CHALLENGES OF TODAY'S MARKETPLACE: DISCUSSING FACTORS AND ALTERNATIVES

Jeremy Schwartz — Global Chief Investment Officer
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On a special edition of our "Behind the Markets" podcast, co-hosted by Wesley Gray, we spoke with Rich Wiggins and Andy Weisman. Wiggins works in the Middle East with one of the largest pools of investment capital in the region, and Weisman is the co-CIO of the Liquid Alternatives Group at Windham Capital, out of Boston.

Our conversation touched on how these gentlemen look at using factors in a portfolio setting and how they consider and manage liquid alternative strategies. We also talked about our two guests' storied pasts.

Speaking of stories, we led off with one that deals with Bernie Madoff. Weisman asked our group if we had read the book *No One Would Listen*, written by Harry Markopolos with David Fisher. Markopolos exposed Madoff's fraud. About seven years before anyone would listen (hence the book's title), Markopolos contacted someone to reverse engineer Madoff's track record. This gentleman thought he could, given that he was an expert in portfolio attribution and such reverse-engineering projects. He spent a week trying to do this, but he could not at all figure out what was going on. It dawned on him that Madoff's returns were too good to be true. The person doing the reverse engineering was Andy Weisman—and he came to the conclusion seven years before anyone else. Weisman clearly caught our attention early in the podcast.

History of Alpha: We talked a lot about factors. Weisman described alpha as the intercept term in a regression equation that is found from setting the expected value of the error term to zero. Factor models started off as just beta with anything not explained by market exposure as alpha. Then came the Fama-French three-factor model that shrank alphas more, and we continue to expand factors going into regressions so that alpha increasingly is being narrowed down. At a high level, often what we think of as alpha is just a misspecification of a factor model, and we have yet to appropriately describe what is driving that portfolio's returns.

How Concentrated Should Your Factor Bets Be? Wiggins worries about combining the so-called smart beta factors into a portfolio mix. Wiggins is concerned that too much is canceled out when factors are combined. Things that are the opposite of each other, like value and momentum—value stocks are identified by a low price/book ratio, and with prices going down (poor momentum) you have value stocks—cancel each other out when combined. Regarding value and quality, many value stocks look "junky" and the opposite of "quality." Wiggins worries that if you try to combine all these factors together, you end up with a product that looks like the market and broad market beta again. Wiggins pointed to "smart beta" combination portfolios that have tiny factor loadings with offsetting contra bets. Wiggins seemed more approving of going big and taking concentrated factor bets—as long as your goal is just to make money.

Risk Parity or Anti-Risk Parity: Wiggins is investigating an investing concept that would take the other side of most risk-parity positions. Risk-parity concepts try to combine assets in a portfolio setting that equalizes risk. Often in a classic 60/40 stock/bond portfolio, 90% of risk will come from the stock allocations. Yet Wiggins described the challenge of this strategy. In 2009, after the crash, risk-parity managers had to sell equities because of the crash and the spike in volatility, which resulted in lowered allocations to stocks. In 2013 during the taper tantrum, risk-parity managers lowered their allocation to bonds because bonds were spiking. Those two events were the opposite of what you wanted to do when return potential was rising even as volatility was spiking. The anti-risk-parity strategy would be a way to make money—but certainly not to control risk. This is either crazy or genius, and you'll have to decide for yourself which you feel.

Interest Rate Momentum Strategies: We talked about one of the big challenges for investor portfolios today: the historically low interest rates and how the 10-year forward-looking returns on bonds are very much related to the starting interest rate on the bond portfolio. Weisman is worried that since the 1950s, 75% of the time, stock and bond prices were positively correlated—i.e., stocks and bonds could decline together. Further, Weisman said that if you have the 10-Year U.S. Treasury note yield over 4.5%, you've never had a two-year rolling window in which stocks and bonds were not positively correlated. Most investors over the last 10 years have become conditioned to bonds being a good hedge for their equities because bond prices rise most of the time when stocks decline. The next bear market in equities could be caused by bond yields rising and bond prices declining. Weisman thus likes strategies that have some type of interest rate momentum as a component—whether from managed futures or some other dynamic duration exposure.

This is just a preview of the great conversation we had on the show. You can listen to the full conversation below. A major thank you to Wes Gray for co-hosting the show with me and for inviting the two guests.

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DEFINITIONS

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Alternative Investment : An investment that is not one of the three traditional asset types (stocks, bonds and cash). Alternative investments typically include hedge funds, managed futures, real estate, commodities and derivatives contracts.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

Regression analysis : statistical process for estimating the relationships among variables. It helps one understand how the typical value of the dependent variable (Y- variable) changes when any one of the independent variables is varied, while the other independent variables are held fixed.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Fama-French : Refers to a factor-based model to describe stock returns developed by Eugene Fama and Kenneth French. Their original three-factor model breaks down the components of stock returns to market risk, company size and book to market ratio, or value.

Smart Beta : A term for rules-based investment strategies that don't use conventional market-cap weightings.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Price-to-book ratio : Share price divided by book value per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Volatility : A measure of the dispersion of actual returns around a particular average level.

Taper tantrum : a period in which global interest rates rose dramatically in 2013 as a response to a shift in monetary policy by the Federal Reserve.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

10-year government bond yield : Yields on the 10 year government debt security.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.