

Interview: SEB's Otto Francke on the new Alternative Risk Premia fund

Stockholm (HedgeNordic) – In May of 2015, SEB launched a new fund called SEB Alternative Risk Premia. The idea is to offer a vehicle that allows investors to benefit from the same return drivers that regular hedge funds capture, albeit to a significantly lower fee.

HedgeNordic took the opportunity to ask the fund's portfolio manager, Otto Francke, what he believes the new fund has to bring to the universe of alternative investment funds.

HedgeNordic: What is it that you aim to achieve with the fund, how do you define risk premia?

Otto Francke: I believe risk premia goes to the core of what asset allocation is all about. Typically you as portfolio manager are rewarded by the market for taking risk. Provided that they offer a positive expected return you want to find and expose your portfolio to as large a set of uncorrelated risks as possible under the old and commonplace premise that diversification is the only free lunch.

When I was growing up I was constantly bombarded by the plate of food model. A balanced meal should be composed of meat, potatoes and vegetables. While the half-life of dietary recommendations these days seems to be counted in months or even weeks rather than years it is interesting to note the shift in focus. If you think about the nutrients that a well-cooked Sunday steak has it includes protein, fat, vitamins, iron etc. Diets these days talk about how much protein to eat, what type of fat is good for you, whether or not to eat carbohydrates etc. In terms of investing the classic plate of food model for portfolio construction is to have a large allocation to equities (equity risk premia) and bonds (duration or credit risk premia). In addition to these traditional risk premia there is also an allocation to alternative investments or active managers thrown in for spice or diversification. However, to continue the meat analogy the equity portfolio can be broken down into "nutrients" as well. These equity nutrients include factors such as value, quality and momentum. One can say that risk premia are to investing what nutrients are to food.

In their search for returns in excess of the traditional premia earned by investing in a particular asset class investors have historically turned to active investment managers to provide an additional alpha over and above their benchmark. However, research has shown that some of the active returns generated by these managers which was previously considered alpha or skill can in fact be explained by exposures to common investment styles and systematic market factors. Some of these market factors can be referred to as "alternative" risk premia.

The Alternative Risk Premia Fund seeks to provide our investors with attractive risk-adjusted returns combined with low correlation to traditional asset classes by investing in these alternative risk premia.

Alternative risk premia strategies are typically systematic and rule based and can be implemented globally through investments in a wide number of asset classes including equities, fixed income, foreign exchange, credit and volatility.

HedgeNordic: Could you explain how the fund is exposed to different risk factors and how it is possible for you to create this exposure to a lower fee compared to the typical hedge fund.

Otto Francke: Many hedge fund strategies are based on or include exposure to alternative risk

premium strategies and many investors have thus gained exposure to these types of strategies through their hedge fund allocation. Examples of such strategies include a global macro manager pursuing an FX carry strategy i.e. buying high yielding while selling low yielding currencies, a long/short equity manager tilting his portfolio towards value stocks or a merger arbitrage manager buying shares of target stocks while selling short the acquirer. All of the above mentioned strategies can be replicated in a systematic manner providing cost-efficiency, liquidity and transparency for the investor.

This is not to say that hedge fund managers fail to add value, the good ones do. It is more to say that an investor should pay for skill rather than for beta. And as investors start to include alternative risk premium into their framework for what constitutes skill or not the alpha component in a hedge fund managers return falls.

HedgeNordic: Is the investment strategy fully systematic?

Otto Francke: The alternative risk premium in which we invest are typically completely rule based and systematic. Our portfolio construction process is systematic with some qualitative input.

HedgeNordic: Are the underlying models developed by SEB or is alpha generation outsourced?

Otto Francke: We try to find good strategies on both a stand-alone basis and from a portfolio point of view. An important part of this research is finding the best supplier to provide our exposure. Sometimes this is outsourced to external parties who might be better or more cost-efficient than if we were to manage them ourselves.

HedgeNordic: What is a reasonable expectation to have on the return profile of the Alternative Risk Premium Fund?

Otto Francke: In the Alternative Risk Premium Fund we aim to generate returns of 6% p.a. in excess of the risk free rate with a volatility of 5-6% independent of the level of interest rates.

HedgeNordic: Is there a risk that the strategy relies too heavily on historical data and fails to account for sudden correlation spikes between different asset classes and sources of alternative risk premium?

Otto Francke: When back-testing and evaluating the track-record of a given strategy it is necessary to do so with care and a large chunk of skepticism. As the data can be full of biases we strive to find fundamental reasons for why a strategy should work, ask ourselves where the hidden risks might be, what type of investor might be taking the other side of strategy and why they would be willing to give up these returns to us.

In our portfolio construction we strive for diversification, weighting each strategy by its contribution to risk while taking into account that certain strategies might have a degree of tail risk inherent in them. Based on qualitative and quantitative criteria we set potential drawdowns for each strategy under stressed scenarios. We then optimize with the aim of not losing more than -4% on portfolio level under a normal market cycle while not losing more than -10% under infrequent but potentially severe volatility in the markets such as during 2008.

HedgeNordic: Who is the strategy suitable for? What investment horizon should you have?

Otto Francke: The strategy is suitable for investors seeking a cost-efficient and liquid addition to their portfolio to complement their equity and bond investments. Finding alternative sources of return is particularly attractive in today's environment of high equity volatility and low interest

rates. I believe the strategy is suitable as a base allocation over an investment horizon in excess of one year.

HedgeNordic: In what market environment does the strategy do well?

Otto Francke: We manage the portfolio to have low correlation to equities and bonds with the aim of generating positive returns in normal market environments with both upward trending and slowly downward trending markets.

HedgeNordic: What makes SEB's alternative risk premia fund unique to other similar fund offerings?

Otto Francke: While many of the larger pension funds have started to invest in alternative risk premia this is resource intense and requires substantial investments in research and infra-structure. The Alternative Risk Premia Fund is one of the first in its kind to be launched in a UCITS format. One of the key differences that we have noticed in our investment process is our focus on including premia with low correlation to traditional asset classes. Our philosophy is that our investors can gain a more cost-effective exposure to for instance equity market risk in other formats.