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MANAGING EXPECTATIONS WHILE MANAGING ALTERNATIVE RISK PREMIA STRATEGIES

Risk premium strategies work best when combined in a multi-factor context rather than considered as stand alone performance drivers. Putting alternative risk premia (ARP) factors together in a portfolio, seeking to maximize diversification effects, is key for successful investing. Whether timing of factors can succesfully be executed in the longer term is subject to debate - a more static approach compared to a dynamic one is likely to be the better choice. Those are some of the conclusions drawn from HedgeNordic´s discussion with Christopher Reeve of London-based systematic hedge fund manager Aspect Capital.

"It's important to bear in mind that the effects being captured by the majority of alternative risk premia strategies are somewhat intermittent in their behaviour. It may be an obvious point but they aren't the sort of strategies which always reliably work and perform brilliantly 100% of the time", says Reeve as a first remark when asked about what to expect from ARP-strategies over time.

According to Reeve, risk premia strategies, if implemented properly, will be able to earn a premium in exchange for taking a specific risk. But this risk will show up at times and as an investor it is important not to rely too heavily on backtested performance data.

"However robustly a risk premium strategy is designed to capture a particular effect, it is likely that there will be an element of selection bias in the model. Although backtested performance might be very impressive it is very unlikely that a risk premium strategy will persistently outperform its backtest and many have struggled in recent years to even match the level of performance shown in backtesting", Reeve says.

Expected performance of ARP

Reeve paints a relatively conservative picture of the risk-adjusted performance to be expected from individual risk premia working in isolation; the real benefit from using them lies in their correlation characteristics, he argues.

"All things considered, any one risk premium strategy is likely to have a pretty low risk-adjusted return on a standalone basis. A long-term Sharpe ratio of around 0.3-0.5 is probably a realistic level to expect for a standalone factor. These strategies aren't super high-frequency, high alpha strategies which capture unique effects. They tend to be more based around medium-term effects which are relatively well-understood."

"While it's clear that the recent environment has not been especially favourable for many of the well-known factors, long-term performance expectations of around a 0.7-0.8 Sharpe ratio for a well-diversified portfolio of different alternative risk premia seems like the sort of level that investors should realistically expect to generate. While this level of performance probably may not rival the higher risk adjusted returns targeted by many multi-strategy hedge funds, it can still be incredibly valuable in a portfolio context and comes with many other benefits of higher transparency and liquidity and lower costs”, Reeve reasons.

Creating a robust portfolio of factors

According to Reeve, the key to successful alternative risk premia investing lies in the manager’s ability to put different factors together in a portfolio, thereby exploiting inherent correlation benefits.

”One question for investors is whether to build a robust portfolio of individual standalone factors themselves, or to invest in a multi-premia product where this has already been done”, he says continuing:

”One major benefit of the multi-premia products is the potential for trading efficiencies from the netting of positions and trades between the different factors, given that nearly all factors operate in the same markets - large-cap equities and major liquid futures. We estimate that this can reduce the total trading turnover of a risk premia portfolio by around 50% when compared to executing each strategy in isolation, and the consequent savings in trading costs can therefore be very significant.”

When it comes to how to efficiently construct a portfolio of multiple factors, Reeve says that there are different schools of thoughts. One argues for a more static approach while others argue that adjusting weights dynamically can add signficant value.

”There are several different approaches for deciding portfolio weights to the different factors, but the key questions are whether the investor or the manager has any skill in predicting which factors will perform better or worse than others over the long term or whether there is any ability to predict when each factor will perform better or worse.”

”In the absence of any desire to try and predict performance, then portfolio construction uses equal return expectations and becomes driven by the correlations of the factors, usually with the aim of maximising diversification. One of the nice things about well-constructed alternative risk premia factors is that the historical correlations between them tend to be pretty stable, and portfolio allocations tend to reflect this.

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”The other school of thought says that varying exposures to the different factors can add significant value. The challenge here for investors is assessing whether there is actually any skill in predicting the better or worse performance periods for individual factors. A more dynamic portfolio construction approach can be guaranteed to add trading costs, regardless of whether it improves performance.”

Beware of correlation spikes

Although correlations historically between alternative risk factors have been low, there is always the risk of them spiking in the shorter term, putting assessments based on longer term patterns to the test.

”Just as with any model, it is important to understand the potential for mis-estimation. Typically this means that one shouldn’t believe correlations are as low as they may appear to be from estimates based on historic data, there is always the potential for correlations to spike in ways which haven’t been seen before in history so a conservative approach makes sense. Assume correlations might be higher than they have been, and take this into account when building the portfolio”, Reeve says.

”Understanding the consequences of a correlation spike is also important. Our risk management systems have a range of different ‘stressed’ measures which use both historic scenarios and synthetic stressed data to model what the impact of a tail event might be. Integrated risk limits and caps also help keep overall leverage under control. This overall risk management is another benefit of running an integrated multi-premia portfolio.”

On recent performance of ARP-strategies

Reeve argues that the main attractive feature of factor strategies is their potential to perform in most different market environments and their independence from traditional assets. However, this also means that they can experience their periods of underperformance at different times, and the recent period has proved difficult for most alternative risk premia portfolios.

”We haven’t seen all factors struggling at the same time as a result of the same events or market conditions. On the whole they have maintained their independent performance but struggled at different times for different reasons.

”Momentum-based factors unsurprisingly struggled in the sharp market reversals earlier in the year, as did most volatility risk premia. Cross-sectional value factors in equity markets have also suffered, but it has been a great example of the dispersion in performance which is possible between factors and even between different versions of what are ostensibly the same factor.”

”Other factors operating in cash equity markets such as quality, momentum and growth have performed well. The recent period has emphasised to us the importance of having exposure to a well-diversified range of different factors in the different asset classes”, he concludes.