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Philippe Jordan
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The alternative beta factor

A diversified exposure to time-tested, alternative beta strategies

For CFM (Capital Fund Management) President Philippe Jordan[01], one of the biggest challenges financial advisers face is how best to create a robust portfolio, able to withstand market downturns and perform over the long term.

"But the real issue," says Jordan, "is not whether a market crisis is around the corner, it's that market crises, both large and small, occur regularly. And this means that the best way to prepare is not by trying to predict the next one, but rather by creating a truly diversified portfolio."

Jordan says diversification remains one of the best ways to prepare for any market crisis, but he does question conventional wisdom in this area.

"We have seen since the GFC that true diversification is difficult to achieve by following conventional wisdom which advocates diversifying an equities portfolio with bonds," he says.

"Arguably bonds are no longer offering investors diversification. And given where we are in the interest rate cycle, investors are increasingly avoiding interest rate duration via bonds, and instead searching for an elusive true diversification investment."

Mitigating the risks

Investors are familiar with alternative assets - investment classes outside of equities, bonds and cash, and which include everything from real estate to commodities and private equity. Alternative beta strategies, on the other hand, are strategies which may hold traditional assets as their underlying investments, but which invest in these assets in a different way.

Alternative strategies use long and short exposures with the aim of exploiting inefficiencies in markets and are based on "factors" such as momentum and value. They attempt to capture, in a systematic way, behavioural biases and alternative risk premia, and include strategies such as long-term trend following and equity market neutral.

Jordan explains that when added to a portfolio of traditional assets, alternative beta strategies have the potential to increase the portfolio's Sharpe ratio, lower overall portfolio volatility, lower drawdowns and improve long-term returns.

"This may sound like the holy grail of investing, but in fact alternative beta strategies are not new, they have been persistent for long periods of time, sometimes up to 200 years. And they have also shown themselves to be de-correlated from traditional assets over the long term."

"We know from behavioural finance that investors are more likely to remain invested if they experience less volatility in their portfolio, particularly during times of market stress, and if they remain invested, they are more likely to achieve their long-term investment objectives," Jordan explains.

CFM has been at the forefront of alternative beta strategies for over 25 years and are one of only a handful of global investors to apply rigorous academic techniques to systematically analyse and interpret massive amounts of data using state-of-the-art technology.

Jordan says that many retail adviser portfolios may be less diversified because they are more exposed to equity and bond markets than they realise, and so including alternative beta strategies in a client's portfolio could be one way of diversifying away from equity risk.

"One of the benefits of CFM's alternative beta strategies is that they are liquid, transparent and lower cost than some traditional alternative investments such as hedge funds which can often be illiquid, opaque and charge high fees," he says.

"We believe that there is no need for investors to pay higher fees for what are essentially beta strategies, or for actively managed strategies which may not perform as expected or offer the diversification benefits claimed."

CFM ISDiversified in action

CFM ISDiversified Trust was created to provide investors with a diversified exposure to alternative beta strategies in a cost-efficient way. It has been designed to act as a core alternative solution for advisers looking for daily pricing, transparency and cost effectiveness.

An investor or adviser could use the fund to purely replace a hedge fund permanently or while due diligence on the hedge fund is performed. It can also be used as a "core and explore" approach to investing in hedge funds – using alternative beta as the core and thereby securing hedge fund exposure but in a cost-effective, transparent way.

The fund can also potentially secure return streams comparable to hedge funds when investing in hedge funds is not possible due to approved product list (APL) guidelines or philosophical bias.

It can also be placed to capitalise on interest rate diversification benefits when used alongside bond allocations in portfolios sensitive to interest rate movements.

Finally the fund can be used to target a given volatility level because alternative beta strategies, by nature of their decorrelation to traditional assets, can smooth volatility and reduce maximum drawdowns.

The quote

The real issue is not whether a market crisis is around the corner, it's that market crises, both large and small, occur regularly.

"Alternative beta strategies provide true diversification because they have consistently been shown to be persistently uncorrelated to traditional markets," Jordan says.

Putting the strategy to work

Jordan says that advisers often ask him about timing, and when they should consider adding alternative beta strategies.

"For me, that's the wrong question. Instead of asking 'how can I predict when the next crisis will hit', they should be asking 'how can I create a portfolio which is robust enough, and diversified enough to withstand the next crisis, and mitigate losses'."

"Understanding why one crisis occurred is often of little value when it comes to predicting the next one, and that's why there is no 'right time to invest'. By having an allocation to alternative beta strategies over the long term, you are taking the most appropriate steps to mitigate losses and minimise drawdowns when the next crisis comes," he says.

Jordan explains that alternative beta is both similar and different from traditional beta, something which can cause confusion.

"Alternative beta is very much like traditional beta in that it has been proven to work over time, is passively managed, is rules based, low cost and typically liquid," he says.

"But unlike traditional beta, alternative beta generally tends to have low correlations to both equities and fixed income. This means that it can be added to a portfolio with the aim of improving performance on a range of risk and return measures, and to smooth the path of returns."

"What advisers need now are investments which genuinely (rather than in name only) diversify a portfolio, and which can protect and perform over time, including in a market crisis," Jordan says. FS

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