HEDGENORDIC

OCTOBER 2018

Challenging the Value of Hedge Funds

Will Alternative Risk Premia Replace Hedge Funds?

Should Investors Consider Alternative Risk Premia?

Drawing the Lines: What is ARP, and What is it not

ALTERNATIVE RISK PREMIA

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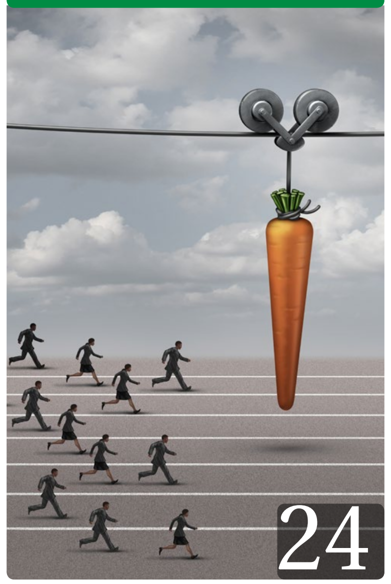

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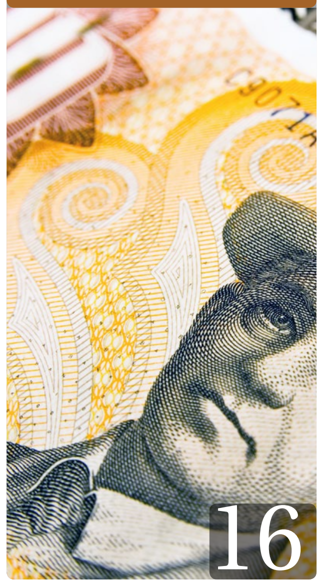

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INTRODUCTION

HedgeNordic is the leading media covering the Nordic alternative investment and hedge fund universe. The website brings daily news, research, analysis and background that is relevant to Nordic hedge fund professionals from the sell and buy side from all tiers.

HedgeNordic publishes monthly, quarterly and annual reports on recent developments in her core market as well as special, indepth reports on "hot topics".

HedgeNordic also calculates and publishes the Nordic Hedge Index (NHX) and is host to the Nordic Hedge Award and organizes round tables and seminars.

NordSIP is a leading news website focused on Sustainable Investment viewed from the Nordics.

The site brings together institutional investors, fund managers and third party service providers concerned with ESG. News, opinions, interviews and analysis are provided are showcased on a daily basis.

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Editor´s Note...

There´s a new kid on the block...

"Build a better mousetrap, and the world will beat a path to your door."

Ralph Waldo Emerson, American philosopher (1803 –1882)

Investors have always been seeking possibilities of achieving a measure of downside protection, accessing differentiated exposures and identifying truly uncorrelated, complementary sources of return. In addition to conventional ways to modify multi-asset portfolios through incorporation of liquid alternatives, such as hedge funds and CTAs, there has been an increase in the number of investors seeking newer ways to improve their portfolios. Alternative risk premia is one of the solutions aimed at capturing such diversity in return drivers. And indeed, among the earliest adopters of alternative risk premia strategies included sophisticated institutions, such as the Nordic pension funds.

Alternative risk premia (ARP) investing has grown in popularity and has become one of the industries buzz terms. But what exactly does it involve, and what should investors look for when considering which alternative risk premia strategies to invest in? In this paper we touch on the theory behind alternative risk premia as well as discuss some of the practical considerations that should help investors get the most out of their allocation to these innovative investment strategies.

The idea behind investing in anything is that it should reward you through a return for the risk involved in making that investment. Traditional risk premia, such as the equity risk premium – the reward associated with investing in the equity markets – are well known by investors. The duration premium and credit premium associated with investing in government and corporate bonds respectively are also widely understood. When these risk premia are added to an (in my opinion) illusionary risk-free return they constitute the total return associated with holding such an asset.

Alternative risk premia are more complex to harvest than traditional risk premia and tend to be extracted using methodologies typically used by hedge funds.

By applying long-short and leveraged portfolio construction both within and across asset classes a distinctive characteristic is that they Alternative risk premia usually have a relatively low correlation with traditional risk premia. While they still have some degree of exposure to macro risk factors, alternative risk premia are exposed to a broader set of risk factors such as investment styles (e.g. value, carry), behavioural biases (e.g. herd behaviour) and investor constraints (e.g. leverage constraints, limits on sub-investment grade bonds exposure) and many, maybe countless, others.

Alternative risk premia also differ from other popular investment strategies in the industry. They differ from smart beta, which are long-only portfolios that apply alternative weighting schemes. One of the main drivers of returns, arguably, within ARP is the possibility to be long or short. We have, however, dedicated an entire article to this distinction in this report as the comparison of alternative risk premia and smart beta is the first trap novices to the subject step into, by reflex.

Secondly, ARP also differ from the traditional alternative managers, such as hedge funds. Hedge fund typically do provide exposure to some of these alternative risk premia.

A main distinction here may be, a hedge fund investment comes with the promise of pure alpha (non-systematic returns), while alternative risk premia investing generally offers cost reduction and a significant improvement in transparency and liquidity.

So, is this new kid on the block, alternative risk premia, a threat to the hedge fund space, possibly a better, cheaper, faster, more transparent return generator – has the market come up with a better mouse trap?

KAMRAN GHALITSCHI
CEO & PUBLISHER HEDGENORDIC

Will Alternative Risk Premia (ARP) replace Hedge Funds?

By Hamlin Lovell, 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.

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

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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.

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 Alternative Risk Premia 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.

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 Alternative Risk Premia 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, to stick with Swedish examples, 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 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 Alternative Risk Premia 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 Alternative Risk Premia 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.

ARP assets could grow to trillions and become much bigger than hedge fund assets, but need not substitute hedge fund allocations.

By Graham Robertson, Partner & Head of Client Portfolio Management – Man AHL

SHOULD INSTITUTIONAL INVESTORS CONSIDER ALTERNATIVE RISK PREMIA STRATEGIES?

INTRODUCTION

Most investor portfolios tend to be dominated by equity market risk. While this has worked relatively well in the past few years given the sustained market rally from the lows of early 2009, the need for portfolio diversification is becoming ever more important.

With stock and bond prices being negatively correlated for nearly the last 20 years, many investors have gravitated to various segments of the fixed income market seeking some degree of portfolio protection. However, both stocks and bonds are currently at or very near all-time price highs.

As investors face potentially weaker returns and higher risk from traditional asset classes, they are increasingly turning to alternative risk premia (ARP) strategies – a relatively recent addition to the alternative investment landscape – in an effort to meet their goals.

In this paper, we aim to explain how the inclusion of an ARP allocation within a broader portfolio could result in a number of possible benefits, including diversification, better risk-adjusted returns than a typical 60/40 equities/bond portfolio, higher liquidity than traditional alternative investments and lower costs.

WHAT IS ALTERNATIVE RISK PREMIA?

To understand the possible benefits of risk premia, it is important to first explain what we mean by risk premia.

To help provide context, we have broken the investment universe into two high-level categories: beta strategies and alternative investments. We can further divide alternative investments into two subsections: alpha and alternative risk premia.

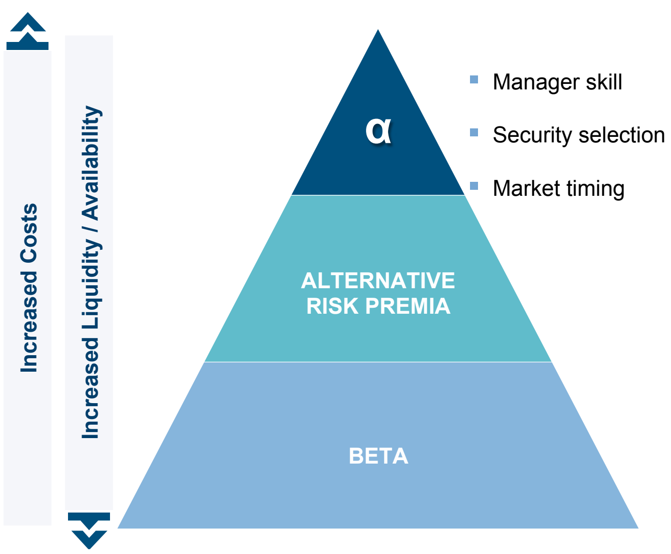
1. The first category is known as 'beta,' sometimes also referred to as 'traditional risk premia'. These strategies tend to own a traditional asset, such as equity or credit, and the investor is rewarded when the asset appreciates in value. These strategies often form the core allocation in investors' portfolios, but can suffer in market downturns as, being long only, they can only benefit if the asset rises with no way to provide downside protection.

2. The second category is called 'alternative investments'. These strategies rely on additional trading techniques such as shorting, balance sheet management, market timing, advanced execution techniques and active risk management. The use of these techniques – largely pioneered by hedge funds – can be used to create a return stream that does not just depend upon prices appreciating, but also has the ability to generate returns when the asset sells off, and so can add powerful diversification to an investor's portfolio.

a. 'Alpha' strategies are a type of alternative investment which rely upon the expertise and skill of a manager to deliver a real investment edge to the investor. For example, these managers will use their deep insight, research skill, market access skills (e.g. to access difficult to trade markets such as local emerging market debt) or utilise highly advanced quantitative techniques in an effort to create an idiosyncratic return stream.

b. There is a second set of alternatives strategies commonly called 'Alternative Risk Premia'. These strategies tend to either 1) avoid trading the less liquid more difficult to access markets; or 2) not rely upon huge amounts of intellectual capital or deep research into single names or highly proprietary mathematical techniques. Due to their less complex nature, these strategies are generally cheaper to execute and implement. Furthermore, this relative simplicity makes them highly suitable for rules-based or systematic implementation.

FIGURE 1: WHERE DOES ARP SIT?



Source: Man Group. For illustrative purposes only.

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THE DIFFERENT ARP STRATEGIES

There are four broadly recognised types of ARP strategies:

• **Momentum** exploits the fact that trends in asset prices in either direction tend to continue for periods of time. This approach can be very useful during large market corrections as the strategy is able to profit from both the market sell-off and the rally in haven assets.

• **Carry** collects premia for holding assets when their prices are stable. An example is in fixed income, where an investor is potentially rewarded for owning an instrument as the instrument collects coupons and rolls down the interest rate curve as time passes.

• **Value** collects premia associated with the fact that relatively cheap assets may outperform relatively expensive assets (e.g. revert to fair value).

• **Defensive** has the potential to offer some sort of protection on the downside. An example would be a long-short equity portfolio with zero equity beta. This portfolio would buy stocks exhibiting less price volatility and sell short stocks with higher volatility. In times of market stress, it is likely that the more volatile stocks perform worse than the less volatile ones due to greater investor uncertainty.

At Man Group, our ARP strategy utilises the above framework to target eight sources of excess return potential (as shown in Figure 2).

FIGURE 2: MAN GROUP'S STRATEGIES

Strategy[1]	Investment Aim	Risk Premia				Asset Class				Strategy Experience
		Mom.	Carry	Value	Def.	Equity	FI	FX	Com.	
Momentum	Seeking to capture trend following momentum across multiple markets	✓				✓	✓	✓	✓	1987
FX Premia	Seeking to capture non-momentum FX risk premia across liquid market currencies		✓	✓				✓		1992
Fixed Income	Seeking to capture risk premium associated with yield curve carry		✓				✓			2007
Volatility	Seeking to capture risk premium associated with volatility surfaces		✓			✓				2006
Equity Value	Seeking to capture equity risk premium arising from valuation inefficiencies	✓		✓		✓				1989
Equity Size	Seeking to capture small cap and quality premia across developed markets			✓	✓	✓				2010
Equity Quality	Seeking to capture equity quality premia across developed markets				✓	✓				2004
Low Beta	Seeking to capture risk premium associated with low beta stocks				✓	✓				2014

Source: Man Group Database. As at 30 April 2018.
Any descriptions or information involving investment process or strategies are provided for illustration purposes only, may not be fully indicative of any present or future investments, may be changed at the discretion of the investment manager and are not intended to reflect performance.
1. The listed strategies are as follows: Momentum = Alt Beta Momentum Strategy Ltd; FX Premia = AHL FX Premia Master Ltd. (Alt Beta FX Carry Strategy was renamed AHL FX Premia Master Ltd and re-purposed on 30 April 2018); Fixed Income = Alt Beta Fixed Income Strategy Ltd; Volatility = Alt Beta Volatility Strategy Ltd; Equity Value = Alt Beta Equities Strategy Ltd; Equity Size = Alt Beta Equity Size Strategy Ltd; Equity Quality = Man Numeric Alternative Risk Premia Quality; Low Beta = Alt Beta Low Beta Strategy Ltd. Please note these strategies are not available for separate investment.

