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Investors still stalwart despite 2018 setback

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Brett Kramer

Reino G. Ecklord Jr. is taking a hard look at what happened in 2018.

Institutional investors are taking a hard look at their alternative risk premium strategies after poor performance in 2018.

Managers of the actively managed multiasset, long/short, factor-based strategies favored by asset owners as portfolio diversifiers suffered last year from what sources said was a rare combination of an unfavorable macroeconomic environment, anxiety about rising inflation and heightened market volatility, which affected returns.

Wide-scale redemptions of alternative risk premium strategies by asset owners haven't surfaced, but investment consultants said a number of chief investment officers and their teams are conducting behind-the-scenes reviews in advance of presentations to their boards of trustees.

Among the institutional investors holding firm on their investments are the $31.1 billion South Carolina Retirement Systems, Columbia, and the $16.8 billion Hawaii Employees' Retirement System, Honolulu.

“Asset owners are examining why they invested in alternative risk premia strategies because they are frustrated by 2018 results,” said Reino G. Ecklord Jr., Chicago-based research consultant, hedge funds at NEPC LLC.

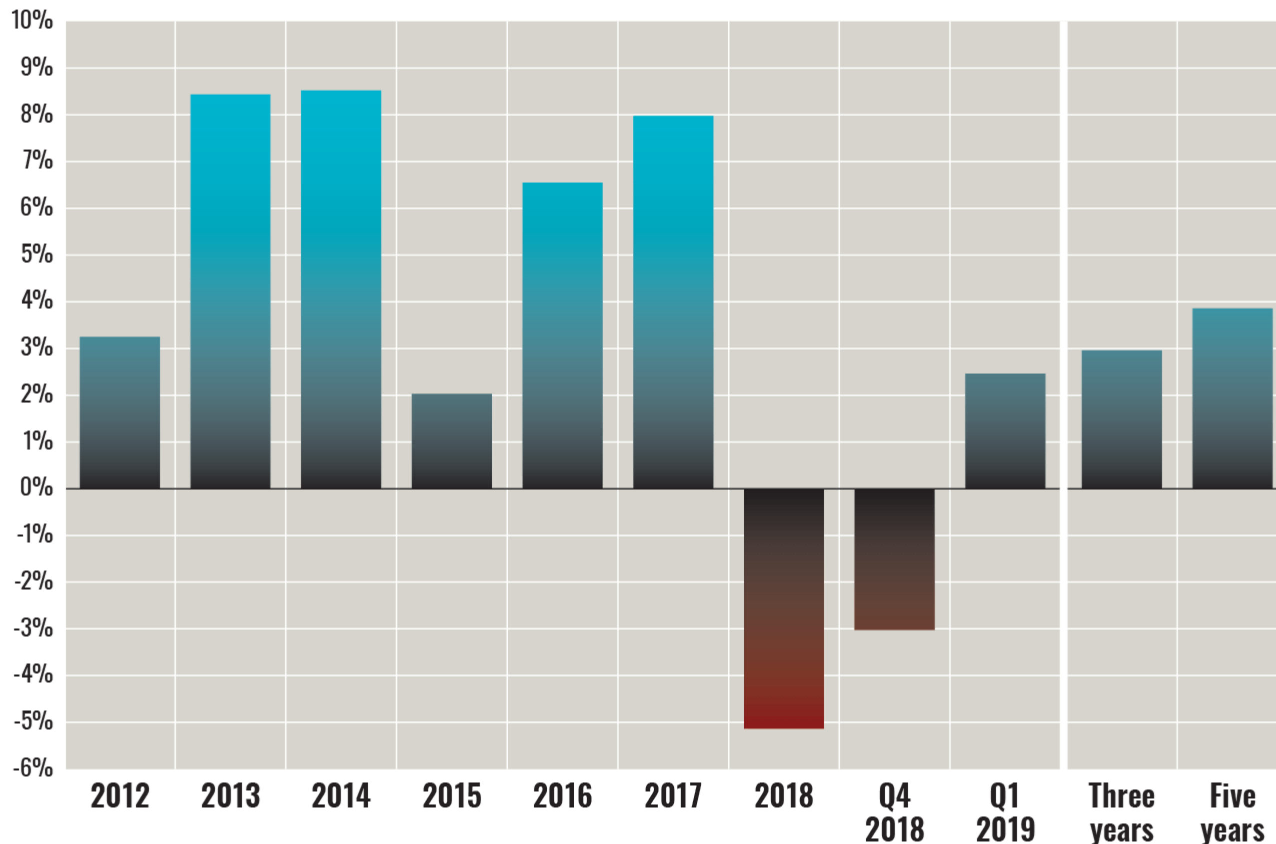
“Clients are revalidating their commitment to these approaches. There has been a pretty constructive level of examination and dialogue,” Mr. Ecklord said.

He stressed that long-term investors such as pension funds, endowments and foundations “need to be sanguine about alternative risk premia strategies in all market conditions because they can exhibit short-term variance.”

Performance in 2018 was disappointing, sources agreed, with a -5.14% average return compared to 7.98% in 2017 for the 22 alternative risk premium strategies in the investment database maintained by eVestment LLC, Marietta, Ga.

Returns of alternative risk premium strategies improved to an average 2.46% in the first quarter of 2019 compared to a -3.02% return in the quarter ended Dec. 31, the eVestment analysis showed.

Institutional investors are frustrated because for many, the primary motivation for investing in multiasset alternative risk premium strategies is the diversification they provide to reduce risk from traditional asset classes, said Kevin Machiz, vice president in capital markets research for investment consultant Callan LLC, San Francisco.



'Diversification did not pay off'

The problem, Mr. Machiz said, is that "2018 was a year when diversification did not pay off for all strategies, both traditional and alternative risk premia."

