



Investing like an institution

A hybrid approach to accessing alternatives

Contents



Investing like an institution

Understanding absolute return strategies

The evolution of institutional investing

Taking a hybrid approach to investing in absolute return strategies

Why should individual investors pay attention to how institutions design their portfolios? Over the past 20 years, institutional portfolios materially outperformed those of individual investors. Institutional investors recognized that market dynamics have evolved, and they developed new ways to enhance their portfolios.

While individuals have different goals and needs than institutions, understanding how institutions build their portfolios, including combining active and rules-based investing strategies, may provide individuals important insight into ways to best achieve their investment objectives.

Investing like an institution

For the past two decades, institutional portfolios outperformed those of individual investors. Understanding the drivers of the differing outcomes may help individuals as they design their portfolios.

One substantial difference between their approaches is clear. On average, individuals allocate only 5% of their portfolios to alternative investments,² while some institutions, such as Yale University, have invested over 70% in alternatives.³

How institutions allocate within this broad category is also instructive. Historically, institutions devoted a meaningful portion of their alternative portfolios to absolute return strategies, which seek to generate positive, low-correlated returns regardless of broad market performance. Such allocations are largely motivated by the desire to smooth a portfolio’s returns—minimizing volatility and drawdowns to generate larger compound returns over time.

Individuals may improve their chance to achieve their investment goals by adopting an institutional approach. To do so, they need to understand how institutions are using absolute return strategies to address the challenges of building diversified portfolios.

YALE ENDOWMENT PORTFOLIO³



Absolute return	26.0%
Venture capital	18.0%
Foreign equity	15.5%
Leveraged buyouts	15.0%
Real estate	9.5%
Bonds and cash	6.5%
Natural resources	6.5%
Domestic equity	3.0%

Average growth of \$100,000 based on annualized rate of return (1997–2017)¹



¹ Past performance is not indicative of future results. Wilshire Compass, DALBAR’s 2018 Annual Quantitative Analysis of Investor Behavior Report (“DALBAR Report”) and the Wilshire Trust Universe Comparison Services® (“Wilshire TUCS®”). Individual investor is calculated as 60% average equity fund investor and 40% average fixed income investor. Data for average equity fund investor and average fixed income fund investor are from the DALBAR Report. Data for average institutional investor is from Wilshire TUCS®, defined as the median total return, gross of fees, of master trusts—all plans.

² “Distribution of Alternative Investments through Wirehouses,” Money Management Institute and Dover Financial Research, 2015.

³ Yale News, October 1, 2018.

Understanding absolute return strategies

Absolute return strategies fit within the broader category of alternative investments. A common misconception is that alternatives are a single asset class, but they include a wide range of asset types and strategies differentiated by their benefits and risks.

An important distinction

“Alternative assets” and “alternative strategies” are two different things. Alternative assets, such as private debt and equity, real estate and natural resources, represent specific investment types or asset classes with inherently distinct characteristics from traditional public fixed income or equity securities.

Alternative strategies, on the other hand, refer to the specific ways a manager invests in a given market or asset class. Alternative strategies can incorporate both traditional and alternative assets and commonly employ both long and short positions to generate returns. Some alternative strategies are classified as absolute return because they seek to generate a targeted level of return regardless of market direction.

ALTERNATIVE STRATEGIES



Event driven

Seeks to capitalize on price inefficiencies due to corporate events or the maturity/call date of a corporate debt security



Equity hedge

Seeks to buy stocks expected to increase in value and short stocks expected to decline in value to hedge out market exposure



Relative value

Seeks to invest in assets whose value is determined to be more attractive than that of similar assets



Global macro

Seeks to profit from the potential impact of economic expectations or political events, usually by using futures instruments to place directional bets on the prices of stocks, bonds, currencies or commodities

Absolute return strategies

Absolute return strategies are some of the most common strategies employed in the \$3 trillion hedge fund industry. Hedge funds typically have high investment minimums, strict investor suitability requirements, and are less liquid and transparent than retail-oriented investment funds. As a result, access to absolute return strategies has historically been limited to institutions and high net worth (qualified) individuals that can meet these requirements.

Over the last decade, however, these strategies have become more accessible for individuals through “liquid alternatives,” or open-end mutual funds. Compared to hedge funds, mutual funds provide several shareholder-friendly attributes including daily liquidity, transparency, lower costs, significantly reduced investment minimums and regulatory oversight.



