2021 PREQIN GLOBAL **HEDGE FUND** REPORT

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Risk Premia Investing Should Be Dynamic

Alternative risk factors, or premia, can be used to exploit the cyclical nature of the global economy

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Investing in known investment factors has been shown to add value to portfolios. But the academic evidence for investing in factors – or risk premia – does not always conform to investors' experience of it. Outsized paper returns simply may not be available in the real world.

Why? Because the value that can be harvested from risk premia is not permanent. It can get crowded out or decay for other reasons. A passive investment in risk premia can therefore leave a lot of value on the table and expose investors to unnecessary drawdown. There must be a better way for investors to harness risk premia than through static allocations.

The Problem with Factor Investing

Alternative risk premia, or factor strategies, have been growing in popularity as a complement to both passive and actively managed portfolios. A key reason for this is that alternative risk premia strategies tend to have low correlations with traditional asset classes so offer investors low-cost diversification. Tried-and-tested alternative risk premia include carry, volatility, value, curve, and momentum.

However, alternative risk premia strategies do not always live up to investors' expectations for two principal reasons. First, academic research based on back-testing over long time periods does not always reveal recent underperformance of a factor. This underperformance is typically due to the gradual overcrowding of trades in a well-recognized factor. In US equities, for instance, the value factor earned investors 700-900bps annual

outperformance 25 years ago. Over the last decade, that outperformance has fallen to just 100-200bps – hardly outperformance at all after costs and fees are extracted.

The second significant problem with most alternative risk premia strategies is in portfolio construction: many strategies equal weight all risk premia. Allocating equally to all factors, including factors that have small or negative performance, does not seem the most efficient way to deploy capital.

Toward Dynamic Portfolios

A more rational approach to factor investing is to start with the premise that risk premia change in value over time and have predictable cycles. A factor that is performing well this year may underperform next year, and vice versa. The clear implication of this is that risk premia should be dynamically managed.

The way we dynamically manage risk premia involves placing 25 well-known factors into four categories, or quadrants. Each quadrant represents a phase in the cycle of a risk factor: factors might be in recovery, in a normal state, in expansion, or in crisis. Loomis Sayles focuses predominantly on identifying the probability that a factor is, or will be, in a crisis state. Machine learning techniques provide forward-looking input by assessing the probabilities of each factor moving into crisis and how the occurrence of a crisis would impact the strategy.

The resulting probabilities are combined with advanced optimization methods to decide weightings to each factor at a point in time. The optimization process ensures that weightings are dynamic but also that huge, and expensive, swings in allocation do not take place which would reduce returns to investors.

It's More than a Crisis Hedge

Because this dynamic allocation of factors is predicated on assessment of tail risk, it substantially reduces the probability of significant drawdown and performs particularly well in times of economic crisis. It is not a pure crisis hedge, however. The long-term correlation of the strategy to market beta is around -0.1, meaning it can deliver outperformance whatever the prevailing market conditions. In fact, dynamic alternative risk premia is an active, systematic approach with the potential for differentiated sources of return, which can be additive to all kinds of existing asset exposures.

Who Is it for?

The strategy can be tailored to address a wide range of needs, including absolute return, income, drawdown management, and inflation hedging. It has the potential to generate meaningful alpha, meaning it can be regarded as a highly active, return-seeking component of a portfolio. It can also serve as a bond portfolio substitute given that it has a similar volatility profile to a basket of bonds. In a world of low, even negative, rates, it is a viable alternative to a long-only fixed-income allocation. Not only does it have low correlation to bonds, but in the potential case of reflation the interest rate risks are significantly lower than for fixed-income assets, which could suffer significant losses.

Some investors view the strategy as a core holding, providing broad market exposure – through its exposure to many different assets and factors – with an alpha and risk-control focus. Equally it can be a standalone diversifier that aims to minimize volatility or drawdown. The ability to tailor the strategy to target a level of risk, to reduce drawdown or to hedge inflation, means it is attractive to a wide range of investors.

A Strong Creative Streak

While experience in investing is always important, to bring a unique strategy such as this to the market requires considerable creativity. We leveraged the talents of 22 Loomis Sayles staff across a wide variety of disciplines, with a sizable weighting toward creative minds (typically PhDs) in innovative quantitative disciplines such as optimization, machine learning, and simulation. These creative minds were then matched to experienced portfolio managers and analysts with asset class expertise.

A critical element in developing the strategy was being ultra conservative about overfitting. In other words, the strategy must work in the real world, not just in theory.

Putting it Another Way

For investors, a dynamic alternative risk premia strategy is a radically different, and more efficient, way of adding alpha to a portfolio. The strategy has little in common with other forms of investing and almost no correlation with traditional asset classes. The identification of tail-risk probability, the unique portfolio construction, and the exposure to all risk premia give the strategy the best chance of capturing alpha across cycles, and also allows it to be tailored to investors' needs.

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Additional Notes