

Will Alternative Risk Premia Replace Hedge Funds?

London (HedgeNordic) – At least 50 ARP strategies have launched in UCITS fund format, with others in '40 Act fund, ETFs or managed accounts. Some 62% of investors with over \$5 billion in hedge funds, were also allocated to risk premia as of July 2017, according to a Morgan Stanley Prime Brokerage report. Around \$300 billion is allocated to alternative risk premia, according to PIMCO, which is about 10% of global hedge fund industry asset of \$3 trillion.

Most ARP strategies are run by systematic and quantitative hedge fund managers, who also continue to run more traditional hedge fund strategies, charging higher fees. It would not make commercial sense to launch products with return profiles too similar to existing products. If ARP is about to render hedge obsolete, then these managers are cannibalising their own core business and making a terrible business decision. It seems improbable that they would want to commit commercial suicide.

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Replication - or doing something different?

ARP and hedge fund replication sometimes characterised as being the same thing, but they need not be. The argument that ARP will replace hedge funds is based on the premise that ARP can replicate hedge fund returns, with lower fees. This is open to question and many ARP strategies are not in fact being marketed as hedge fund replacements.

Promising to replicate hedge fund returns at lower cost is a naïve and dangerous way to try and sell ARP, which leaves managers hostage to fortune, because the objective is a moving target. Markets and hedge fund strategies are changing all the time. For much of the post-crisis period, correlations between and within markets have been unusually high, which has made it easier to devise a back-test “recipe” that generates returns similar to hedge fund returns. But correlation does not prove causation, and as financial market volatility and correlations start to normalise, there is more dispersion in returns, which may make it harder to copy them.

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ARP is anyway forcing hedge fund managers to articulate more clearly what differentiates their strategy. For instance, all equity market neutral managers who I have interviewed over the past year, have been keen to demonstrate that both their return profile, and their individual factors, are not correlated to the types of generic factors, such as value, quality, growth and momentum, that form the basis of some ARP equity strategies. Similarly, most CTAs are keen to show how they are different from a basic trend follower in terms of some non-trend models, holding periods, markets traded, execution methods, alternative data inputs and so on.

Capacity versus scalability

In simple terms, capacity-constrained strategies continue to command hedge fund fees, whereas more scalable strategies that can be accessed through ARP are seeing fee pressure. Many systematic managers, such as Alpha Simplex (who recently hired Katy Kaminski), Aspect, Crabel, Cantab/GAM Systematic, GSA, Fulcrum, Man Group, Pimco, Winton, offer a low-cost trend-following strategy, usually only charging flat management fees with no performance fees. These strategies may not be marketed as ARP, but are competing for allocations from fee-sensitive investors. They tend to have substantial spare capacity.

In contrast, some of the best performing CTAs are those strategies run by Man Group, Systematica, GAM Systematic/Cantab Capital, Aspect Capital, and Florin Court (seeded by Brummer and Partners) trading “alternative markets”, usually Over the Counter (OTC) markets or those on obscure exchanges that are harder to access. As some of these vehicles have little or no spare capacity, and long waiting lists of potential investors, they have no need to cut fees. I have not noticed any ARP launches offering access to these markets, partly due to the costs involved in developing a network of OTC counterparty relationships. Short term trading CTA strategies are also much less scalable.

Because many hedge fund strategies are not scalable, many of the largest hedge fund managers, also offer long only strategies, sometimes classified as “smart beta”, as well as ARP, which can be viewed as “alternative beta”. These can be complementary, rather than competitive.

A scale game

The idea of ARP displacing hedge funds does not fit in well with the commercial rationale for launching ARP strategies. Traditional hedge fund strategies make most profit from performance fees, and so will close to new investors in order to avoid diluting returns. Most ARP strategies do not earn any performance fee, and so are all about scale and asset gathering, which means they need to target the largest pools of assets.

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The global hedge fund industry only runs about \$3 trillion. Exchange traded funds (ETFs) running over \$4 trillion have already overtaken hedge funds and are growing much faster, so tapping into the ETF growth trajectory is more interesting for ARP managers. JP Morgan Asset Management has launched ARP ETFs. The global mutual fund market is even bigger, at over \$30 trillion, while pension funds run over \$40 trillion (according to the Willis Towers Watson Global Pension Assets Study 2018). Attracting even small slices of these markets works out at much more assets than taking a large bite of the hedge fund market. ARP assets could grow to trillions and become much bigger than hedge fund assets, but need not substitute hedge fund allocations.

Gaps in ARP offerings

Most ARP strategies I have seen are based on the same broad strategies as systematic and quantitative hedge funds. How could an activist strategy, such as those run by Cevian Capital or Accendo, that involves years of close engagement with a small number of companies, be replicated? I have also yet to see many ARP doing strategies such as merger arbitrage, credit long/short, and distressed debt. These strategies may require more discretionary analysis of unique legal

documents, regulatory and legal processes such as anti-trust, and multi-year creditor restructurings that entail active involvement in committees. Asset backed securities (ABS) strategies investing in mortgage securities also require much analysis of individual issues.

The merger arbitrage ETF with ticker MRGR has lost about 5% over the past five years, during which time the average merger arbitrage hedge fund manager has made low single digit annual returns – the Credit Suisse Risk Arbitrage index is up by about 20% over the same period. Deal breaks have caused losses for those following a “scattergun” approach of holding all companies subject to takeover offers, and this clearly suggests that it may not be easy to replicate all types of hedge fund strategies.

Liquidity and illiquidity premiums

Most ARP strategies are highly liquid and offer daily dealing, whereas many hedge fund strategies have monthly or quarterly dealing, or even multi-year lock-ups to align with their multi-year holding periods for investments. Some hedge fund strategies, such as direct lending and distressed debt, are explicitly designed to pick up illiquidity premiums, and may tailor deal structures to each individual borrower.

Conclusion

In long only investing, the “passive versus active” debate is a false dichotomy because most large institutional investors use both types of products for different strategies or asset classes. For instance, they might use an index tracker for a relatively efficient market such as large cap US equities, but use active managers for less efficient markets such as small cap equities, European equities, fixed income and credit.

Similarly, other allocators may use ARP strategies to the extent that they want exposure to “plain vanilla” trend-following, and other relatively simple and scalable risk premiums, while using hedge funds at full fees to access less scalable strategies, alternative markets, less liquid markets, and strategies that require more human discretionary input.

Fee-constrained investors may only be able to use ARP to access alternatives, while other investors might view ARP and traditional hedge fund strategies as complementary- and allocate to both types.

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