Liquid alternatives (mutual funds and ETFs) currently constitute \$334.6B in assets, having doubled in AUM since 2010.⁴

COMPARISON OF MUTUAL FUNDS AND HEDGE FUNDS

	Open-end mutual funds	Hedge funds
Suitability (investor qualifications)	Low barriers to investment	Usually requires the investor to be a qualified purchaser
Transparency (price/portfolio)	High	Typically limited
Minimums	Low (often as low as \$1,000)	High (typically \$1,000,000 or more)
Valuations	Daily	Periodic
Liquidity	Daily	Periodic

Individuals have turned to liquid alternatives for many of the same reasons that institutions allocate to absolute return strategies: to generate returns with low correlation to traditional investments, and as a possible hedge against a broad market downturn. Looking at how institutional investing has evolved over the past several years can help demonstrate how absolute return strategies can fit into an individual’s portfolio.

⁴ Morningstar, as of April 25, 2019.

The evolution of institutional investing

For decades, institutions looked to actively managed hedge funds to provide differentiated returns. As institutions formed a better understanding of the drivers of these returns, they evolved their approach, incorporating rules-based strategies alongside a more tailored selection of actively managed strategies. This enabled them to take a more targeted approach to portfolio construction and create cost-efficient portfolios.

Deconstructing hedge fund returns

Historically, hedge fund performance has been largely attributed to manager skill, or alpha, supporting the high level of fees and limited transparency that typically accompanied these types of investments. Following the financial crisis, however, global central bank stimulus helped fuel a bull market in asset prices and rising asset correlations. This environment made it increasingly difficult for hedge fund managers to generate alpha and contributed to the significant rise of passive investing. As many hedge funds struggled to outperform—or even keep pace with—the broader market, institutions began to evaluate hedge fund performance and their higher costs with greater scrutiny.

Building on the foundation of research of Eugene Fama and Kenneth French in the 1990s, which studied the underlying drivers of returns, institutions and researchers deconstructed hedge fund returns into different types of return categories that reflect varying levels of skill and cost associated with capturing them. The research provided a clearer understanding of hedge fund returns and led institutions to rethink how they incorporate managers and rules-based strategies within their portfolios.

DECONSTRUCTING HEDGE FUND RETURNS



A portion of any manager’s performance can now be attributed to general market performance, commonly referred to and quantified as “market beta.” The rise of index funds and ETFs over the last decade reflects investors’ growing appetite for cheap exposure to this type of broad market performance, rather than paying potentially higher fees to a manager. More recently, researchers also identified how specific underlying attributes of stocks, bonds, commodities and currencies can further help explain hedge fund performance. These underlying return drivers are often referred to as “factors” and represent an alternative risk and return that an investor captures by investing in securities with specific characteristics.

Finally, after attributing the returns associated to these two types of beta, any excess return is attributed to manager skill, or alpha. Institutions recognize the scarcity of true alpha and are willing to pay the potentially higher cost to managers who have a track record of consistently generating alpha.

With this new framework, researchers have shown that a portion of returns that were long attributed to the mystique and skill of hedge fund managers could actually now be traced to investing in securities with certain types of attributes.⁵ Given this broader understanding of investment returns, institutional investors sought to gain exposure to these targeted underlying return drivers more systematically and cheaply than by investing through hedge funds. This understanding forms the basis of factor-based investing.

Understanding factors

Perhaps the oldest and best-known example of a factor is **value**, which refers to the risk and return associated with buying cheaper stocks compared to expensive stocks based on a predefined set of valuation criteria (e.g., price-to earnings, sales-to-earnings). Investors are also likely familiar with another well-known factor, **size**, which refers to the tendency of smaller stocks to outperform their larger peers over time. Other primary factors include **momentum**, **carry** and **quality**, as summarized in the table below.

FACTOR	TARGETED SOURCE OF RETURN
Value	Captures the tendency for cheap stocks to outperform expensive stocks
Size	Captures the tendency for stocks of smaller companies to outperform larger companies
Momentum	Captures the tendency for securities that have outperformed over short-term periods to continue to outperform in the future
Carry	Captures the tendency of higher-yielding securities to provide higher returns than lower-yielding securities
Quality	Captures the tendency for securities of higher quality (based on defined financial metrics) to outperform lower-quality securities

Factor investing, smart beta and alternative beta are often used interchangeably in the financial press, but there are key distinctions investors should understand.

⁵ "Common risk factors in the returns on stocks and bonds," Eugene F. Fama and Kenneth R. French. Journal of Financial Economics.