Why have we chosen these eight risk premia strategies? There are two main reasons for this:

First, these risk premia strategies have historically shown to have had low correlation to one another. So, whilst any individual ARP strategy could go through a difficult period due to various underlying factors, the low correlations suggest that the other ARP strategies would not be impacted in the same way by these same factors.

Second, these ARP strategies typically tend to have a low correlation to traditional assets. This is important if investors are looking for sources of diversification to traditional risk premia. Additionally, because we anticipate that an ARP strategy would generally have a low correlation to traditional asset classes, it has the potential to improve risk-adjusted returns when combined with them.

SHOULD INSTITUTIONAL INVESTORS ALLOCATE TO ARP NOW?

It's easy to see why many institutional investors have favoured a traditional portfolio consisting of equities and bonds given historic performance.

However, as Figure 3 shows, equities appear expensive: Price-to-earnings ratios were only higher in 2000 (pre the lost decade) and in 1929 (pre the Great Depression). In addition, bonds have limited upside: the tailwind from yield compression over the 1981 to 2016 period is unlikely to continue, in our view.

Given these lofty valuations and the typically uncorrelated nature of ARP strategies to traditional assets, we believe that their inclusion in a portfolio has the potential to enhance risk-adjusted returns.

Indeed, according to our calculations, Man Group found that the inclusion of 20% ARP in a hypothetical 60/40 equity/bond portfolio has the potential to increase the Sharpe ratio by 0.2 [2].

ADDITIONAL POTENTIAL BENEFITS OF ALLOCATING TO ARP

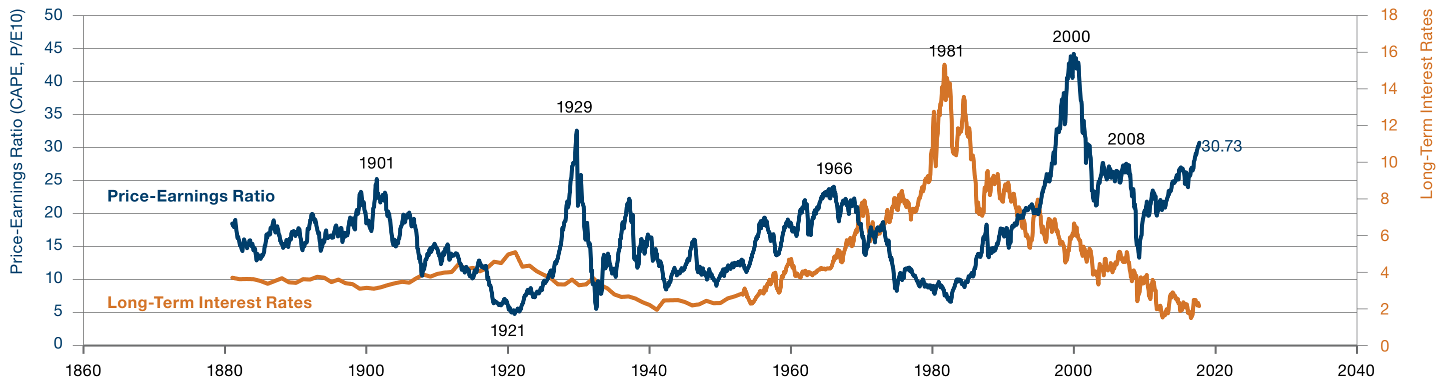
• **Low costs:** By avoiding strategies with high intellectual properties, costs can be kept low. This is an increasingly important part of the consideration for institutional investors.

• **Liquidity:** By trading only highly liquid markets, ARP strategies can usually be exited quickly, providing greater (usually daily) liquidity than conventional alternatives funds.

• **Transparency:** As they are less complex than traditional alternative investments and rely less upon intellectual capital, ARP strategies could provide a high degree of transparency that may assist with items such as regulatory reporting.

At Man Group, we observe that clients are using ARP for varying reasons:
• As a way of diversifying against or redeploying long-only assets in size;
• Fee constraints in relation to their alternatives portfolios;
• As a standalone holding replacing traditional diversifying strategies, i.e. individual hedge funds, funds of hedge funds and diversified growth funds.

FIGURE 3: VALUATIONS APPEAR TO BE STRETCHED



Source: Man Group; www.econ.yale.edu/~shiller/data.htm; as of March 2018. For illustrative purposes only. The long-term interest rate is the 10-Year Treasury Constant Maturity Rate; P/E is for the S&P 500 Index.

2. Simulated past performance is not indicative of future results.
Please note that the performance data used to create this figure is simulated to the extent that it has been created by constructing an example portfolio. Equity market returns and volatility were based on Vanguard Balanced Index Fund Investor (VBINX) historical returns between September 2015 and May 2018. ARP is based on a representative investment product or products that follow the Man Alternative Risk Premia Strategy. An example fee load of 1% management fee has been applied to the ARP strategy. The data therefore does not represent the actual performance of a fund or strategy and is shown for information purposes only.

CHOOSING AN ARP MANAGER

There are many things an investor might consider when selecting an ARP manager. We believe three of the main ones are:

• **Experience:** While ARP strategies have become more and more common in asset management, many ARP managers and strategies tend to have relatively short track records. Investors might therefore look at a manager's wider experience in the use of alternatives investing techniques such as leverage, derivatives and shorting, to name a few.

• **Technological expertise:** ARP strategies require a quantitative, model-driven approach. As such, managers must have strong technological infrastructure that will support the portfolio, from research and risk management to trading and implementation.

• **Cost efficiencies:** We believe that the most efficient managers will have a tried and tested trading platform to realise cost efficiencies, whether those are explicit, implicit or hidden. How does a manager minimise execution costs and slippage?

Additionally, the definition of a specific ARP strategy may vary significantly between offerings, so investors need to take care to do their due diligence. For example, managers could use different sets of investments (e.g. the largest 50 stocks versus the largest 500), rebalancing frequencies (e.g. daily versus weekly) and hedging techniques (e.g. stocks versus indices), to name a few.

CONCLUSION

ARP strategies are capable of providing institutional investors with significant portfolio diversification in a liquid, cost-efficient and transparent form. Our view is that these features are highly desirable in an environment where traditional asset classes' valuations are high. When choosing a manager, investors should take into consideration experience – both in terms of strategy expertise, and the risk and execution platforms upon which these strategies are deployed.

Appendix:

Month end	Man Alternative Risk Premia SP	Vanguard Balanced Index Fund Investor Shares (VBINX) 60/40
31/05/2018	-0.47%	1.93%
30/04/2018	1.31%	-0.09%
31/03/2018	1.08%	-0.93%
28/02/2018	-4.24%	-2.61%
31/01/2018	3.52%	2.71%
31/12/2017	1.07%	0.78%
30/11/2017	1.71%	1.79%
31/10/2017	4.05%	1.31%
30/09/2017	-0.98%	1.26%
31/08/2017	2.91%	0.42%
31/07/2017	2.13%	1.28%
30/06/2017	-1.90%	0.55%
31/05/2017	-0.17%	0.89%
30/04/2017	1.33%	0.93%
31/03/2017	-0.15%	0.02%
28/02/2017	1.96%	2.48%
31/01/2017	-2.05%	1.25%
31/12/2016	1.96%	1.21%
30/11/2016	0.31%	1.61%
31/10/2016	0.63%	-1.68%
30/09/2016	0.01%	0.08%
31/08/2016	-1.40%	0.06%
31/07/2016	2.36%	2.64%
30/06/2016	2.18%	0.93%
31/05/2016	-0.36%	1.04%
30/04/2016	-2.68%	0.51%
31/03/2016	0.62%	4.59%
29/02/2016	0.02%	0.28%
31/01/2016	3.07%	-2.81%
31/12/2015	-1.34%	-1.41%
30/11/2015	2.51%	0.24%
31/10/2015	-1.12%	4.61%
30/09/2015	2.76%	-1.45%

Past performance is not indicative of future results.
Please note that the performance data is not intended to represent actual past or simulated past performance of an investment product. The data is based on a representative investment product or products that follow the Man Alternative Risk Premia Strategy. An example fee load of 1% management fee has been applied.

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"Supply and demand imbalances continue to create inefficiencies that can be exploited by earning a risk premium"

Risk Premia in Fixed Income

By Hamlin Lovell – HedgeNordic

Most alternative risk premia strategies are seeking to pick up between one and seven risk premiums, using a 100% systematic and rules-based strategy. But the original concept of a risk premium is much broader than this. Risk premiums can be exploited by managers who are 100% systematic, 100% discretionary, or those, such as Copenhagen-based Moma Advisers, who are somewhere in between.

Moma CIO, Morten Mathiesen, "starts off using quantitative models to identify potential opportunities, but finds that some discretionary analysis is needed to forecast how demand and supply will change. Each trade has a profit forecast, based on the quantitative model, which typically constructs a portfolio of strategies with an expected annualised return between 7% and 12%".

"By applying a systematic investment strategy with strict focus on downside risk, we have managed to build a 15-year track record with an annual average return of 13% with an annual volatility of 6.5% resulting in a 15-year Sharpe Ratio just below 2" he adds.

The recurring question posed by investors is whether Asgard's returns are sustainable over the next 5, 10 or 15 years. "Supply and demand imbalances continue to create inefficiencies that can be exploited by earning a risk premium" argues Mathiesen.

Arbitrage versus risk premia

The opportunities are not arbitraged away, because they are not, strictly speaking, arbitrages in the first place: they are not risk-free trades. Financing must be secured and maintained in order to hold trades to maturity. In the interim, there is reinvestment and roll risk when various spreads are reset at fixings. "We must have an opinion about what the fixing rolls into" says Mathiesen. Therefore, he feels that the term "risk premium" is more appropriate than "arbitrage" (although many of their trade types would, loosely speaking, be described as "fixed income arbitrage" by many managers and investors).

"Although the fund is not a typical risk premia fund, the Risk Premia name was incorporated due to the philosophy, that the portfolio managers are harvesting risk premiums in the various bond and interest rate markets, primarily in Scandinavia" explains Birger Durhuus, CEO of Moma Advisors.

Nordic mortgage bonds

At the simplest level, mortgage securities can offer higher yields, even after hedging the interest rate risk. This can be a compensation for prepayment risk, but mortgage bonds without prepayment risk also offer some extra yield. While part of the

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returns do come from this yield pickup on mortgages relative to government bonds – a risk premium - security selection is also important. Asgard's returns have greatly outperformed a passive strategy of holding a generic hedged Scandinavian mortgage bond portfolio.

Returns have also beaten an index-based approach because the fund tactically varies the allocation to the sub-strategies, according to the opportunity set. On average, Nordic mortgages might have contributed around three quarters of the strategies profits, but this fluctuates over time. Recently, in 2018, Asgard has increased exposure to mortgages after spreads had widened earlier in the year.

