Honey, I hedged the premia…!

Stockholm (HedgeNordic – Teaser) – Alternative risk premia have been a widely covered topic in the last decade. The idea of allocating across risk factors instead of traditi onal asset classes is gaining traction and the market is flooded with various product off erings in the alternative beta space. Hedging against risk premium exposures, as we do at IPM Informed Portfolio Management, is therefore sometimes perceived as odd, not least since we also support risk premium investing and believe that, properly handled, it is capable of increasing allocati on efficiency. Below we try to shed some light on why we think it is a good idea to hedge against the golden goose.

In the context of modern portfolio theory, a risk premium represents the expected excess return for bearing risk that cannot be eliminated via diversification. Although this premium may vary over time, it can neither disappear nor be arbitraged away. It is a compensati on for accepti ng and maintaining exposure to a specific and persistent source of risk. Originally viewed as a reward for bearing volati lity risk in traditi onal asset classes, such as holding equiti es over bonds or bonds instead of cash, the concept of risk premia has evolved over time. With the introducti on of the Fama & French value, size factors and a growing acceptance towards carry and momentum trading, risk could no longer simply be synonymous with plain volati lity. How was it that their returns could be generated without being accompanied by a corresponding increase in risk as we knew it? Early att empts at explaining this involved concepts such as “hidden risk factors” and gradually this line of thinking lead to a more generalized framework. These days, risk not only encompasses “tail events” but also sometimes transcends the realm of what we can quantiatively measure.

You can read the full article on pages 44-46 in the Special Report on CTA & Macro Strategies 2016.