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The future is here – dynamic beta and portable alpha

The aftermath of the credit market collapse has left investors bloodied and in pain. Many an investor, who had invested in equities and bond markets, ended up losing money. As a result of this investment misfortune there surely must come a stage where investors rethink strategy so as not to commit the same mistakes twice.

Fixed income as an asset class has often been an afterthought allocation. When you have sexy assets such as equities, commodities and property that provide euphoric returns (but exceedingly large volatility), why bother with the poor (geeky) cousin: the fixed income world. Yet fixed income serves an important purpose when implemented correctly. It provides capital protection for when times turn sour, as well as income generation and diversification. However, pension funds have historically invested via an index (either active or passive) to get their beta exposure to the market.

Problems with benchmarks

There are four problems with this traditional approach:

1. **First**, indices are biased towards the issuer as opposed to the investor. Typically, the larger the borrower, the greater component of the index it becomes. The active or passive investor is therefore forced to hold some exposure to this large borrower. The index does not assess the borrower on creditworthiness (size matters).
2. **Second**, it is assumed the ideal duration (maturity profile) of the benchmark (roughly 3 years and 5 years for an Australian and Global benchmark respectively), will protect investors in the long run – regardless of movements in interest rates. Investors with specific liability profiles face a mismatch. Generally their liability streams are longer (10+ years in most cases), and the assets they owned through the index are much shorter maturity and subject to fluctuations in interest rates.
3. **Third**, indices represent only a fraction of the fixed income markets and are weighted towards the traditional markets of North America and Europe rather than the growth regions of Asia.
4. **Fourth**, indices face a significant compositional drift, such that past performance and structure in the asset allocation process is not representative of the future.

Dynamic positioning is necessary

2008 is a perfect example. During the first part of the year, the RBA was bent on fighting future inflation. Even though the world was falling apart around them, they continued to raise interest rates. During this period the UBS composite index produced a mere 2.6% return for 6 months, while simply putting your money in cash funds would have produced nearly a 4% return.

The second half of 2008 was a different story. The RBA, having realised that raising rates was a mistake, decided to cut interest rates aggressively (4% in only three months). The UBS composite index produced a whopping 12% return, while cash holdings only produced 2.5% during the same period. In order to maximise return for clients, an active fund manager was better served being in cash during the first half of the year, and invested in the UBS composite during the second half of the year. Timing is everything!

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Active management a must – Dynamic beta is essential

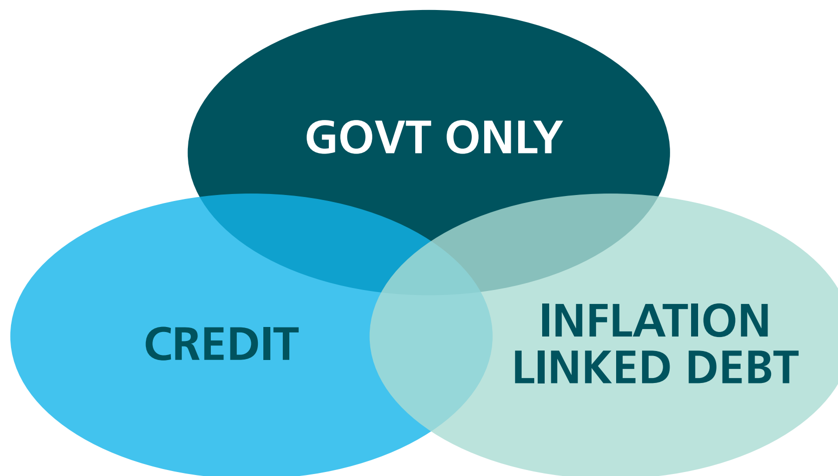
Instead of taking the risk return characteristics of a benchmark, shouldn't an investor actively allocate to sectors and asset classes based on the risk/return characteristics over the short to medium term?

Strategic asset allocation does have its merits. However it makes no attempt to adjust the distribution of assets to take advantage of market conditions, leaving portions of the portfolio vulnerable to market downturns.

Unlike strategic and tactical asset allocation, dynamic asset allocation does not adhere to a static, fixed percentage allocation. The objective of a dynamic beta strategy is to identify profitable instruments in the current market environment. Therefore, the allocation process becomes dynamic – changing in response to market conditions and perceived opportunities for profit.

Dynamic beta should not be confused with market timing. Rather, a dynamic beta portfolio strives to proactively forecast which asset classes are attractive or unattractive on a forward looking basis. Success depends on the ability to identify the asset classes with the greatest potential for higher returns over a market cycle. Not every decision will be perfect, yet a dynamic strategy not only offers the potential for superior risk-adjusted results, but also helps protect investors' portfolios over market cycles.