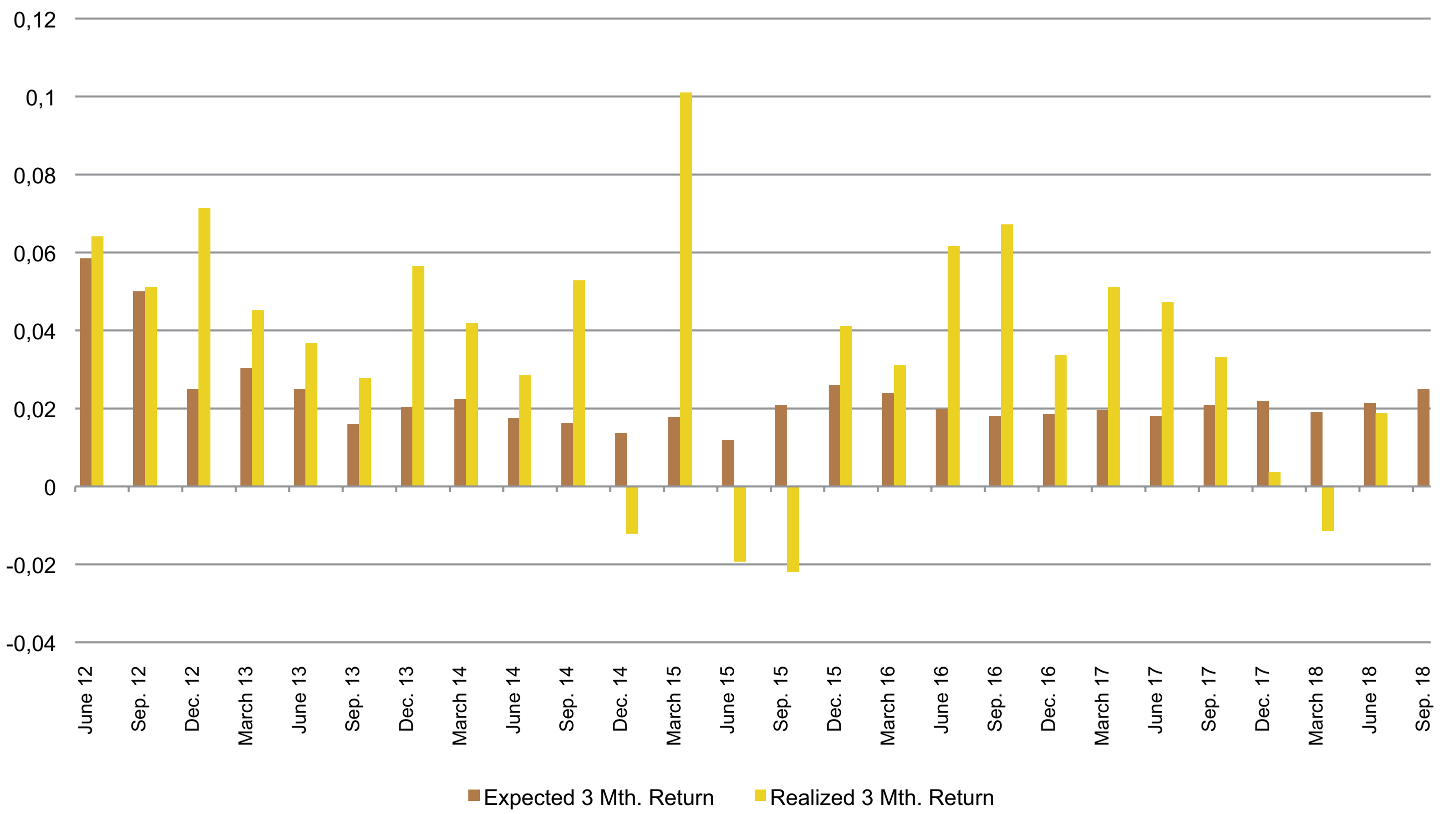
Yield curves

Elsewhere, pension funds and insurers forced to invest for liability-matching and solvency reasons, create a strong demand for long dated European government bonds, which leads to quirks such as an inverted yield curve at the long end. "Those with deep pockets and long-term time horizons can profit from this" says Mathiesen.

Cross currency basis swaps

The same strategies may not work every year, so Mathiesen needs to be open minded about opportunistically moving capital around to find attractive trades. The ECB's asset purchases have reduced yields on Euro-denominated covered bonds to levels that price out Asgard, but this has created new opportunities by segmenting the Eurozone market from those using other currencies. "Corporates in Scandinavia can borrow more cheaply in Euros, which creates a one way traffic demand for cross-currency basis swaps" says Mathiesen. That in turn leads to attractive levels of "roll down" yield on the cross-currency basis swap curveAs banks have scaled back or shut down their proprietary trading activities, there is less competition. "We do what the banks used to do" he adds.

Expected vs Realised Returns



BIRGER DURHUUS
CEO, MOMA ADVISORS

MORTEN MATHIESEN
CIO, MOMA ADVISORS

Country spreads

Asgard also moves in and out of the CITA (Copenhagen Interbank Tomorrow/Next Average) versus EONIA (Euro Over Night Index Average) interest rate trade, to hedge the risk of Danish Krona appreciation. "At times of Euro risk aversion, the DKK is seen as a "shadow Deutschmark" and a safe haven, leading to appreciation pressure, which then forces the Danish Central Bank to lower interest rates to keep the DKK pegged to the Euro" explains Mathiesen.

Around 80% of trade types come under the above four categories. There are also other trades mainly designed to be portfolio hedges, such as the basis between three and six -month swaps, which can blow out in a crisis but can be seen as low cost insurance insofar as it has a neutral carry. In addition, Asgard trades calendar spreads on the volatility curve of interest rates, which can generate positive roll down carry.

This year's returns have so far been modest, but Mathiesen is optimistic that the long-term positive trend will continue in months and years ahead. "We have already seen a pick-up in return in the past 3 months, and our experience is, that in the case of a few slow quarters, expected and realized return increases in quarters ahead". This somewhat mean-reverting pattern of returns is shown on the graph below."The level of expected return is of course not as high as it was in 2009 when all risk premiums were stretched, but the current level is approximately equal to the average of the last 5 years. I still find that very attractive in today's environment".

The Irish-domiciled Asgard Fixed Income Risk Premia fund pursues the same strategy as the Cayman-domiciled Asgard Fixed Income Fund, which launched in 2003 and is closed for subscription. Moma Advisors, an authorised AIFM, launched an Irish ICAV, which is an AIF, to more easily access European investors..

In its first few months, the ICAV showed some "tracking error" versus the Cayman fund as it took some time to build up the book. Now performance is very similar, as the two portfolios have been aligned.

"We did run into a few unexpected challenges in the process taking the strategy onshore and under AIFMD regulation, such as changing the custodian and depositary, but these issues have been resolved, and we are now fully focused on delivering returns to the investors of the fund" says Durhuus.

The Irish fund has so far raised EUR 270 million. Asgard estimate that capacity for the overall strategy, including both the Cayman and Irish funds, could be around EUR 800-1.000 million, but realistically acknowledge that they will not know what the optimal capacity is until assets reach that level. The Investment Manager is now having conversations with institutional investors worldwide.

by Kamran Ghalitschi – HedgeNordic

MANAGING EXPECTATIONS WHILE MANAGING ALTERNATIVE RISK PREMIA STRATEGIES

Risk premium strategies work best when combined in a multi-factor context rather than considered as stand alone performance drivers. Putting alternative risk premia (ARP) factors together in a portfolio, seeking to maximize diversification effects, is key for successful investing. Whether timing of factors can succesfully be executed in the longer term is subject to debate - a more static approach compared to a dynamic one is likely to be the better choice. Those are some of the conclusions drawn from HedgeNordic´s discussion with Christopher Reeve of London-based systematic hedge fund manager Aspect Capital.

"It's important to bear in mind that the effects being captured by the majority of alternative risk premia strategies are somewhat intermittent in their behaviour. It may be an obvious point but they aren't the sort of strategies which always reliably work and perform brilliantly 100% of the time", says Reeve as a first remark when asked about what to expect from ARP-strategies over time.

According to Reeve, risk premia strategies, if implemented properly, will be able to earn a premium in exchange for taking a specific risk. But this risk will show up at times and as an investor it is important not to rely too heavily on backtested performance data.

"However robustly a risk premium strategy is designed to capture a particular effect, it is likely that there will be an element of selection bias in the model. Although backtested performance might be very impressive it is very unlikely that a risk premium strategy will persistently outperform its backtest and many have struggled in recent years to even match the level of performance shown in backtesting", Reeve says.

Expected performance of ARP

Reeve paints a relatively conservative picture of the risk-adjusted performance to be expected from individual risk premia working in isolation; the real benefit from using them lies in their correlation characteristics, he argues.

"All things considered, any one risk premium strategy is likely to have a pretty low risk-adjusted return on a standalone basis. A long-term Sharpe ratio of around 0.3-0.5 is probably a realistic level to expect for a standalone factor. These strategies aren't super high-frequency, high alpha strategies which capture unique effects. They tend to be more based around medium-term effects which are relatively well-understood."

"While it's clear that the recent environment has not been especially favourable for many of the well-known factors, long-term performance expectations of around a 0.7-0.8 Sharpe ratio for a well-diversified portfolio of different alternative risk premia seems like the sort of level that investors should realistically expect to generate. While

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this level of performance probably may not rival the higher risk adjusted returns targeted by many multi-strategy hedge funds, it can still be incredibly valuable in a portfolio context and comes with many other benefits of higher transparency and liquidity and lower costs", Reeve reasons.

Creating a robust portfolio of factors

According to Reeve, the key to successful alternative risk premia investing lies in the manager's ability to put different factors together in a portfolio, thereby exploiting inherent correlation benefits.

"One question for investors is whether to build a robust portfolio of individual standalone factors themselves, or to invest in a multi-premia product where this has already been done", he says continuing:

"One major benefit of the multi-premia products is the potential for trading efficiencies from the netting of positions and trades between the different factors, given that nearly all factors operate in the same markets - large-cap equities and major liquid futures. We estimate that this can reduce the total trading turnover of a risk premia portfolio by around 50% when compared to executing each strategy in isolation, and the consequent savings in trading costs can therefore be very significant."

When it comes to how to efficiently construct a portfolio of multiple factors, Reeve says that there are different schools of thoughts. One argues for a more static approach while others argue that adjusting weights dynamically can add signficant value.

"There are several different approaches for deciding portfolio weights to the different factors, but the key questions are whether the investor or the manager has any skill in predicting which factors will perform better or worse than others over the long term or whether there is any ability to predict when each factor will perform better or worse."

"In the absence of any desire to try and predict performance, then portfolio construction uses equal return expectations and becomes driven by the correlations of the factors, usually with the aim of maximising diversification. One of the nice things about well-constructed alternative risk premia factors is that the historical correlations between them tend to be pretty stable, and portfolio allocations tend to reflect this.

"There are several different approaches for deciding portfolio weights to the different factors, but the key questions are whether the investor or the manager has any skill in predicting which factors will perform better or worse than others over the long term or whether there is any ability to predict when each factor will perform better or worse."

"The other school of thought says that varying exposures to the different factors can add significant value. The challenge here for investors is assessing whether there is actually any skill in predicting the better or worse performance periods for individual factors. A more dynamic portfolio construction approach can be guaranteed to add trading costs, regardless of whether it improves performance."

Beware of correlation spikes

Although correlations historically between alternative risk factors have been low, there is always the risk of them spiking in the shorter term, putting assessments based on longer term patterns to the test.

"Just as with any model, it is important to understand the potential for mis-estimation. Typically this means that one shouldn't believe correlations are as low as they may appear to be from estimates based on historic data, there is always the potential for correlations to spike in ways which haven't been seen before in history so a conservative approach makes sense. Assume correlations might be higher than they have been, and take this into account when building the portfolio", Reeve says.

