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Capturing hedge fund beta

The JPMorgan Systematic Alpha Fund offers investors the diversification benefits of hedge funds as well as the ability to implement a liquid and transparent core alternatives allocation for existing portfolios.

As investors become savvier they can see the benefits of gaining exposure to the core alternative risk premia associated with hedge fund investing – otherwise known as alternative beta.

To know the function of alternative beta it is important to understand the definition of beta as being the compensation for bearing some form of economic risk.

J.P. Morgan Asset Management portfolio manager Yazann Romahi[01] says a lot of the returns embedded within hedge fund investing are due to exposure to some economic risks that are long-short – and that explains what alternative beta is really about.

"Traditionally we thought of risk premia as long-only exposures like equity or fixed income but no-one said that economic risk had to be long-only, in fact, it can be long-short in nature," Romahi says.

The JPMorgan Systemic Alpha Fund* aims to capture returns from alternative beta by using long and short positions, minimising sensitivity to the underlying asset classes. Through systematic investment processes the fund focuses on reducing manager-specific risks associated with hedge fund investing.

As Romahi explains, fundamentally not all hedge fund styles are amenable to capture through alternative beta strategies.

"Those [hedge fund styles]that are amenable to capture through alternative beta techniques are those that are more liquid in nature – such as equity long-short or merger arbitrage and other event-driven strategies, as well as global macro and convertible bond arbitrage strategies – essentially those hedge fund styles that trade in liquid underlying assets," he says.

Recent J.P. Morgan Asset Management research has focused on alternative beta in the event-driven hedge fund style, which represents 22% of the assets under management of hedge funds, and includes strategies such as merger arbitrage, share buybacks, shareholder activism or index rebalancing arbitrage. Hedge fund managers traditionally argue that the event-driven style is an ideal opportunity for superior fundamental research to capitalise on special situations that the rest of the market lacks the expertise to analyse, Romahi says, focusing on the example of merger arbitrage.

"Typically when there's a new merger event the stock jumps up. [Entering post announcement], if the deal completes, you [the arbitrageur] can make around one to 3%. If the deal fails, there's a [typical] 20% downside – so you can see it's very negatively skewed," he says.

"There's small upside, large downside and the active manager would say that they're going to analyse all these deals – determining which deals are more likely to complete and which deals are more likely to fail, and focusing their portfolio on those that are more likely to complete.

"The academic would argue, well actually there's a risk premium here – there's a beta. The reason there's a risk premium is because it's compensation for bearing that negative skew."

The firm's research says this compensation can also be considered as a form of insurance risk premium, where the arbitrageur is offering liquidity to those shareholders who want to sell their holdings and realise the large gain they have already made, while protecting themselves against the possibility that the deal will not close.

Romahi suggests the key as an alternative beta investor in the Systemic Alpha Fund, is to diversify across all the deals to reduce the skew and thereby seek to earn a positive return. He says this should then act as the new benchmark for the active merger arbitrage manager – "that is essentially the beta of merger arbitrage."

The same rationale applied to other event-driven styles. For example, shareholder activism is a material hedge fund style, accounting for more than US$110 billion as at June 2016, which has historically been considered as idiosyncratic. The firm says there is research to suggest activism improves short-term stock performance and improved long-term operating performance, while targets also are more likely to be subject to other types of corporate events, such as takeovers. The research again shows that by taking a diversified exposure to the entire investable universe of activism targets, it is possible to effectively capture the excess returns associated with the style in a systematic fashion.

Based on a strategy running since 2009, the JPMorgan Systematic Alpha Fund aims to deliver a total return in excess of its benchmark (Bloomberg AusBond Bank Bill Index) by focusing on the capture of alternative beta across the core hedge fund styles of equity market neutral, global macro, as well as event-driven. Since the Australian fund's inception in November 2015, it has generated a 3.60% return net of fees – the benchmark has returned 2.04%. The event-driven hedge fund style was the leading contributor to the fund's return in the 12 months to December 2016. This was largely driven by the merger arbitrage strategy, which benefitted from wide spreads. Global macro was also a positive contributor to return, led by FX factors.

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The fund manager says there's two main avenues for investors to think about when approaching the use of alternative beta, and systematic alpha specifically, within an investment portfolio.

Romahi says one approach is to think about having a core/satellite approach where the core allocation to alternative beta strategies is complemented by a satellite exposure to high conviction alpha managers. He says in doing this an investor will likely improve their liquidity profile and bring down the overall fee of any alternatives allocation.

"The alternative of course is to look at it being an alternative to traditional alternatives where you simply replace your high-cost hedge funds with lower-cost alternative beta," he says.

"Fundamentally when you think about what you're gaining with alternative beta, [it] is that you're getting a low-cost, transparent and daily liquid access to hedge fund risk premia."

Romahi explains the industry has seen growing interest in these types of strategies and it has put pressure on active manager performance and fees.

He adds that one could assume the growth may potentially mean crowding affects in the risk premia themselves, "and so the question is what do these crowding effects do."

"Fundamentally every single one of these risk premia has some kind of economic basis for it," Romahi says.

"So as long as there is a strong economic basis, it won't be arbitraged out."

"What typically happens with risk premia, whether traditional risk premia or alternative risk premia, is they go through these cycles – they become expensive, investors de allocate, then they become cheap and perform and people reallocate and so on," Romahi says.

"Ultimately, for investors looking to capture returns from alternative risk premia we feel that the JPMorgan Systematic Alpha Fund does this with the added advantage of daily liquidity and lower cost." **FS**

Source: J.P. Morgan Asset Management Investment Insights "The turn of events: Event-driven investing in the context of alternative beta", August 2016, Yazann Romahi and Albert Chuang.

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