility

Defensive

Merger  
Arbitrage

Convertible  
Arbitrage

Equity  
Market  
Neutral

# ALTERNATIVE BETA INVESTING SPECTRUM

	Smart Beta	Risk Premia	HF Risk Premia
<b>Objectives</b>	Generate higher Sharpe ratio returns to an asset class based on factor-weighted exposure as opposed to cap-weighted	Capture empirical risk premia across asset classes to deliver positive absolute returns with low market correlation	Execute liquid hedge fund strategies in systematic way to achieve low correlation, absolute returns
<b>Implementation</b>	Long-only	Long-short	Long-short; based on sub-strategy exposure
<b>Portfolio Fit</b>	Hybrid active-passive exposure designed to outperform traditional options; likely to exhibit high market correlations	Overall portfolio diversifier driven by anticipated low correlation and positive expected returns	Overall portfolio diversifier driven by anticipated low correlation and positive expected returns; possible lower-cost HF alternative

- **Investment strategies can encompass a number of different alternative risk premia or isolate specific factors**
- **Range from long-only to long/short options**

# HEDGE FUNDS - ALT BETA TRADE OFFS

## Objectives

- Common goals
- High Sharpe ratio with limited correlation to traditional risk assets

## Liquidity

- Hedge funds generally less liquid
- Alt beta can't access illiquid strategies

## Fees/Expenses

- Management/performance fees less with Alt Beta
- Trading costs can be high

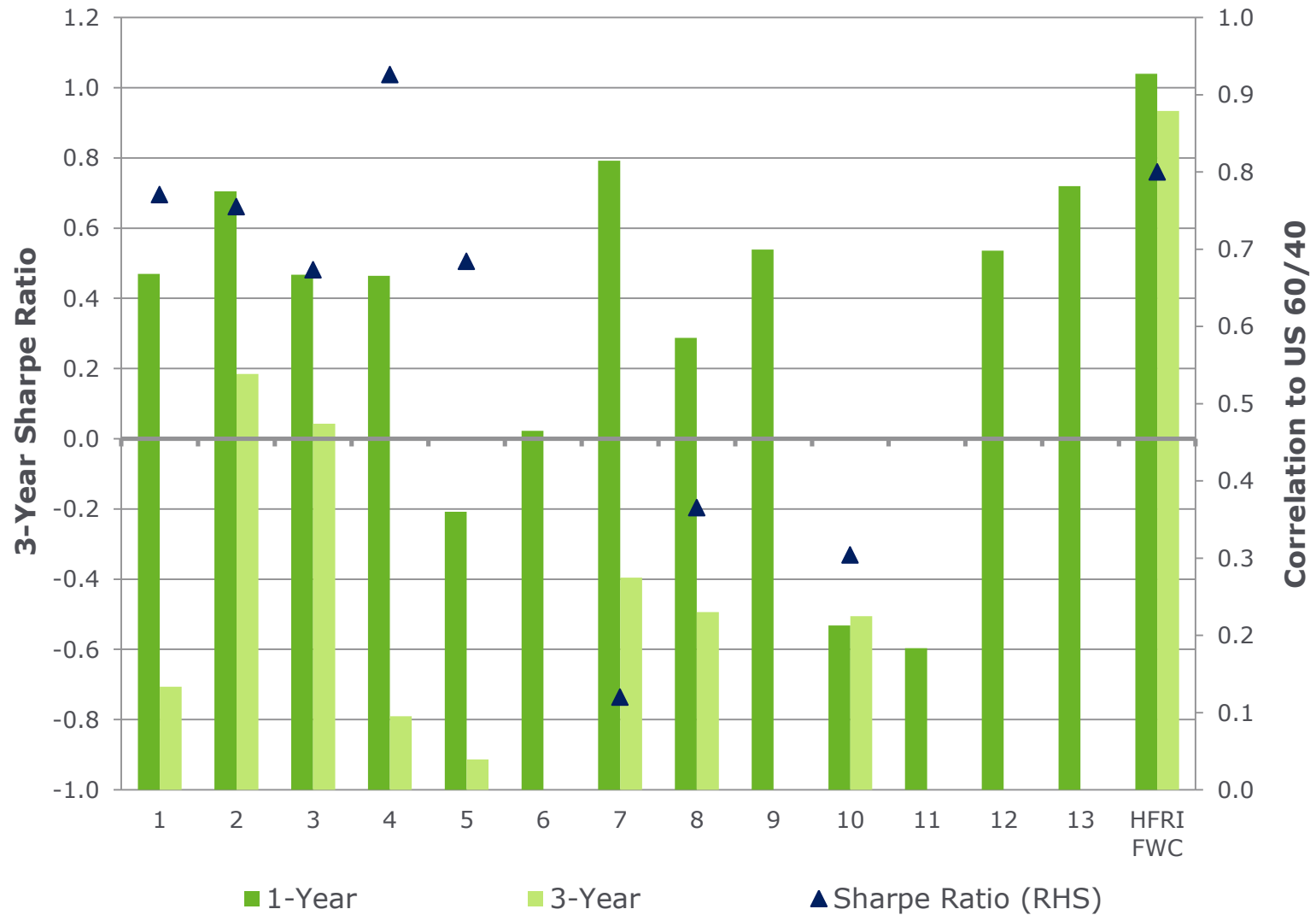
## Complexity

- Alt beta may swap fundamental complexity for quantitative complexity

## Performance

- Limited track records for alt beta strategies

# EARLY PERFORMANCE INDICATIONS



Source: eVestment, HFR  
Note: Performance is reported net of fees

# COMPARING ALTERNATIVE BETA STRATEGIES

- **Early stage of development has led to some significant differences in alternative beta strategy offerings**
  - Creates manager selection opportunities
- **Which factors or risk premia are included?**
- **Which asset classes are being traded?**
- **How are models researched/developed?**
- **How are risk premia/factors accessed?**
- **How is the portfolio constructed and monitored?**

# DISRUPTING HEDGE FUNDS?

- **Smart beta – No**
  - long-only approach to applying alternative betas; likely to exhibit high correlation to traditional risk assets
- **Alternative mutual funds – No**
  - 40Act constraints challenge efficacy; somewhat evidenced in performance
- **Hedge Fund Replication - Unlikely**