"Understanding the consequences of a correlation spike is also important. Our risk management systems have a range of different 'stressed' measures which use both historic scenarios and synthetic stressed data to model what the impact of a tail event might be. Integrated risk limits and caps also help keep overall leverage under control. This overall risk management is another benefit of running an integrated multi-premia portfolio."

On recent performance of ARP-strategies

Reeve argues that the main attractive feature of factor strategies is their potential to perform in most different market environments and their independence from traditional assets. However, this also means that they can experience their periods of underperformance at different times, and the recent period has proved difficult for most alternative risk premia portfolios.

"We haven't seen all factors struggling at the same time as a result of the same events or market conditions. On the whole they have maintained their independent performance but struggled at different times for different reasons.

"Momentum-based factors unsurprisingly struggled in the sharp market reversals earlier in the year, as did most volatility risk premia. Cross-sectional value factors in equity markets have also suffered, but it has been a great example of the dispersion in performance which is possible between factors and even between different versions of what are ostensibly the same factor."

"Other factors operating in cash equity markets such as quality, momentum and growth have performed well. The recent period has emphasised to us the importance of having exposure to a well-diversified range of different factors in the different asset classes", he concludes.

"All things considered, any one risk premium strategy is likely to have a pretty low risk-adjusted return on a standalone basis."

CHRISTOPHER REEVE
DIRECTOR OF RISK
ASPECT CAPITAL

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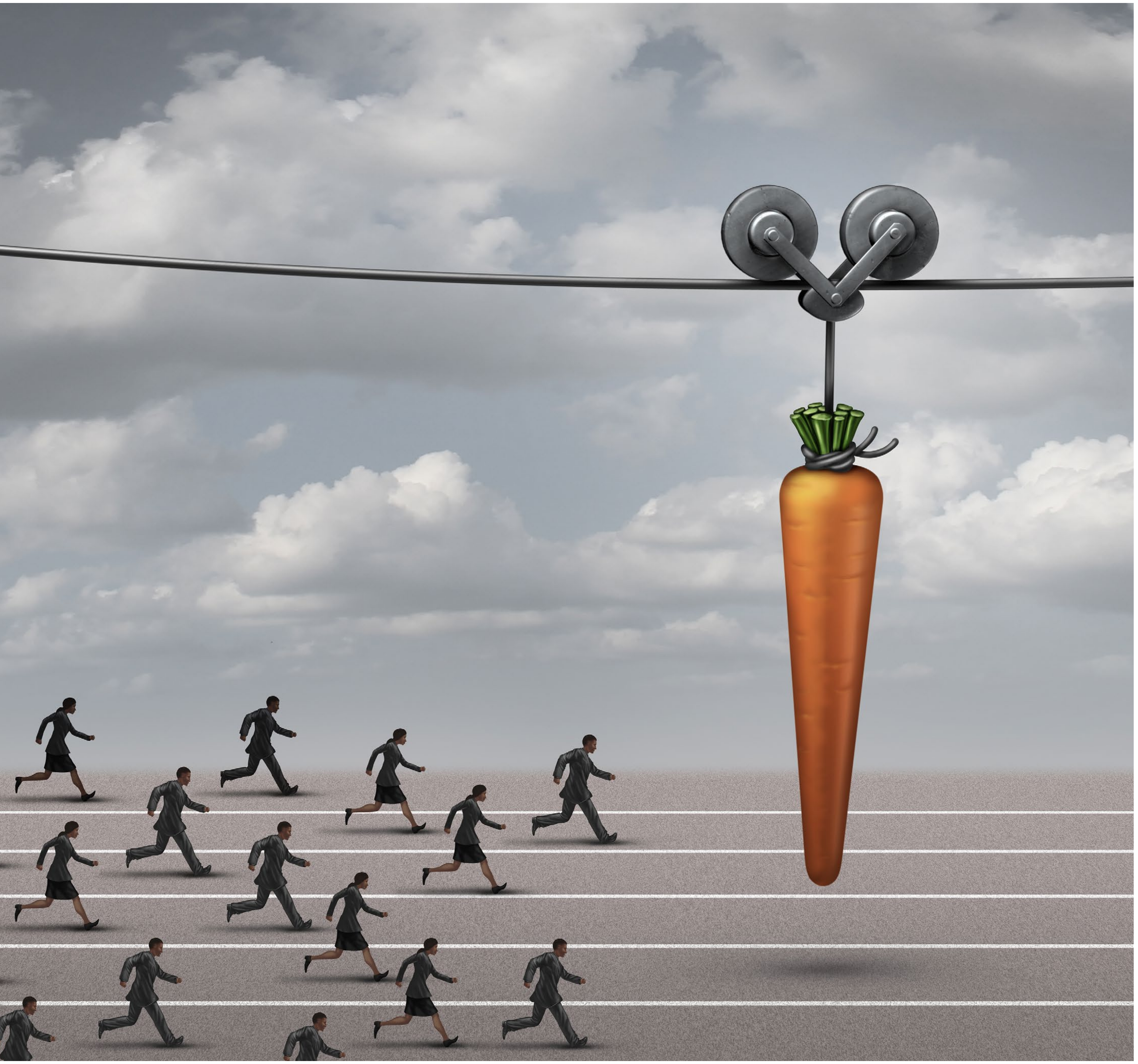

Increasing confidence in value factor exposure

By Hamlin Lovell – HedgeNordic

DANIEL LEVEAU

SENIOR INVESTMENT STRATEGIST, INFORMED PORTFOLIO MANAGEMENT - IPM

Since 2006, Swedish Informed Portfolio Management - IPM has run an actively managed, risk factor investing strategy, applied to unleveraged, long-only equity portfolios. The strategy is based on the same investment philosophy as its flagship, systematic fundamental macro strategy that was launched in 2003. The value-oriented equity strategy aims to outperform a market cap-weighted benchmark through a full cycle. Since inception, it has – despite the strong headwind for the risk factor value – kept pace with standard market cap-weighted equity benchmarks, while outperforming generic value investing approaches – such as the MSCI World Value Index, which is composed of the cheapest half of the market, based on various valuation multiples (e.g. price to book value).

Compared to generic value-tilted indices, IPM uses a broader range of measures to define value, and a conceptually different approach: "we do not focus on what we call relative value, e.g. PE- or PB-ratio, but on absolute value, e.g. the absolute size of a company's earnings or book value. We thus apply a fully price-indifferent approach" says Senior Investment Strategist, Daniel Leveau.

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That said, the strategy does not deviate all too much from the generic value risk factor, as IPM expects value to generate a positive risk premium long-term, based on decades of performance history, and academic research. IPM's tracking error versus MSCI Value has fluctuated between about 1.5% and 4% since 2011, as shown on the right.

Partly with the benefit of hindsight, Leveau finds explanations as to why value has been the "Cinderella" strategy for nearly a decade. The inflows into passive, index investing, are implicitly making big style bets on the risk factors growth and momentum, resulting in an increasing, fundamentally-agnostic demand for such stocks. Low, zero and negative interest rates also increase the valuation of more distant cash-flows of growth stocks, while the hunger for yield inflates the valuation of those that simply pay high dividends. Meanwhile, mega-cap technology growth stocks that currently enjoy a compelling narrative about the digitalization of many business models have generated strong growth in profits, but their valuation multiples have expanded at an even faster pace.

Value has also underperformed due to "value traps", such as retailers that have gone bankrupt after losing market share to internet platforms such as Amazon, or Italian banks that traded at a fraction of their book value because investors accurately judged that many loans were bad debts, destined to be written off.

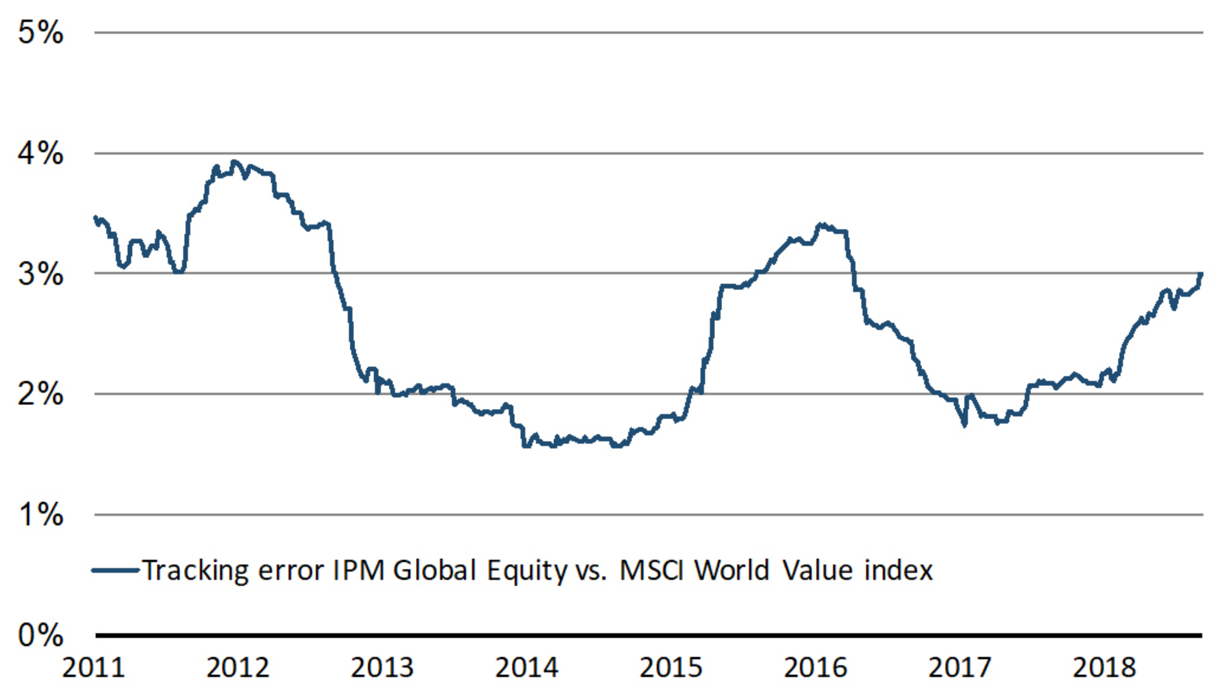
While Leveau believes there is no fool-proof way to avoid "value traps", IPM's value bet - typically around 50% of factor exposure - is tempered by exposure to the risk factors momentum, quality and small cap. The first two of these are partly designed to sidestep some value traps.

Value tends to be inversely correlated to momentum, and paying attention to negative price action can be wise where the share price turns out to be a good signal of headwinds. Quality measures, such as debt coverage ratio and accruals, can also help to avoid superficially cheap companies that are over-leveraged and maybe expensive on an enterprise value basis, or that struggle to convert reported profits into tangible cash-flows. The quality factors used by IPM have similar characteristics to the 'G' for Governance in ESG. Additionally, "the strategy is diversified across a very large number of stocks in order to minimize cluster risk to any specific stock" says Leveau.

Compared to a market cap-weighted strategy, IPM on average slightly over-weights small cap stocks but is nowhere near any capacity constraint. Around $3.3 billion of IPMs' $8.6 billion assets under management are in the equity strategy, which remains open to investment, in UCITS funds and separately managed accounts.

> "Value investing exploits the bipolar tendencies of financial markets, which result in stocks becoming overvalued when investors are manic with everyone chasing the same, big fat carrot, and undervalued when they are depressive."

TRACKING ERROR



Rolling 52-week tracking error based on weekly returns in EUR for the time period 2010-2018 (as per end of August 2018)

The size of IPM's bets versus market cap-weighted indices will vary according to the perceived opportunity set. Despite the recently increased valuation and performance dispersion between value and growth stocks, tracking error versus MSCI World has not made new highs, as the strategy is highly diversified on a single stock level. IPM's active share has increased markedly however, as shown on the next page.