The dynamic portfolio for 2009–2010



Corporate debt

Over the next two years, most central banks will be on hold or leave rates very low. Credit and credit spreads are at extremes. Senior debt of major corporations and banks are trading at levels that have not been seen since the Great Depression! Historically, inflation in developed economies has been about 2.5 to 3%. Central Banks have maintained an additional real rate of around 2% above inflation to manage major economies. This puts neutral cash rates around the world around 5%. We know that current rates of 3% in Australia and 0% in the US and the rest of the world are artificially low, and once the crisis subsides, Central Banks will have a tightening bias.

Given this environment, it makes prudent sense to allocate one's fixed income exposure to corporate bonds that are AA or better and yield 6.5 to 7%. An investor could possibly get an additional 1 or 2% by going down the capital structure. Aside from default risk, the major risk in owning corporate bonds is interest rate risk. As interest rates are normalised, the credit component of one's fixed income can underperform. Buying floating rate assets immunises your portfolio to rising interest rates.

Advantages – Risk return profile argues for high running yield, with little default risk.
Disadvantages – Liquidity is poor, mark to market risk and default risk continue to be high.

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Government and government guaranteed debt (WGBI Benchmark)

For the conservative investor who does not want credit risk and would prefer to avoid default risk, governments look attractive. However, corporate debt guaranteed by the major governments looks even more attractive. By guaranteeing the debt, the government has in essence removed any default risk and stands behind the issuer in case of a default. These bonds provide the investor an additional 100bps in returns over sovereign debt. A portfolio that combines both government and government guaranteed debt appears prudent to an active beta manager, depending on risk tolerance levels.

Again, interest rate risk can be actively managed in a government/ sovereign portfolio by overlaying futures to actively manage the portfolio.

Advantages – Robust liquidity and default risk is minimal.
Disadvantages – Interest rate risk is high.

Inflation protection

The world is at a crossroads. Either the massive stimulus thrown at global economies lights a massive fire (or future inflation), or we end up in a deflationary spiral. If the world ends up like Japan and stimulus fails to ignite, then kiss your risk assets (read equity) returns goodbye. If the roaring fire succeeds, then investors should buy some cheap insurance now. Inflation protection can be bought by owning global inflation index bonds, commodity exposures, property and other traditional inflation hedges.

Advantages – Cheap insurance available to structure inflation protected portfolio.
Disadvantages – If the world falls into a deflationary spiral, inflation protection will not be needed.

Dynamic beta conclusion:

- Depending on an individual investor's view and risk tolerance levels, it is possible to construct a portfolio of dynamic betas over the short term (two to three years) that can outperform a traditional bond index significantly.
- Allocating to floating rate credit for the next two years will protect against rising interest rates and will outperform a standard credit benchmark with longer duration.
- With the stimulus currently in place, it is possible that in the medium term we will be looking down the barrel of a high inflation, low growth period. At this point, switching out of credit into inflation protection is optimal.
- For the investor that does not want to time the credit/inflation spread, a portfolio of government/government guaranteed assets (with a duration overlay to offset a rise in rates) offers investors liquidity, less volatility and low default risk.

Portable alpha:

If beta can be managed dynamically and/or passively, an investor can easily overlay alpha strategies over any of the beta portfolios to enhance returns. Using strict risk and leverage controls, alpha can be ported by using derivatives such as futures, options, swaps and credit default swaps.

Portable alpha need not include borrowing against a list of assets to leverage the portfolio (this method is what has got a lot of funds into trouble). Instead, it can be achieved by using exchange traded or over the counter derivatives which require minimum margin requirements and are either.

Using a breadth of instruments, a portfolio of alpha positions can be implemented to take advantage of structural inefficiencies, market mis-pricings, and cross-country and/or cross-sector spread movements. Typically, a good fund manager is expected to add an additional 100 to 150 bps of alpha over the beta.

Advantages to clients

Investors can now cherry-pick from any or all of the above. A conservative investor can passively pick a beta and a more aggressive investor can choose both the beta and alpha. An even more dynamic investor can not only customise the beta based on their risk tolerance and return expectations, but also add portable alpha.

In these uncertain times, investors should be proactive in portfolio construction to take advantage of all the opportunities that exist. Rather than stick to the norm and suffer through the ups and downs of the market, adopting a dynamic allocation process that changes in response to market conditions has the potential for superior risk-adjusted results and better capital protection over business cycles.

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