Is alternative beta the same as smart beta?

Yes and no. The differences between market beta, smart beta and alternative beta can best be explained with real world examples. The S&P 500 Index is a market capitalization-weighted index and perhaps the most widely quoted proxy for the performance or beta of the U.S. equity market. As a market cap-weighted index, the companies within the S&P 500 are weighted according to the total market value of their outstanding shares.

In contrast, a smart beta strategy might reconstruct the index using the same 500 companies but change the weightings based on a metric other than market value, such as price-to-earnings.

Alternative beta strategies seek to gain exposure to the same factors as smart beta, but go a step further to include both long and short positions. For example, a common hedge fund strategy of buying undervalued stocks and shorting overvalued stocks can be replicated by creating an index that simply ranks stocks based on a set of defined criteria (e.g., price-to-earnings) and buys the top 50 “cheapest” stocks and sells the bottom 50 “expensive” stocks. This rules-based approach may be a more cost-efficient way of gaining exposure to the value premium of the equity markets as opposed to investing with hedge fund managers, depending on the market environment and the need for active management.

DIFFERENCES IN RULES-BASED STRATEGIES

Market beta	Smart beta	Alternative beta
EXAMPLE S&P 500 Fund	EXAMPLE S&P 500 Value Fund	EXAMPLE S&P 500 Value Long/Short Fund
SEEKS TO match market benchmark	SEEKS TO outperform benchmark	SEEKS TO deliver uncorrelated returns
STOCKS WEIGHTED by market cap	STOCKS WEIGHTED by value (i.e., P/E ratio)	STOCKS BOUGHT (low P/E ratio) STOCKS SOLD (high P/E ratio)

Why institutions use alternative beta strategies

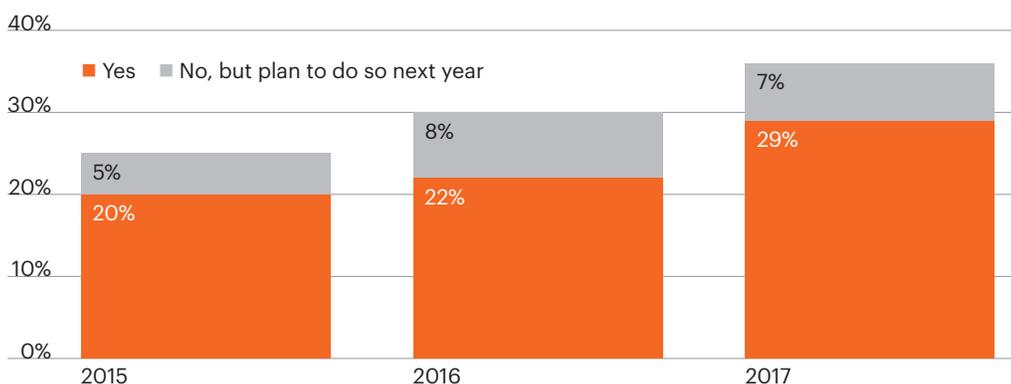
Institutions have incorporated alternative beta strategies for the following reasons:

- **Potential to generate low-correlated returns:** Through the combination of long and short investing, alternative beta strategies seek to provide absolute returns and diversification from traditional stocks and bonds.
- **Direct, cost-efficient access:** A rules-based approach captures returns directly without paying high fees typically associated with hedge funds.
- **Liquidity:** Alternative beta indices can be traded daily and avoid the lengthy notice periods, or “lock-ups,” often associated with hedge funds and other private investment vehicles.
- **Transparency:** Transparency of the underlying indices allows for a deeper understanding of the strategy, which leads to greater precision in portfolio construction and risk management.
- **Targeted return sources:** Alternative beta strategies target specific return drivers across asset classes (e.g., stocks, bonds, currencies, interest rates, commodities) to identify unique returns sources historically available only through hedge funds.

Growth of alternative beta market

Institutional interest in alternative beta strategies has grown significantly in recent years as institutions reconsider their hedge fund exposure in favor of more cost-efficient options. For example, CalPERS, the largest public pension plan in the U.S., allocated \$22 billion of its global equity portfolio to alternative beta equity strategies in 2018.⁶ In addition, approximately 36% of institutions surveyed by J.P. Morgan planned to invest in alternative beta strategies in 2018.

ALLOCATION TO ALTERNATIVE RISK PREMIA



Note: Figures based on selections from respondents in each respective year.