In other words, IPM has been steadily reducing its position overlap with the MSCI World Index, as shown below. This is partly driven by a bigger "value" style bet. "Our active share has increased as a function of in particular stretched valuations of the US stock market and technology companies" says Leveau.

IPM is of the opinion that value is undervalued relative to growth, but the bifurcation between the two styles is not at the extreme seen at the peak of the TMT bubble in 1999 and nor is value as attractively priced in absolute terms as it was then. Still, Leveau reckons that value stocks, today trading at a slight discount to fair value, could prove to be more resilient than they were in 2008.

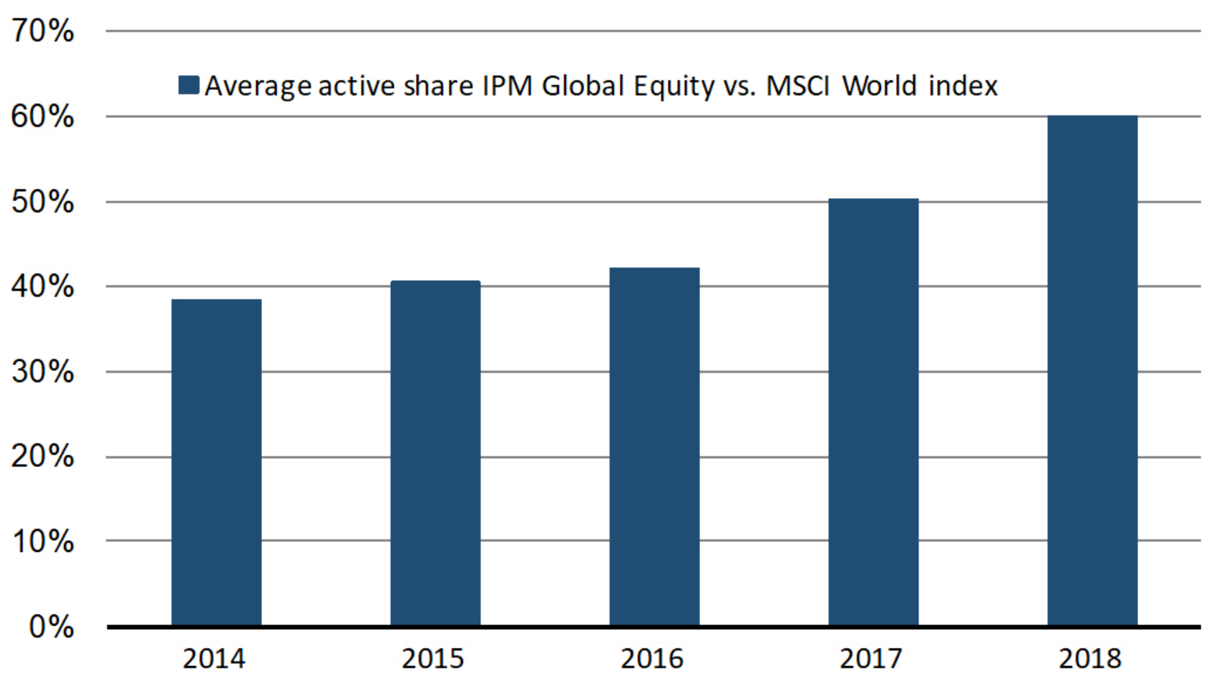
ESG and risk factors

IPM has been a signatory of the UNPRI since 2010.

"IPM's comprehensive ESG analysis approaches ESG from four angles, which in combination actually only have marginal implications for risk factor exposures" says Leveau.

IPM's "factor integration" approach uses various financial metrics as a proxy for governance. As aforementioned, overweighting companies with good governance, and underweighting those with weak governance, has some overlap with the quality factor. This is intended - and is justified on performance grounds. Based on IPM's research, the governance factor is expected to add between 0.25%-0.50% to annual returns (depending on region), and reduce drawdowns, without increasing volatility, relative to MSCI indices.

ACTIVE SHARE



Average active share, time period 2014-2018 (as per end of August 2018).

IPM's "norms-based screening" can also be described as "negative screening" or exclusion, and avoids investing in companies that do not meet the UN Global Compact criteria or weapons-related conventions, e.g. companies deemed to violate the spirit or letter of the Non-Proliferation Treaty. Viewed in isolation, these exclusions could result in unintended risk factor exposures. But IPM's "best in class" substitution, a form of "positive screening", helps to counterbalance unintended sector, region or country biases arising from the screening. Companies with similar characteristics to those excluded are over-weighted. "As a consequence of this approach, IPM's ESG policy does not materially change either the absolute or relative portfolio risk" explains Leveau.

IPM also has a transparent policy on engagement and proxy voting. IPM engages with companies both bilaterally and in conjunction with other investors; consultant GES International has been retained to assist with engagement since 2006. IPM is an active owner and discloses both its historical voting record and its future voting intentions to investors. ISS is retained for advice on proxy voting.

Why value?

So, IPM's degree of value exposure does fluctuate, and has been increasing for the past five years, but it is always expected to remain the dominant risk factor of its equity strategy.

Longer term, IPM has confidence in the value factor due to academic research, led by Fama and French, demonstrating how value investing exploits the bipolar tendencies of financial markets, which result in stocks becoming overvalued when investors are manic with everyone chasing the same, big fat carrot, and undervalued when they are depressive. "Rebalancing portfolios out of recent outperformers and into underperformers profits from subsequent mean reversion, in what Treynor dubbed the "noise-in-price"" says Leveau.

Career risk is one explanation for stocks becoming oversold. "Many managers tend to dispose of stocks that have performed sub-par and are exposed to negative media coverage for the simple reason that they do not want to have to explain these holdings to their investors" says Leveau. In contrast, a culture of independent thinking results in IPM focusing on optimizing long-term investment results.

By Eugeniu Guzun – HedgeNordic

Alternative Risk Premia Versus Smart Beta: Same, Same, but Different

Most investors occasionally dream of finding multi-bagger stocks that can jack up invested capital. But investors are constantly warned against putting all their eggs in one basket. Warren Buffett, for example, recommends that investors consistently buy low-cost index funds, arguing that spreading money around via index investing is less risky and more rewarding over time. Inevitably, however, investors will always search for ways to outperform. Lately, there has been an increased focus on getting more portfolio exposure to factors such as value, size, momentum or other anomalies thought to offer a little extra return, contributing to the rise of factor-based investing.

Factor investing has attracted increased attention, partly because the past performance of traditional active managers appears to have been attributable to the exposure to certain factors such as size and momentum. This has led to increased investor demand for smart-beta products, often termed factor-based investments. These products, typically a cheaper alternative to active managers, depart from the conventional method of weighting components by their market capitalization to provide investors with more exposure to securities with certain characteristics that can beat the market over time.

New investment approaches build on the practice of investing in risk factors have been developed. The concept of alternative risk premia investing is seen as an extension of the factor-based investing approach, and is applied employing long/short and leveraged portfolio construction to better capture a particular risk factor or a set of risk factors. Smart beta and alternative risk premia investing bring many years of academic research to investors, with both approaches helping investors to capture sources of extra return stemming from risk factors such as value, carry, quality, and momentum. Peter Lindahl, a portfolio manager of a Finnish hedge fund that pursues market-neutral factor investing, says: “At Evli, we regard both [alternative risk premia and smart beta] as factor investing strategies, as they harvest similar academic factors like momentum and value.”

Going to the Core of ARP and Smart Beta Investing: Risk Premia

Factor-based investing represents an investment process designed to harvest certain risk premia from exposure to specific risk factors. Most investors are well aware of traditional risk premia such as the equity risk premium, which is the reward associated with investing in equity markets. The term premium - the reward investors receive from the added risk of owning longer-term bonds - and the credit premium - the reward investors obtain from holding riskier bonds issued by entities other than governments - are also understood by many. However, research has found other sources of risk premia, clustered under the “alternative risk premia” label.

Alternative risk premia are systematic sources of return that arise after breaking down an asset class such as equities into common drivers of return supplementary to the market beta, the traditional equity risk premium. Some alternative risk premia can be viewed as risk premia in a strict sense, while others can only be viewed as market anomalies. Many categorize alternative risk premia into two camps: skewness risk premia or pure risk premia, which stem from size or value risk factors; and market anomalies, risk factors stemming from behavioral biases. However, this distinction is not always completely objective as some risk factors can be viewed as both risk premia and market anomalies.

One example of alternative risk premia is the so-called cross-section momentum equity risk premium, which can be harvested by going long on past best-performing stocks and short on past worst-performing stocks. The carry currency risk premium serves as another example. The premium can be exploited by going long on the currencies of countries with high interest rates and short currencies of the countries with low interest rates. In a research paper from April 2017 titled “Alternative Risk Premia: What Do We Know?”, Amundi lists the following categories of risk premia: carry, event, growth, liquidity, low beta, momentum, quality, reversal, size, value, and volatility. Carry, value, and momentum are considered by Amundi as the most relevant alternative risk premia as they are present across all asset classes. Peter Lindahl, a portfolio manager of Evli Factor Premia Fund, corroborates Amundi’s opinion. “In our view, value, momentum and carry work across asset classes, and are among the most harvested factor premia in ARP strategies,” Lindahl told HedgeNordic. “Quality, low volatility and size are also harvested, but are equity specific. Trend - also called the cousin of momentum and the prime strategy of CTAs - is another popular one. Short volatility strategies are also factor risk premia, but are not always included in portfolios due to their riskier nature.” The figure below presents a classification of alternative risk premia by asset class, according to Amundi.

Same, Same, but Different

These alternative risk premia represent the raw material used to build smart beta and alternative risk premia strategies. Alternative risk premia and smart beta can sometimes, mistakenly, be lumped together and used

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Asset Class

Risk Premia	Equities	Rates	Credit	Currencies	Commodities
Carry	Dividend futures High dividend yield	Forward rate bias Term structure slope Cross-term-structure	Forward rate bias	Forward rate bias	Forward rate bias Term structure slope Cross-term-structure
Event	Buyback Merger arbitrage				
Growth	Growth				
Liquidity	Amihud liquidity	Turn-of-the-month	Turn-of-the-month		Turn-of-the-month
Low beta	Low beta Low volatility				
Momentum	Cross-section Time-series	Cross-section Time-series	Time-series	Cross-section Time-series	Cross-section Time-series
Quality	Quality				
Reversal	Time-series variance	Time-series		Time series	Time-series
Size	Size				
Value	Value	Value	Value	PPP Economic model	Value
Volatility	Carry Term Structure	Carry		Carry	Carry

Asset Class

interchangeably, but there are a number of important distinctions between the two. Whereas smart beta is usually captured using long-only investment strategies, alternative risk premia are harvested using more complex long-short strategies, sometimes market-neutral strategies. But perhaps the main distinction between the two hinges on the fact that smart beta strategies have exposure to both traditional and alternative risk premia. As Lindahl explains, "the difference between alternative risk premia and smart beta is that the latter is a long-only strategy, where the main risk exposure you get is traditional equity risk premia, and then factor premia [or alternative risk premia] on top of that." "With ARP, the aim is usually to avoid traditional asset class risk and get as high a factor exposure as possible," he adds.

A value-oriented smart beta portfolio, for instance, will be fully invested in a basket of value stocks (with high book-to-market ratios, which have been found to provide higher returns at lower risk compared to growth stocks), which means the long-only smart beta portfolio will exhibit a fairly high degree of correlation to equity markets. The exposure to the value risk premia, however, will be partial only. By eliminating the effect of market directionality, alternative risk premia products provide a purer exposure to the return potential of the risk premium stemming from value. The graph in the upper right corner of the page sketches the relation between traditional risk premia, alternative risk premia, and smart beta strategies.

