Poor Expectation Management by ARP Funds

Stockholm (HedgeNordic) – Alternative risk premia funds, which employ a ruled-based approach to harvest risk premia such as value, quality or momentum, have attracted increased interest on the promise to deliver hedge fund returns in a liquid, cost-efficient and transparent form. There was a lack of diversification benefits from alternative risk premia strategies particularly in 2018 and many of these funds underperformed traditional assets in the past three years, according to research from investment consultancy MJ Hudson.

According to MJ Hudson, which surveyed 34 asset managers offering diversified multi-asset alternative risk premia funds that account for the majority of assets managed in this market, alternative risk premia funds had an average excess return over cash of 1.5 percent in 2019. According to MJ Hudson's Alternative Risk Premia Fund Review 2020, "equity factors were a key source of underperformance in 2019." The excess returns delivered by surveyed funds in 2019 ranged from a negative 17 percent to 12.4 percent, with the median fund returning about three percent in excess of cash.

The report points out that "over a three-year horizon, ARP strategies have underperformed traditional assets." The returns, however, are commensurate with those of liquid alternative investment benchmarks. A subset of 18 funds with a track record of at least three years delivered an average annualized excess return over cash of essentially zero for the period of 2017 to 2019.

Alternative risk premia funds were hit particularly hard by the coronavirus-induced broader market sell-off in the first quarter of 2020. According to the Financial Times, less than 20 percent of alternative risk premia funds tracked by MJ Hudson generated positive returns year-to-date, with the worst-performing fund falling by 25.5 percent.

According to own research by Antti Suhonen *(pictured)*, a senior advisor at MJ Hudson and Professor of Practice in Finance at Aalto University School of Business in Helsinki, alternative risk premia funds lost 7.6 percent on average since the start of 2020. Quoted by the Financial Times, Suhonen warns that the poor returns generated by alternative risk premia funds in 2020 would give already-disappointed investors further reason to question their effectiveness.

"Alternative risk premia funds clearly face a challenge in justifying their existence," said Suhonen. According to Suhonen, rosy performance simulations combined with "poor expectation management" led investors to wrongly perceive alternative risk premia funds as a hedge against tail risk.

Evli Factor Premia, a member of the Nordic Hedge Index engaged in market-neutral factor investing across asset classes, performed strongly in the turbulent first quarter of 2020. The fund managed by Finnish asset manager Evli gained four percent in the first quarter and is up 5.3 percent year-to-date through April 27. Just like many other alternative risk premia funds, Evli Factor Premia had a difficult 2018, when several factors underperformed at the same time.

Image courtesy of MJ Hudson.