Source: J.P. Morgan 2018 Institutional Investor Survey. This 15th annual institutional investor survey collected responses from over 250 investors globally. <https://www.jpmorgan.com/jpmpdf/1320744896869.pdf>.

⁶ Financial Times. “Can factor investing kill off the hedge fund?” July 22, 2018. www.pionline.com/article/20180717/ONLINE/180719873/calpers-signs-rosenberg-equities-for-1-billion-portfolio.

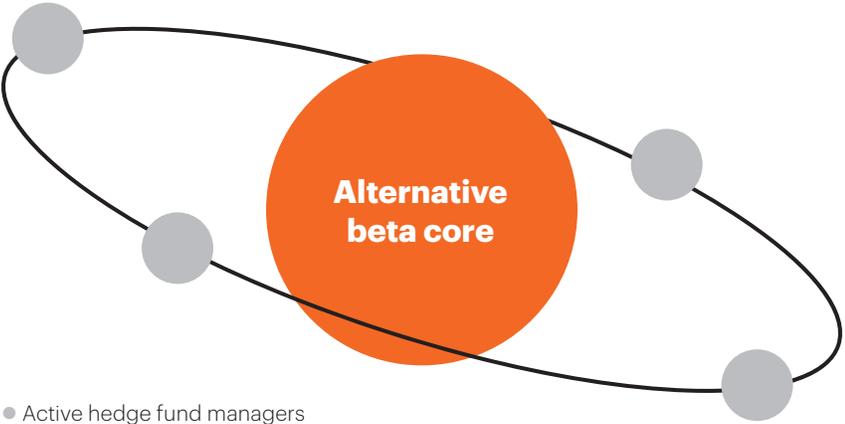
Taking a hybrid approach to investing in absolute return strategies

Many pensions, endowments and foundations are taking a hybrid approach to investing in absolute return strategies by combining actively managed hedge funds and rules-based alternative beta strategies to generate low-correlated returns and enhance cost-efficiency. The hybrid approach reflects the view that allocating to alternative beta strategies and active managers may provide investors with the greatest opportunity to gain exposure to the full spectrum of alternative sources of risk and return.

Constructing absolute return portfolios through the hybrid approach

Many institutions have implemented the hybrid approach by using a “core-satellite” asset allocation model. In this model, alternative beta strategies serve as the “core” allocation with the goal to deliver a meaningful portion of excess returns previously attributed to active managers—yet at a lower cost than active managers. This core allocation is complemented by a select number of “satellite” active managers with a proven, repeatable investment process and a long track record of generating alpha within strategies that complement or enhance the core allocation.

CORE-SATELLITE MODEL



Many institutions consider the following general guidelines when allocating to active managers.

1

Identify strategies that are consistent with the investment objective and complementary to the risk-return characteristics of the core alternative beta allocation. For example, for an absolute return objective, selecting managers that have demonstrated a proven ability to generate low-correlated returns across market cycles and especially during periods of market downturns is critical.

2

Choose a manager that has a proven track record of generating returns with a high level of alpha to justify the higher fees associated with allocating to active managers.

3

Periodically rebalance manager allocations as market conditions and views on the strategies best positioned to take advantage of the opportunity set change over time.

While not required, manager allocations are often deployed in markets or strategies that entail a high degree of human analysis and decision-making due to their opacity, complexity or inefficiency. Such markets or strategies are not well suited for systematic, rules-based strategies. For example, a credit long/short strategy may be best implemented through an active manager since it involves the purchase and sale of credit investments that often have differing maturities, coupons, covenants and call features. In addition, most credit investments trade over the counter through a vast intermediary broker-dealer network rather than a centralized exchange. The complexity and lack of uniformity requires human judgment in order to effectively implement this type of absolute return strategy.

On the other hand, a managed futures strategy involves the purchase of exchange-traded instruments (i.e., futures contracts) within standardized, highly transparent liquid markets. These strategies are often fully systematic and typically employ “trend-following” or “momentum-based” investing across asset classes. While historically delivered by managers with high fees, managed futures can be accessed through alternative beta strategies with greater cost efficiency given their compatibility with a rules-based implementation.