Both alternative risk premia and smart beta investing have their own merits, and one can find a role for both strategies in the same portfolio. Peter Lindahl reckons the two strategies can serve as supplements "since they are used differently in an asset allocation." "A smart beta strategy works well in a long-only equity allocation, while an ARP strategy may provide diversification benefits to the broader asset portfolio, due to its tendency of having a low correlation with traditional asset classes," says Lindahl.

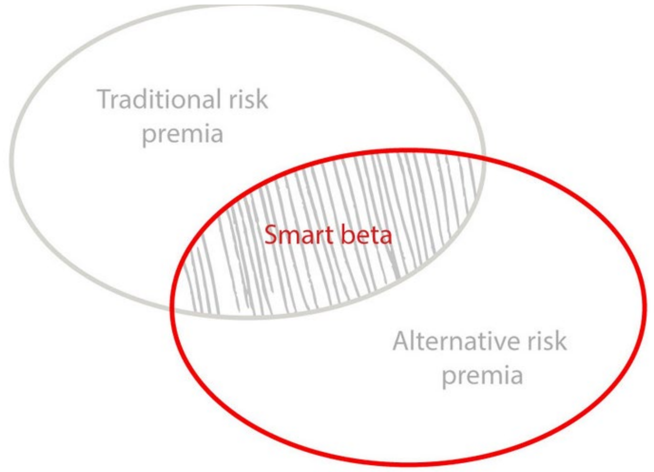
There is very little doubt that alternative risk premia strategies can offer better diversification benefits to portfolios greatly exposed to market directional risks, as they can capture alternative risk premia more efficiently than smart beta strategies. However, the benefits of smart beta investing include greater capacity and the limited use or complete absence of leverage, shorting, or derivatives. More importantly, the distinction between alternative risk premia and smart beta investing has clear implications for fees. Long-only smart beta strategies can be accessed inexpensively, whereas alternative risk premia strategies seek to capture alternative risk premia only via more sophisticated approaches associated with higher fees. Although alternative risk premia

PETER LINDAHL

HEAD OF SYSTEMATIC FUNDS, SENIOR PORTFOLIO MANAGER

EVLI FUND MANAGEMENT COMPANY LTD

> **"In our view, value, momentum and carry work across asset classes, and are among the most harvested factor premia in ARP strategies,"**



products might be expensive in absolute terms, they are often viewed as inexpensive in relative terms: compared to more expensive hedge funds offering similar exposure to alternative risk premia and compared to less expensive smart beta products offering not-so-pure exposure to the same premia.

In summary, alternative risk premia products are also factor-based but differ in a number of ways from smart beta products. First, alternative risk premia can be applied in multiple asset classes, with equities representing only a minority of risk exposure. Smart beta, meanwhile, is equity-focused only. Second, alternative risk premia products can offer exposure to many more risk factors and their associated risk premia than smart beta. Third, unlike smart beta, alternative risk premia strategies employ leverage and short factors that are less desirable. All in all, alternative risk premia products offer investors the possibility to isolate the desired alternative risk premia, while limiting the exposure to market beta and other alternative risk premia.

Investors have always had exposure to these alternative risk premia through hedge fund strategies such as quantitative equity strategies, macro-oriented strategies, or managed futures. But "there seems to be continued strong demand for ARP strategies," says Lindahl. "Investors have bought into what academic research of the past decades has shown: factors are alternative sources of returns and may provide attractive investor benefits, like superior risk-adjusted returns and improved diversification," he adds. In addition, the opportunity to diversity the sources of return and risk at costs far below the fees charged by alternative managers such as hedge funds also boosted investor demand for ARP products. Nonetheless, "this demand may have slowed down a bit in 2018 due to less favorable factor returns over the past six months or so," observes Lindahl.

JONAS THULIN

HEAD OF ASSET MANAGEMENT
ERIK PENSER BANK

Challenging the Value of Hedge Funds

By Kamran Ghalitschi, HedgeNordic

Erik Penser Bank's recently appointed head of asset management, Jonas Thulin, sees little value adding hedge funds over ETF:s as the pletora of cheap index products has expanded and improved over the years. By applying very simple performance and correlation criteria, 98 percent of his hedge fund universe fails to meet expectations, the ex. Nordea and Crédit Agricole strategist argues.

> "Since I joined a year ago, we have reduced the number of hedge funds from six to currently two. This is a result of the fact that very few of these funds live up to expectations and charge high fees."

Most of his professional life, Thulin has worked with economic forecasting trying to find investment trends that could be exploited, either from an asset allocation standpoint or from an operational business perspective.

Starting out at Swedish telecom giant Ericsson in 2000 as responsible for forecasting the telecom market and working with financial forecasting, Thulin transitioned to a role in 2006 as a senior FX and fixed income strategist at French banking Group Crédit Agricole. In 2008 he left to join Nordea as head of strategy and research and later heading the global alpha strategy and asset allocation team.

Last year, Thulin joined Erik Penser Bank as head of asset management. At Penser, he is primarily responsible for managing the bank's discretionary mandates and to overlook a couple of funds. His role also encompasses forming the big picture thematic views on which the asset allocation theme acts. In the monthly "house view" the team pictures the broad market trends and what they see as being the major triggers in the shorter term.

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Selling out of Swedish small-caps

Thulin aims to stay active in allocation decisions and recently has made some major allocation adjustments, one of which is selling out completely of Swedish small-cap companies, fearing the impact of the coming election results in Sweden. On top of that the allocation team positioned for rising Italian interest rates during the summer while also buying into utilities in the US and selling off emerging markets exposures.

The team looks at markets from a 0-3 month and 3-6 month perspective, currently holding a somewhat neutral view on equities, being bullish commodities and alternative investments and bearish the Swedish krona, in the fixed income space the team is taking down risk in the very short term and holds an overall bearish stance.

"In short we see a completely different growth path in the US compared to Europe and Sweden, where the economy in the US is picking up while Europe and Sweden show declining activity. Differences in interest rate levels, inflation levels, consumer confidence levels and investment flows are guiding our positioning. We currently believe in a stronger dollar, particularly against the Swedish krona, higher volatility, lower growth in equity markets, higher interest rates and inflation and higher gold and oil prices", Thulin says.

ETFs preferred choice

In order to exploit their thematic views, the asset management team at Penser systematically scan the universe of available products to find the most efficient way of executing trade ideas. More often than not this results in allocations to one or more ETFs.

"ETFs are typically the most efficient way for us to execute thematic views. They are cheap and gives a clean exposure offering good liquidity. I would say that the overall portfolio exposure to ETFs is between 70-80 percent today and has increased significantly over time."

Also in the alternatives space, Penser is looking increasingly at cheap exposures and has reduced the number of hedge funds to only a handful.

"Since I joined a year ago, we have reduced the number of hedge funds from six to currently two. This is a result of the fact that very few of these funds live up to expectations and charge high fees. Even putting soft requirements on performance and correlation measures filters out the vast majority of these funds in our screening process. If we want performance to be positive over 3 months, 1 year and 3 years while holding a correlation to equities of below 40 percent, our selection universe falls from 597 to 10 funds", Thulin says.

Thulin is particularly sensitive to hedge funds showing a positive bias and correlation to equity markets as this is not serving any purpose from a portfolio perspective.

"We want the alternative exposures to serve as diversifying components in our portfolio and we have sold out of funds showing a systematic correlation to global equities.", he says.

Using hedge funds as a means to protecting the portfolio from tail risks and major market equity downturns seem to be a sought-after characteristic, but Thulin is yet to be convinced about using CTAs in that context.

"We have been quite disappointed with the way CTAs have managed to exploit underlying trends in recent years. We have seen quite consistent trends in equities, bonds and commodities but with very little output from the managers. Again, in this context we think there are alternatives on the ETF side where multi-factor ETSs including the momentum factor is a real option these days."

Using ARP-strategies to gain hedge fund exposure

Thulin underscores that ETFs make a good job replicating the return streams of hedge funds these days and that there is vast universe to chose from when it comes to alternative risk premia, both as stand-alone factor exposures and as more actively managed multi-factor solutions.

"We tend to prefer going through single factor funds and to do the active management ourselves. Those funds charges between 20-40 basis points in fees which is already much lower compared to the average hedge fund fee. On top of that, we get a much more efficient currency hedging using ETFs, we don´t think hedging costs are sufficiently transparent and efficient when it comes to hedge funds."

"We tend to prefer going through single factor funds and to do the active management ourselves. Those funds charges between 20-40 basis points in fees which is already much lower compared to the average hedge fund fee."

Thulin says that momentum has been the best preforming risk premia strategy this year and that it has performed relatively well compared to momentum-based hedge fund strategies, particularly it did a good job in more quickly recouping the losses from the February scare.

Where he sees alternative strategies fulfilling a need is within very niche strategies where Thulin and his team have difficulties finding the exposure elsewhere.

"If we want exposure and exploit relative value opportunities in Swedish fixed income markets for example, we do not have the competence in-house to do a good job on that side. In that case passive investments are no real option either so we would end up looking for hedge fund talent."

Thulin also points to the fact that the active and somewhat opportunistic approach they have when allocating portfolios currently does not support the case for hedge funds given the weakness of the industry as of late.

"A fund could look great over five years but that does not help us in the short term as our clients are typically more short-sighted looking at what the portfolio brings on a yearly basis. This currently makes the case for hedge funds a bit more difficult."

What is then included on the alternatives side given the bullish house view on the asset class?

Thulin says that the alternatives bucket has been somewhat redefined lately putting things in that does not fit into the other silos of the portfolio.

"We have positioned for higher inflation expectations and been shorting Italian bonds through derivatives. These positions have been put into the alternatives bucket together with more traditional alternatives exposures including hedge funds."

As it stands, the portfolio that Thulin and his investment team runs has added 8 percent on the year with a Sharpe of 2.2 over the last 12 months and he says that the main priority is now protecting the downside as he foresees increased volatility ahead. Remains to be seen if a more challenging market for perceived risky assets could have him revisit hedge funds again.

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Strategies Harvesting the Value Premium: All Born Different

By Eugeniu Guzun – HedgeNordic

"The selection of factors appears to be the main decision investors have to make when evaluating alternative risk premia and smart beta strategies. But beyond the initial choice of factors, asset classes and geographical focus, there are other factors which can lead to enormous differences in performance across managers harvesting the same premium. "

The rising popularity of factor investing and alternative risk premia strategies in particular can hardly go unnoticed. This increased popularity has triggered a surge in the variety of investment options capturing factor premia. Strategies harvesting factor risk premia should theoretically be rule-based, transparent and replicable, so investors logically anticipate consistent behavior across investment options. However, even seemingly homogenous strategies rarely display consistent behavior across providers, research finds. More interestingly, the process of harvesting the value premium can be especially inconsistent across managers. The following article outlines the main reasons causing the inconsistent behavior.

The term value investing certainly means different things to many people, but the practice of value investing essentially involves looking for inexpensive stocks relative to fundamentals. Past research finds that companies with cheap security prices relative to fundamentals tend to outperform the market in the long term, and that is what makes value an investment factor - a historical driver of returns. Although there is an ongoing debate on whether the source of the value premium is risk-based or a behavioral anomaly, one thing is certain: investors willing to get exposure to this "risk" factor receive compensation in the form of the value premium.

Sources of Performance Dispersion

Countless managers running alternative risk premia strategies claim to harvest the value premium either through a single-factor or a multi-factor strategy, but the performance of strategies harvesting this specific premium can differ significantly across managers. This disparity of results mainly stems from differences in how managers define the value premium and the methodologies used to harvest this premium. The figure below reveals the major sources of performance dispersion of strategies harvesting the value premium in equity markets.

