Alternative Risk Premia: Nordic Experiences and Expectations

(Partner Content From Kirstein) – Copenhagen-based consultancy Kirstein in this article outlines institutional investors' experiences and expectations from investing in alternative risk premia. Results and conclusions are solely based on proprietary research carried out by Kirstein and from conversations with Nordic asset owners in the first part of 2019.

Background

Investment opportunities from alternative risk premia has been vividly discussed for a long time among Nordic investors, but is also an area which in recent years has seen notable inflows from the institutional investment community. Looking back, the first generation risk premia solutions seemed quite simplistic and investors often took an outset in the 1970's research by Eugene Fama and Kenneth French. Today, the market for risk premia has evolved profoundly, and there seems to be a quite strong division between how investors carry out allocations. On the one hand side, investors will either use dedicated factor strategies (style, size, low volatility etc.), whereas the more advance players utilise quite advanced solutions across multiple asset classes and often implement leverage to make the most out of the factors.

When discussing factor investments with Nordic investors today quite often quant and risk premia investments are interrelated topics. For the same reason, a number of investors are still hesitant towards moving all in in light of how many quants broke down during the GFC.

Current exposures to ARP

A rough estimate based on our research indicates that around EUR 110bn are allocated to risk premia strategies. It is obviously important to note for the asset management community, that a substantial share of these assets is managed internally by the institutions. The largest investors in our research (AUM exceeding EUR 25bn) manage around 97% of the risk premia allocation internally, while smaller investors tend to outsource around 35%. Over time, we expect that the growing migration into more complex risk premia may support greater outsourcing levels.

Overall, the most common approach to risk premia strategies are via long only equity strategies and this is also the area in which the majority of investors expect to increase risk premia allocations going forward.

Why ARP matters to investors?

From conversations with the Nordic Investors, two prominent reasons for implementing alternative risk premia solutions to portfolios are often mentioned to be 1) low correlation to traditional asset classes and 2) an opportunity to generate better risk adjusted returns. In years with high market volatility as well as investment environments which are expected to change for the worse, alternative risk premia strategies are by more and more investors expected to be the solution.

An important trend among Nordic investors has been the focus on driving down costs of external management, and in this game, an increasing number of investors have perceived alternative risk premia as a cost efficient alternative to traditional long only management—and classic hedge funds for that matter. An interesting development has also taken place among a number of Nordic insurance companies, which have in previous years implemented risk premia strategies in a quest to optimise allocation constraints under Solvency II. Although risk premia is not perceived as a solvency-optimal solution per se, a number of insurers are still working with managers in this area. Furthermore, a number of Nordic asset owners mention that systematic investment approaches provide an easier and more effective way of managing risk in the portfolio.

What factors are in favour?

Since the early days of factor investing, factors have become numerous and more exotic year by year. Relating this to conversations with the surveyed investors, there seems to be a rather high degree of overlap between the factors that are currently considered by the investor community to what is offered by the asset management community. Less seasoned investors will often only look at a few factors, whereas the more experienced investors will look at a wide variety of factors, from conventional factors to alternative and even illiquid risk premia.

The most preferred factor not least among smaller investors is value. Value has been the best performing factor in equities over the long run whereas value has proven to be less reliable in fixed income. The preference for value is deeply rooted across different investor types and sizes. Quality is preferred by many investors followed by defensive (low volatility) and momentum. Least preferred is dividend yield, which typically relates to equity whereas the same factor in disguise, carry, seems to be in favour when dealing with fixed income strategies.

As a consequence of this proliferation of factors, the vast number of available factors could suggest that it might be better to have more factors than less. That said, there seems to be little consensus today among institutional investors to how many, and more importantly which factors that will provide the best returns, diversification etc. in the years to come.

Main concerns

Many investors mentioned that they are concerned about crowding in academic risk premia which consequently should have led to overly rich valuations of securities with the desired characteristic. These comments were probably influenced by the wide performance disparities and generally disappointing results for risk premia strategies in 2018. In this context, interest in newer kinds of risk premia is quite logical.

Investors across the Nordics mention that the ease of implementation is also a key focus, pointing to the very important point of slippage. The return from different risk premia tends to be rather slim, and therefore the cost of implementation can be crucial for in order to generate decent returns from risk premia strategies. Hence, investors believe the best managers have a very disciplined and direct focus on implementation.

Conclusion

So, in conclusion, it seems rather clear that risk premia is gaining traction both in single-factor long-only portfolios, but also in multi-asset, multi-factor long-short portfolios. Today, investors tend to prefer the traditional academic risk premia such as value, small cap, etc., but are at the same time concerned by possible overcrowding and therefore lower returns within this space. This may lead to the search for new and potentially less crowded risk premia. Rather interestingly, the long-only factor portfolios to a large degree seems to substitute both fundamental active managers, but also passive investments whereas the long-short portfolios are added to the investors’ portfolios to obtain uncorrelated returns in a low yield and high valuation environment.