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Are you really diversified?

Global growth and interest rates – these are the driving forces within most portfolios. But what if there was a better way to diversify?

If there is a golden rule in investing, that people follow without question, it would have to be diversification.

"Diversification is key," you'll often hear people say – as though no further explanation is warranted.

However, things are often not as simple as they seem, especially in the late cycle.

Anthony Lawler, head of GAM Systematic at GAM Investments, understands that traditional diversification doesn't always work.

"We are at a point in the cycle where traditional diversification is a bit more challenging," Lawler says.

"Equities are expensive relevant to their own histories and bond returns are very low. So the easy diversification of going into bonds is less helpful than it has been historically."

GAM Systematic Alternative Risk Premia allows investors to access exposure to diversification that is beyond what they would generally seek.

Alternative risk premia typically employs unconventional investment techniques and aims for low correlation to traditional asset classes.

While most investors understand intellectually the importance of diversification, they may be looking for that diversification in investments that are still driven by the same macroeconomic factors that drive equity and bond markets.

Finding returns outside these economic forces takes a specific set of expertise.

Lawler explains that it all comes down to thinking about what is really driving returns.

"It's important for investors to find different return drivers for their portfolio, so to try to look for diversification from things that are not driven by global growth and interest rates - the two things that drive equity and bond returns, which drive most of our portfolios," Lawler says.

"For our investors, we would say to look for different ways to get liquid return drivers that are different to bonds and equities."

For some time now, institutional investors have understood the importance of alternatives for diversifying not only returns – but risk too.

And, in the low-yield environment where bonds are not performing for investors in the ways they once did, it is becoming harder to see bonds as providing the diversification of risk that they once did.

"Institutional investors are turning to alternatives, first of all to diversify their bond risks," Lawler says.

"Bond returns are a lot lower than they have been historically from an expected return perspective. So a lot of institutions are looking for ways to diversify that bond duration risk."

And, the other reason Lawler says institutional investment teams are moving towards alternatives goes back to thinking about the root factors that drive returns in portfolios.

"Alternatives in general are a way to reduce your dependence on global growth or equity-like returns," Lawler explains.

While those are some of the reasons for institutional investors to consider alternatives, alternative risk premia has the added bonus of reliable liquidity.

"Alternative risk premia is a form of liquid alternatives, or a form of diversification away from equity and bond risks," Lawler says.

He explains that while some might not have heard of alternative risk premia – it's not necessarily new.

The actual trades that come through in alternative risk premia are not new, they've been done for forty years. Largely by hedge funds traditionally," Lawler says.

"What is new is this wrapper called alternative risk premia – or the ability to get liquid alternatives at a much lower fee level. But, you can think of alternative risk premia as unconstrained multi-asset."

Alternative risk premia allows investors to trade across asset classes in a liquid manner.

Importantly, the trades are both long and short.

These factors mean that through alternative risk premia, Lawler explains, investors can capture returns that are not equity and bond related.

This systematic approach to investing and managing risk might remind some of smart beta.

But, Lawler explains that smart beta and alternative risk premia are at different ends of a continuum.

Smart beta portfolios are typically concentrated on one asset class – and that asset class is generally equities.

Through smart beta, investment managers will typically create portfolios with a different weighting mechanism for market risk.

"Smart beta can mean having a value bias or anything other than a market capitalisation bias to your long-only equity holdings," Lawler says.

But, he explains, as investors move along that continuum to consider multi-asset class investments and long/short rather than long only – that's where alternative risk premia comes into play.

"Alternative risk premia is a systematic way of capturing alternative returns rather than a systematic way of capturing market returns," Lawler says.

The quote

Alternative risk premia is a way for investors to get diversification in their portfolios across the whole cycle.

Watch the video on www.fsitv.com

That's not to say that it is completely unrelated to smart beta.

"They are related in some ways – you can think of alternative risk premia as the smart beta of alternatives," he explains.

Many economists and investment professionals are of the informed opinion that we are currently late in the economic cycle.

So, how does alternative risk premia function at this point in the cycle?

For Lawler, one of the significant benefits of alternative risk premia is that it is not necessarily cycle-sensitive.

"Alternative risk premia is a way for investors to get diversification in their portfolios across the whole cycle," Lawler says.

"Late in the cycle though, it may be especially appealing because bond duration exposures are not as appealing as they were when yields were higher."

He says right now, those in the know are seeing even more potential in alternatives and alternative risk premia.

"So, a lot of advisers and institutional investors are looking to alternative risk premia to generate returns for the portfolios that are not driven by global growth and interest rates because those are the main risks that investors already have in their portfolios," Lawler says.

"Alternative risk premia is a way to invest in liquid assets, get more diversification than simply being in bonds and to have the returns be driven by something that isn't the same thing driving equities and bonds."

For Lawler, alternative risk premia is the best way to reap rewards for taking non-traditional risk.

The GAM Systematic Alternative Risk Premia fund is managed by GAM's highly experienced Alternative Risk Premia investment team, part of GAM Systematic.

GAM Systematic Alternative Risk Premia seeks to identify, structure and invest in alternative return sources. The fund aims to deliver consistent returns, with low correlation to equities and bonds and a focus on capital preservation. **FS**

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