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First, the investment universe is a clear source of dispersion, with both recent and not-so-recent research studies, including research papers by Eugene F. Fama and Kenneth R. French, pointing out that value premiums vary substantially across countries. The low degree of correlation between value premiums on international equity markets calls for country-specific approaches to harvesting the value premium.

Second, there is no consensus on how to define value. Value can be defined by a simple single measure such as the price-to-book multiple, as an average of a combination of multiple measures of value, or by using forward-looking estimates. Managers harvesting the value premium typically sort stocks based on some measures of fundamental value relative to price, but the choice of metrics – price-to-book, price-to-earnings, price-to-operating cash flow, price-to-free cash flow, dividend yield – differs significantly across managers.

Even if using a similar set of metrics, practitioners might vary the inputs or the adjustments made in defining each measure. For example, the decision of whether to include intangible assets or non-operating assets in the calculation of a company's book value can vary among managers. As another example, managers may treat unusual or non-recurring items differently when estimating the profit-generating power of a business. That said, individual definitions of value and the respective metrics and tweaks used to define value represent a second major source of performance dispersion across managers harvesting the value premium.

One can notice performance dispersion even across portfolios of securities selected from the same investment universe by the same firm or manager using a similar definition of value. As shown in the graph below, there are obvious differences between the cumulative returns generated by three similar value indices created by index provider MSCI. MSCI's ACWI Value Weighted Index, ACWI Value Index, and ACWI Large Cap Value Index are three indices that focus on the same geographical region and share a similar definition of value, but their cumulative returns still differ due to different implementation and portfolio construction techniques.

The Value Weighted Index generated a cumulative return of 33.9 percent from the beginning of June 2011 through the end of August 2018, while the Value Index and the Large Cap Value Index delivered cumulative returns of 28.1 percent and 26.4 percent, correspondingly. The average pairwise correlation of the monthly returns of these indices stands at 0.99, but the cumulative returns of these indices differ quite significantly for this high degree of correlation.

FIGURE 1

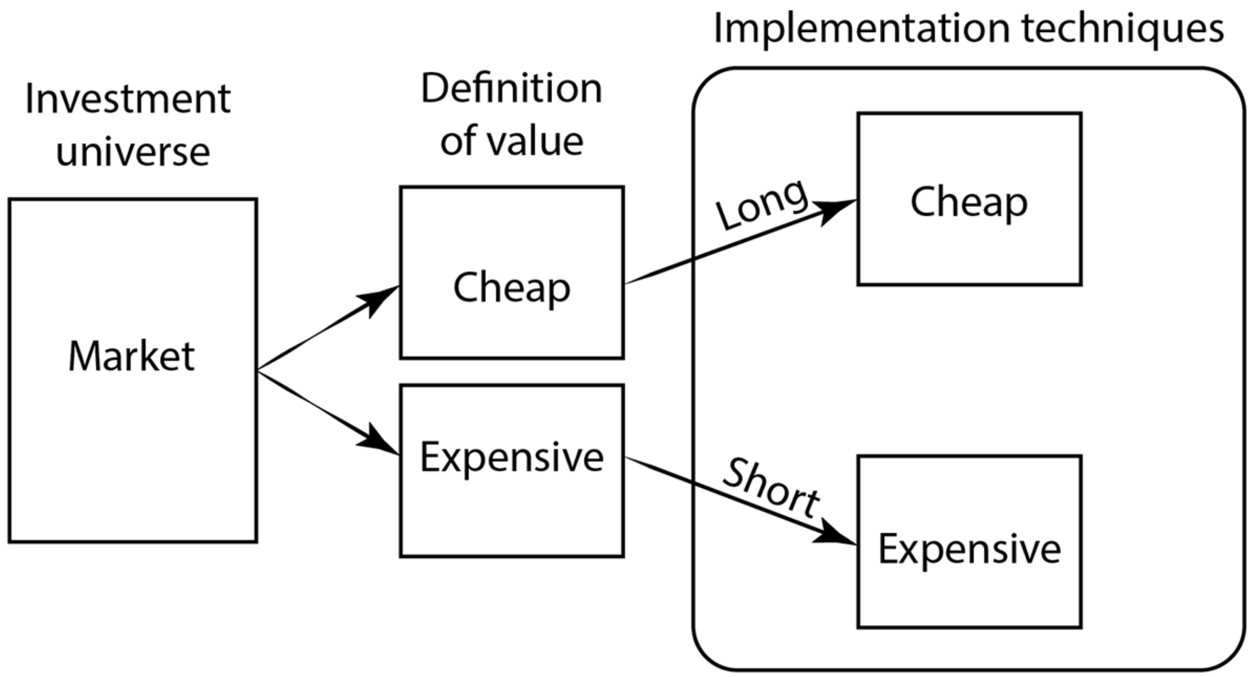

Figure 1: Sources of performance dispersion across alternative risk premia strategies harvesting the value premium in equity markets. Source: HedgeNordic.

FIGURE 2

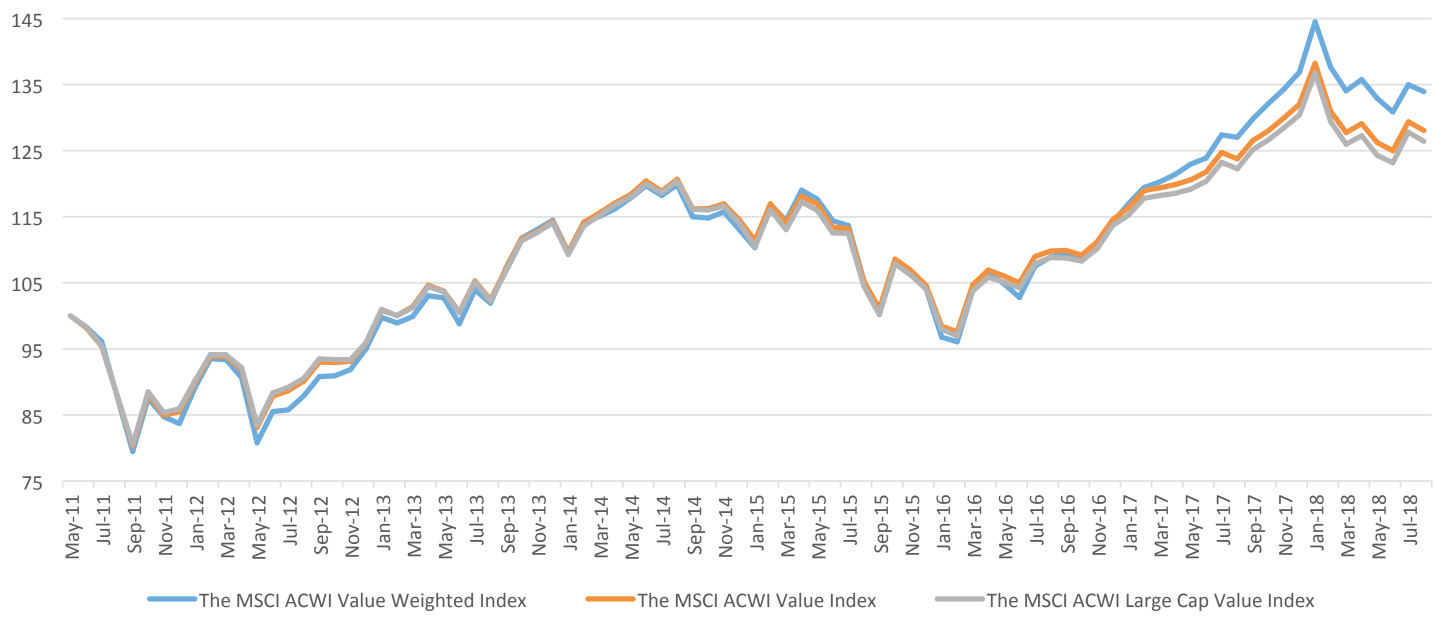

Figure 2: Same factor, different results. Total cumulative returns for MSCI ACWI Value Weighted Index, ACWI Value Index, and ACWI Large Cap Value Index. Rebased to 100 from 31 May, 2011. Data source: Thomson Reuters Eikon.

The index weights for the Value Weighted Index are determined using fundamental accounting data, including book value, earnings, and cash earnings, rather than market prices. Meanwhile, index weights for the other two indices are based on three price level valuation ratios, namely book value-to-price, 12-month forward earnings-to-price and dividend yield. The difference between the last two indices, is that the former includes both large- and mid-cap securities, whereas the latter includes only large-cap securities.

As presented above, portfolio weighting is one example of how implementation techniques might differ. One approach of weighing stocks in a portfolio is fundamental weighting, with weights determined using fundamental accounting data such as book value, earnings or cash earnings instead of market prices. Another approach incorporates price level valuation ratios for the portfolio construction process. Despite using similar fundamental value metrics in both the fundamental and price-relative weighting approaches, even small differences in portfolio construction and portfolio management can lead to serious differences in performance.

Conclusion

Risk premia represent great sources of return and diversification beyond traditional asset classes. The selection of factors appears to be the main decision investors have to make when evaluating alternative risk premia and smart beta strategies. But beyond the initial choice of factors, asset classes and geographical focus, there are other factors which can lead to enormous differences in performance across managers harvesting the same premium. For equity-focused strategies harvesting the value premium, one source of performance dispersion across managers is differences in the definition of value and the associated metrics used to define value. A more important source of dispersion comes from the variety of implementation techniques or portfolio construction approaches. Just as with other investment strategies available in the market, investors should pay attention to how fund managers build investment portfolios and how these portfolios are managed.

ARP in Multi-Manager Portfolios / Funds of Hedge Funds

An acquired taste for now

by Hamlin Lovell – HedgeNordic

“Not every hedge fund strategy can be accessed through ARP: “For instance, distressed debt requires proper, deep, forensic research, and strategies such as high frequency trading are capacity constrained”.

Most of those who run multi-manager vehicles in the Nordics are not investing in Alternative Risk Premia (ARP). For instance, Coeli Asset Management CIO, Erik Lundkvist, told HedgeNordic “We are not allocating to ARP”. Optimised Portfolio Management (OPM) Portfolio Manager, Martin Alm, is also not exposed to ARP. “We have looked at about ten ARP products, mainly in UCITS, but want to keep investing in alpha-focused products and not ARP, which is not as sophisticated. We also think that a fund of funds investing in ARP would need extremely low fees, since you can’t add as much value as the manager of the fund of funds” says Alm.

Still, OPM are open minded about accessing some hedge fund strategies at lower fees, and are invested in a trend-following product run by London-based GSA Capital, which charges fees comparable to those in many ARP. Says Alm “the GSA product is more sophisticated than buying a momentum strategy from an investment bank. It also uses the same technology as their alpha products”.

However, some other big allocators in the Nordics have developed a taste for ARP.

“‘Tier one’ allocators - meaning the largest pension funds, state pension funds, and insurance companies – have been the leaders in implementing ARP in portfolios” says Otto Francke, Portfolio Manager at SEB Solutions, who advise some of these giant investors.

SEB’s experience of analysing ARP dates back over 15 years. “We started seeding hedge funds and equity market neutral in the early 2000s. Then we viewed ARP as risk factors that we did not want to have in alpha portfolios based on skill alone” recalls Francke.

But in 2012 a reverse enquiry changed that. “An institutional client asked us to develop what was in effect ARP. That triggered a substantial research effort. We spent a couple of years looking at strategies, data and infrastructure. We found many investment bank offerings were overly simplistic, too expensive, and not buy-side quality. For instance, equity strategies used only one factor, bought the top quartile ranked on this factor for their long books, equal weighted, and shorted the benchmark against it. We asked why would you equal weight stocks with different risk characteristics, and why introduce sector and market cap biases by shorting a broad index?” says Francke. “The inputs were simple but the outputs in terms of return profile were not” he adds.