  - Possibly to replicate some overall hedge fund strategy styles (hedge fund risk premia) but individual manager performance is nearly-impossible to replicate
- **Strategy premia (Hedge Fund Risk Premia) – Possibly (for some)**
  - Potential for certain hedge fund sub-strategies to be re-defined as “beta”; alpha opportunities could persist due to security selection decisions
- **Alternative Risk Premia – Possibly but more likely to co-exist**
  - Historical evidence is compelling
  - Limited real-time track records; less evidence for how strategies function across market cycles

# SUMMARY

- **Hedge fund industry appears to be in a mature phase**
  - Hedge fund managers must adapt and differentiate themselves in order to persist
  - Risk of new entrants in the market competing for same investor dollars
- **Alternative beta strategies are in an earlier stage of their lifecycle**
  - Compelling thesis; limited real-time evidence
  - Differences in approach make manager selection paramount
  - Historical factor risk premia evidence solid but go-forward challenges exist
- **While potentially offering similar benefits to hedge funds, alternative beta strategies are not a magic bullet**
  - May offer alternatives and complements to hedge fund strategies
  - Reconsider the overall role of hedge fund strategies and refine role of each manager in the portfolio

# APPENDIX



# ALTERNATIVE BETA GLOSSARY

Factor/Risk Premia	Definition
Value	the tendency for cheap assets to outperform expensive assets
Momentum	the tendency for recent performance to persist in the near future
Carry	the tendency for higher-yielding assets to generate higher risk-adjusted returns than lower-yielding assets
Defensive	low beta anomaly; tendency for high-quality to out-perform low-quality
Volatility	tendency for options to be overpriced (implied volatility > subsequent realized volatility)

Note: does not represent an exhaustive list of potential risk premia

# ALTERNATIVE BETA GLOSSARY

Hedge Fund Strategy	Definition/Goals
Merger Arbitrage	Construct standard merger-arbitrage trades on announced deals
Convertible Arbitrage	Construct portfolio of convertible bonds and hedge equity and rate risk to capture premium
Equity Long/Short	Develop portfolio of individual securities, long and short, based on systematic valuation metrics
Global Macro	Construct relative-value trades across markets and asset classes or trend/momentum oriented positions

Note: Does not represent exhaustive list of potential HF risk premia

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