

## TWO UNANSWERED QUESTIONS ABOUT ALTERNATIVE BETAS

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Alternative betas, or risk premia, are established investment strategies that are simple enough to automate with a computer but too complicated for most investors to implement directly. For instance, you can program a computer to buy “value” stocks and short “growth” stocks, but few investors choose to do this on their own. The same argument can be made for merger arbitrage, currency carry trades, momentum, trend following, commodity roll trades and other common trading strategies employed by hedge funds.

The advertised appeal of alternative beta products is that they have a low correlation to traditional assets and have a high-expected return – the practical definition of a valuable diversifier. With widespread pressure to bring down the cost of investing, many investors are considering whether to invest directly in alternative betas to avoid high hedge fund fees and improve liquidity. Having examined a broad range of these products, we conclude that there are two (big) unanswered questions. Each arguably undercuts the diversification thesis.

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### 1. WHAT ARE EXPECTED RETURNS?

There is a paradox in the alternative beta diversification thesis. Expected returns for alternative risk premia are supposed to be high since most investors do not or cannot invest in them directly. However, the proliferation of products should lead to capital inflows and hence drive down returns over time.

This is not a small issue. Take benchmark equity strategies, where we have two decades of data since they were “discovered.” In 1993, Fama observed that buying value and shorting growth delivered substantial excess returns over 1963-1990. During that period, the Sharpe ratio was 0.57, somewhat higher than the long term Sharpe ratio of the equity markets. Similarly, Carhart showed in 1997 that momentum over the same period offered similarly compelling returns – an even higher Sharpe ratio of 0.85.

These strategies did not remain undiscovered for long. Numerous firms soon offered products and funds specifically to provide access to these strategies. The results were entirely predictable. As capital flowed in, returns declined. In the past ten years, the Sharpe ratios of value and momentum have been 0.15 and 0.02, respectively.

A related issue is that few products actually have live track records. Those that do were often launched in the past several years. Most products are marketed as indices, for which reporting standards are very low: simply labeling a pro forma track record an “index” sidesteps most of the onerous disclosures that apply to investment products. As an investor, you often have to dig to learn when the index was formally launched; anything prior to this should be discounted for back-fill bias. Consequently, the pro forma returns, or a portfolio of them, will generally be overstated.

The obvious risk of these strategies is that inflows into a capacity constrained strategy will drive down returns to the point where they are no longer an effective source of diversification. By analogy, as discussed previously in a [note](#), CTA returns have been low for almost a decade, and the most likely culprit is the influx of capital.

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## 2. DO THEY REDUCE IDIOSYNCRATIC RISK?

“Beta” strategies generally reduce idiosyncratic risk. When you invest in the S&P 500, you don’t need to worry about whether a manager bets wrong and goes off the rails. The term “beta” also implies something that can be clearly defined. In this context, the moniker “alternative beta” is something of a misnomer.

### MODELING RISK:

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Alternative beta products substitute “manager” risk with “model” risk. Due to the complexity of setting numerous parameters, one firm’s alternative beta will look very different from another’s. We addressed this in the [merger arbitrage space](#) and found very different results among providers. The implication for investors is that alternative beta products are more akin to low cost, systematic single strategy funds rather than a beta product *per se*.

Whereas some firms offer products that have been optimized, others are offered piecemeal. Barclays reportedly offers close to one thousand discrete products. For the former, investors need to evaluate the quality of a complicated optimization; in the latter, the range of products is overwhelmingly broad. In either case, the products fail to provide the clarity and simplicity that most investors associate with the term “beta.”

### IMPLEMENTATION RISK:

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Due to their complexity, alternative beta products typically are offered in swap form. There are several material issues with this. Liquidity for OTC products can be contingent upon stable markets: a standard ISDA agreement has sixteen pages covering market dislocations. The ability to execute is dependent upon getting the counterparty to repurchase the contract which, as many discovered during the crisis, may be difficult during a chaotic market. Buyers bear the credit risk of the counterparty that may or may not be priced into the product. All in pricing can be opaque at best, especially when it is dependent upon execution. Trading and transactions costs can be very high, such as for the execution of roll trades outside of specified windows.

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## CONCLUSION

Based on our review, there is a fundamental disconnect in how the products are positioned and the reality of investing in them. While the headline cost of investing may be low, overall pricing is much more opaque. As noted, liquidity is more constrained than advertised.

However, the biggest issue – and the most difficult to answer – is whether alternative betas are subject to arbitrage over time. No one knows where the tipping point is, and it’s nearly impossible to gauge contemporaneously. Because of this, product providers focus on historical returns, which are easy to calculate but unlikely to reflect returns going forward. As Kahneman observed in [Thinking Fast and Slow](#), when asked a difficult question, human beings have a tendency to pose themselves an easier question and answer it instead. Well said.