Franckealso notes that “back-tests showing Sharpe ratios as high as 1.5 or 2 are a warning flag that the strategy has been over-fitted and over-optimised. It is very rare that a pure strategy would have such a high Sharpe ratio and anyway, we do not need a Sharpe of 2. A Sharpe of 0.3 is fine for ten uncorrelated strategies that can be combined to give a fantastic overall Sharpe at the portfolio level”.

SEB has subsequently developed 18 internal ARP strategies across asset classes, and is also free to buy externally, from investment banks or hedge fund managers, where the IP and strategy warrants it. Francke identifies the four key advantages of his preferred ARP strategies as being fees, transparency, liquidity and balance sheet efficiency.

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Fees

Fees for ARP should be seen in the broader industry context: fees in general are coming down right across the asset management industry. Francke finds it "impossible to generalise about fees on ARP, as it depends on the IP involved, data sources, and structuring. If a more generic strategy has very low costs then fees should not be much more than just execution and transaction costs. But where a certain level of skill is involved it is harder to create a DIY strategy. Then we need to outsource and pay appropriate fees".

Francke welcomes the potential to access some strategies at lower fees: "certain actively managed hedge fund strategies that once charged 2 and 20 for simple equity value, quality and momentum are becoming commoditised, so that investors can gain factor exposures in an efficient, transparent and liquid way. Meanwhile, hedge funds have upped their game and the good ones offer more refined alpha".

Transparency

"ARP can also offer better transparency than some hedge fund strategies" Francke has noticed.

Liquidity

"And for liquid strategies, it is not optimal to be in a hedge fund with monthly liquidity, when ARP can offer daily liquidity" he adds.

Balance Sheet efficiency

SEB typically uses swaps, which can be linked to managed accounts or indices. Where ARP can be accessed through swaps, notes or certificates that may be unfunded – or at least not fully funded – the structure can free up space on balance sheets, which can be redeployed into other investments. Swaps can also allow ARP to be used as an overlay. "Costs depend on size, and relationships with providers" says Francke.

STRATEGIES APPROPRIATE FOR ARP

Francke does not think every hedge fund strategy can be accessed through ARP: "For instance, distressed debt requires proper, deep, forensic research, and strategies such as high frequency trading are capacity constrained".

MARTIN ALM
PORTFOLIO MANAGER, OPM

ERIK LUNDQVIST
CIO, COELI ASSET MANAGEMENT

Some strategies may be amenable to both ARP and traditional hedge fund structures. "Trend following lends itself very well to an ARP framework, but hedge fund managers can add additional value on top of the beta component" he says.

Francke is alert to the risk that some ARP strategies could become over-crowded. For instance, he remembers the "quant meltdown" month of August 2007, when managers pursuing similar quantitative equity strategies on a leveraged basis were all forced to rush for the exit together. Still, Francke argues that "not all factors are created equal. Some, such as Value, seem to be fairly generic but depending on factor design, it is possible to come up with fairly different portfolios".

ESG

Francke finds that some forms of ESG can be easily implemented in ARP. For instance, metrics scoring carbon intensity can be used, and SEB's negative screening of certain companies has been used from the start.

However, difficulties arise in two areas: impact investing, and strategies using derivatives.

Francke argues that "it is very difficult to gain access to impact investing in a systematic way, because the whole idea is to invest in companies subject to structural change". This is probably an inherent problem that is not easily solved.

The challenges of implementing ESG through index derivatives may be overcome quite soon however. Historically, with little or no ESG equity index futures available, and customised baskets of equities being less liquid than the standardised futures, it was difficult to pursue a global macro or managed futures strategy on an ESG basis. Going forward however, investors should watch this space as EUREX are about to launch ESG index futures sometime during 2019.

Insurer Swiss Re has already said that they are now using the equity MSCI ESG Index family and the fixed income Bloomberg Barclays MSCI Corporate Sustainability Index family.

Says OPM's Alm "we are still waiting to see more systematic managers incorporating ESG. Our approach to ESG tries to be more proactive, and does not only exclude certain industries or companies".

OTTO FRANCKE
PORTFOLIO MANAGER, SEB MERCHANT BANKING

Assessing E, S and G in a World of Factors

By Aline Reichenberg Gustafsson, CFA
Editor-in-Chief NordSIP - Nordic Sustainable Investments

Nowadays, talking about adding Environment, Social and Governance (ESG) factors into an investment process is common jargon, but most often, the word 'factor' is used in a broader sense than in the context of a systematic investment strategy. While it is increasingly accepted that investing sustainably, and taking into account ESG, produces better risk-adjusted returns, many still argue that the data quality is insufficient, the comparability between different sources weak and historical series too short to be able to integrate ESG in systematic processes fully. And yet, in some instance, there seems to be strong evidence of correlations between elements of sustainability and investment factors.

In a recent paper[1] published on the back of a global survey conducted in collaboration with BNY Mellon, Amir Amel-Zadeh and George Serafeim point out that comparability, timeliness and reliability are the critical qualitative characteristics that make financial information decision-useful, as identified in the most widely used accounting standards (US GAAP and IFRS). It thus unsurprising that almost half of the respondents (45%) cite the lack of comparability across firms, and the lack of quantifiable ESG information (38%), or the lack of comparability over time (35%), as the limiting factors in their firm's ability to use ESG information in their investment decision.

However, in a study performed by MSCI already more than five years ago[2], a quantitative strategy taking into account the firm's ESG Research Intangible Value Assessment scores could show a positive contribution on return. The absolute or relative ESG score of stocks might not have demonstrated tremendous performance differentials, even though it was possible to produce comparable results to those of a benchmark index through optimisation. However, a 'momentum' tilt, which integrated the changes of ESG scores over a year, had a positive effect not only on the subsequent ESG scores of the optimised portfolio but also on financial performance. In other words, companies who are doing more of the "right things" are likely to experience a positive stock price movement.

A couple of years later, Gerhald Halbritter and Gregor Dorfleitner calculated[3] that, indeed, the Fama and MacBeth cross-sectional regression model revealed a significant influence of several ESG factors, but that investors were unable to exploit this relationship. It is not until late 2016 that a more in-depth analysis of ESG in the context

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of factor investing was performed by Dimitris Mela, Zoltàn Nagy and Padmakar Kulkarni[4]. First, the authors tested ESG as a potential new factor by integrating it into the framework of equity factor models. By assigning numerical ESG scores to companies, they argued, these numbers were quickly transformed into exposures or z-scores. However, during the period tested (January 2007 to June 2016), only the first two deciles of ESG scores showed excess returns. Lower scores didn't show any clear relation to performance. It seemed that the lowest ESG decile also produced favourable excess returns. Moving on further into their analysis, the authors compared their ESG factors with traditional factors, digging down to stock-level comparisons. The average level of correlation they measured was low, which indicated that ESG scores were mostly independent, and therefore constitute a new source of information. However, the statistics were stable and highly significant over time. For example, a positive correlation of 0.17 with the size factor, and a negative correlation of -0.17 with the mid-cap factor were observed, which means that larger companies tend to have higher ESG scores, and furthermore, this measurement was most robust for the "E" pillar.

Interestingly, in other studies it is not the "E" but the "G" factor that has attracted the most attention. In Mela, Nagy and Kulkarni's paper, they measured a low negative correlation of the "G" pillar with earnings variability and residual volatility of -0.10 and -0.11 respectively, but with a high level of significance. This result would suggest that companies with a good level of governance tend to show a low level of earnings variability and residual volatility. More recently, Swedish-based systematic asset manager IPM[5] conducted a study which analysed the returns of stocks in three different geographical regions (the USA, Europe and Global) between 1996 and 2018. The results showed that the Governance factor effectively improved the relative return per annum by as much as 0.5% for globally, just below 0.25% in Europe and almost 0.5% in the US, while the relative volatility was practically unimpacted. The maximum relative drawdown, however, was significantly improved, especially in the US where it was more than 2% lower.

While research indicates that ESG is either related to factors, or have a positive influence on returns on their own to an extent, there are still opportunities for improvement. Both the quality and availability of data is improving and should provide for more precise definitions and categorisations. Besides, elements influencing the environment, for example, could start having a stronger impact on returns, as society increasingly responds to the threats of climate change. In the same vein, the opportunities engendered by global challenges, such as population growth and lack of resources, are becoming more strongly intertwined with elements figuring in ESG scores.

> "A quantitative strategy taking into account the firm's ESG Research Intangible Value Assessment scores could show a positive contribution on return."

At the same time, as strategies are built to support the companies that provide solutions to remedy these issues, the metrics of ESG become more strongly related with return generation than with risk avoidance. There is a strong chance, therefore, that E, S and G will soon have a new opportunity to pose as relevant factors in systematic investment processesto Källström. "We have learned a lot over the past five years, and it is only natural that we strive to improve on a continuous basis. While we keep our fundamental investment beliefs firmly anchored, we constantly seek to perfect our approach in every asset class we work with. As such, this upcoming shift in hedge fund allocation can be seen as dramatic from one perspective, but it is also an evolutionary step."

1 Why and How Investors Use ESG Information: Evidence from a Global Survey, Amir Amel-Zadeh, Said Business School, University of Oxford and George Serafeim, Harvard Business School, July 2017.
2 Optimizing Environmental, Social, and Governance Factors in Portfolio Construction, An Analysis of Three ESG-tilted Strategies, Zoltàn Nagy, Doug Cogan, Dan Sinnereich, MSCI Research Insight, February 2013.
3 The wages of social responsibility – where are they? A critical review of ESG investing, Gerhard Halbritter and Gregor Dorfleitner, March 2015, in the Review of Financial Economics.
4 Factor Investing and ESG Integratio, Dimitris Melas, Zoltàn Nagy and Padmakar Kulkarni, MSCI Research Insight, November 2016.
5 Systematically Sustainable, NordSIP, May 2018.

> "While research indicates that ESG is either related to factors, or have a positive influence on returns on their own to an extent, there are still opportunities for improvement."

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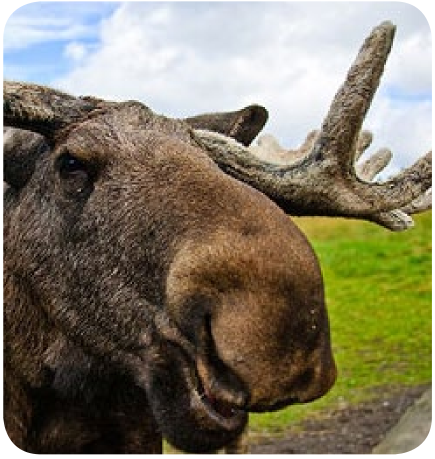

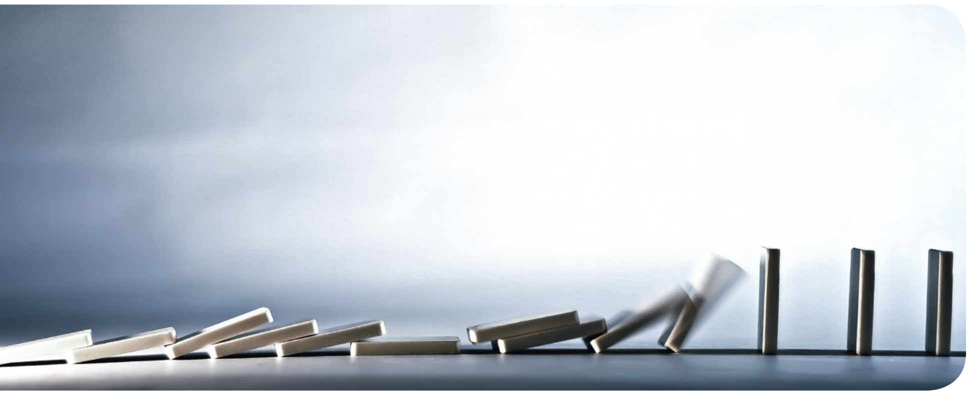

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