EXAMPLE APPLICATION OF ALTERNATIVE BETA AND HEDGE FUND MANAGERS



Alternative beta



Hedge fund manager

Investment strategy	Managed futures Global bonds and currencies	Credit long/short
Market liquidity	High	Lower
Security type	Global equities	Investment grade and high yield bonds
Security selection	Historical, return-based momentum signals	Fundamental, bottom-up security selection

Investment considerations

As the table below shows, the performance of absolute return strategies has varied over the last 10 years. We believe this dispersion in returns over time highlights how critical strategy selection and manager due diligence are when investing in absolute return strategies.

Just as many institutions hire consultants to aid in identifying top tier managers and determining when to deploy certain absolute return strategies, we believe individuals will increasingly need to leverage the knowledge and insight of their financial advisors to help achieve their financial goals.

HFRI STRATEGY CATEGORY RETURN (%) BY YEAR

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
25.8%	11.9%	-0.2%	11.0%	14.3%	5.6%	-0.3%	8.7%	12.8%	1.0%
25.0%	11.4%	-3.1%	8.7%	12.5%	4.0%	-1.0%	6.4%	8.0%	0.6%
24.6%	10.5%	-3.7%	6.4%	8.4%	3.1%	-1.3%	5.0%	7.2%	-2.3%
19.9%	10.5%	-3.9%	6.4%	7.1%	1.8%	-1.5%	4.6%	5.5%	-3.0%
4.3%	8.1%	-7.5%	-0.3%	-0.4%	1.1%	-3.6%	0.1%	2.5%	-5.7%

- Event driven
- Global macro
- Equity hedge
- Relative value
- Multi-strategy blend

Multi-strategy blend is represented by equal weights to the HFRI Event-Driven (Total) Index, HFRI Macro (Total) Index, HFRI Equity Hedge (Total) Index and HFRI Relative Value (Total) Index. The HFRI Event-Driven (Total) Index is designed to capture hedge fund performance of investment managers who maintain positions in companies currently or prospectively involved in event-driven corporate transactions. The HFRI Macro (Total) Index is designed to capture hedge fund performance of investment managers who trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. The HFRI Equity Hedge (Total) Index is designed to capture hedge fund performance of investment managers who maintain positions both long and short in primarily equity and equity derivative securities. The HFRI Relative Value (Total) Index is designed to capture hedge fund performance of investment managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities.

When considering the use of absolute return strategies, investors should have clear expectations of its purpose. Certain strategies may be better portfolio diversifiers, while others may provide return enhancement potential. Advisors also need to be aware of the potential portfolio tradeoffs. Alternatives, including absolute return strategies, can increase a portfolio's expected efficiency (risk-adjusted return) while also increasing a portfolio's active risk (divergence from the portfolio benchmark).

Summary

Investing like an institution means incorporating a meaningful allocation of alternative investments into one's portfolio. More and more, when doing so, institutions are taking a hybrid approach to portfolio design, one that combines actively managed hedge funds and rules-based alternative beta strategies to maximize returns and enhance cost-efficiency. A hybrid portfolio enables institutions to target specific outcomes and risk profiles, while offering increased flexibility and greater breadth in capturing the full spectrum of alternative return sources.

Today, individual investors possess the ability to access the types of strategies that institutions are using to seek absolute returns and manage risk.

Glossary of terms

Absolute return strategy

Absolute return strategies seek to generate positive returns, irrespective of broader market performance. These strategies tend to differ from long-only strategies by incorporating both long and short investments and alternative assets (e.g., private credit, private equity, real estate, natural resources, infrastructure, currencies).

Alternative strategies:

- **Event driven:** Seeks to capitalize on price inefficiencies that occur due to corporate events, such as mergers or acquisitions, or the maturity/call date of a corporate debt security
- **Equity hedge:** Seeks to buy and sell short individual equity securities in order to hedge out equity market exposure and/or monetize security selection opportunities
- **Relative value:** Seeks to invest in assets based on the determination that their value is more attractive compared to the value of similar assets
- **Global macro:** Seeks to take advantage of the impact of global macroeconomic events on asset prices

Alpha

The excess return of an investment relative to the return of a benchmark index

Beta (also referred to as “traditional beta”)

A measure of a stock’s volatility relative to the overall market. “Traditional beta” investments seek to match the returns of the market.

Alternative beta

Seeks to generate more-targeted exposure to the underlying drivers of returns across asset classes. It expands the investment horizon beyond traditional stocks and bonds by targeting specific drivers, or “factors,” of returns across a broad range of asset classes, and incorporates shorting and hedging.

Smart beta

Seeks to outperform a benchmark by using rules to invest in the benchmark’s stocks in a way that differs from the benchmark’s method.



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