Many alternative risk premium strategies focus on four factors — value, momentum, carry and defensive — and in other years, "a big drawdown in one factor usually is offset by others that are doing well," he said. But he noted that in 2018, none of the factors did well.

Callan clients currently invested in alternative risk premium approaches have not redeemed their investments because after reviewing their portfolios, "many have conviction that the strategy isn't broken and that there's light at the end of the tunnel," Mr. Machiz said.

The incorporation of the strategies as a diversifier in institutional portfolios often manifests as a less expensive, more transparent, liquid substitute for all or part of a hedge fund allocation, NEPC's Mr. Ecklord said.

He said investors can tap into a range of strategies that invest long and short across all four of the typical factors to produce a market-neutral portfolio that replicates a hedge fund.

The average fee of for alternative risk premium strategies is a flat 100 basis points compared with hedge funds' typical 1% or 2% management fee and 10% or 20% performance fee, Callan's Mr. Machiz said.

Other sources said the fee range for multiasset alternative risk premium strategies is 50 to 150 basis points.

The South Carolina Retirement System Investment Commission, Columbia, which manages the systems' investment portfolio, achieved significant cost savings by replacing some hedge funds with alternative risk premium strategies.

In 2017, the retirement system awarded $300 million to Wellington Management Co. LLP and $200 million to Man Group PLC to manage in alternative risk premium strategies, replacing part of the system's hedge fund portfolio. Manager fees are 110 basis points and 95 basis points, respectively.

The alternative risk premium strategies are part of the fund's $3.1 billion portable alpha portfolio, along with hedge funds with total assets of $2.6 billion.

While disappointed by the estimated -4.38% return of its alternative risk premium strategies in 2018, CIO Geoffrey Berg noted in an email that it's “not very different” from the -4.03% return of the HFR Fund of Funds Composite index, a hedge funds-of-funds index.

“These strategies are meant to be an uncorrelated alpha source for our portable alpha program. We see them as similar to multistrategy hedge funds,” Mr. Berg said.

The retirement system doesn't track hedge fund returns separately, Mr. Berg said. The composite return of the portable alpha portfolio, including alternative risk premium and hedge fund returns, was 2.68% in 2018.

Mr. Berg said pricing for alternative risk premium investments is efficient and much cheaper than hedge fund fees, noting that an alternative risk premium manager that returns 7% gross and charges a flat 1% fee provides the investor with a 6% net return. By contrast, a hedge fund manager would have to generate a gross return of at least 9.5% to achieve a 6% return for the investor after netting out a 2% management fee and 20% performance fee.

Mr. Berg did express disappointment that the retirement system didn't meet or exceed its benchmark of three-month U.S. Treasury bonds plus 250 basis points for the alternative risk premium portfolio in 2018, but stressed “this is a very short period of time to judge performance.”

He added: “On a positive note, the month of December provided us with a small glimpse into how our mix of alternative beta strategies would behave in a market sell-off. During the December sell-off, our alternative beta portfolio generated a positive return while equities lost 9.03%.”

Risk mitigation portfolios

Other asset owners incorporate alternative risk premium strategies with other defensive strategies to create risk mitigation portfolios.

The $2.5 billion crisis risk offset portfolio of the Hawaii Employees' Retirement System, for example, combines an alternative return capture portfolio (40%), systematic global macro funds (35%), and long-dated U.S. Treasury bonds (25%). The portfolio has a 15% target weighting in the overall portfolio and was launched in March 2017.

Howard M. Hodel, investment officer, risk management, and his staff conducted a year-long review of the crisis risk offset portfolio and in March restructured the alternative return capture subportfolio, which includes alternative risk premium strategies and systematic global macro managers.

The biggest change was a move to highly customized alternative risk premium strategies built to the plan's specifications regarding underlying investment factors by ARP Americas LLC and Lombard Odier Investment Managers. The managers were hired at the end of March and funded with just over $200 million each, Mr. Hodel said.

The change was made to reduce the directionality and correlation to equities within the alternative risk premium portfolio, Mr. Hodel said.

Assets were moved out of a customized alternative risk premium strategy managed by Mellon Investments, which managed $100 million as of Dec. 31. Mellon remains on the approved manager list for alternative risk premium strategies, Mr. Hodel said, stressing that the shift of assets was made purely because of the fund's change in investment approach.

As of Dec. 31, the return of Mellon's risk premium strategy was -0.53% for the quarter and 1.3% for the year. Despite last year's poor performance, consultants said institutional investor demand remains steady and searches and hires for

alternative risk premium strategies continue.

CalSTRS set to finish

One of the world's largest pension funds, the $227.8 billion California State Teachers' Retirement System, is set to finish the buildout of its $20 billion risk mitigation portfolio with the hire of two systematic alternative risk premium managers this year. The two firms will split management of 5% of the portfolio, about $1 billion in current dollars.

CalSTRS has hired managers for the other strategy components of the portfolio: long-duration U.S. Treasury bonds (40% weighting), trend-following (45% weighting) and global macro (10% weighting).

Michelle Mussuto, a spokeswoman for the West Sacramento-based pension fund, declined to comment on the status of the manager appointments because trustees haven't considered the hires.

The £28 billion ($36 billion) Brunel Pension Partnership, Bristol, England, is researching multiasset diversified growth funds that may include alternative risk premium strategies to add diversification to temper equity risk within the portfolio.

The fund issued a request for information about diversifying strategies and is in the “early stages” of designing the strategy, said David Cox, head of listed markets.

He said the investment team is considering the addition of alternative risk premium strategies. “We do think this is a very interesting area and will have a clearer idea of our own views when we've progressed in our research in a couple of months.”

Brunel has earmarked slightly less than £2 billion for the new diversification portfolio and will begin the search for managers midyear.

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