ABR Dynamic Funds' Portfolio Construction Series: Part 17

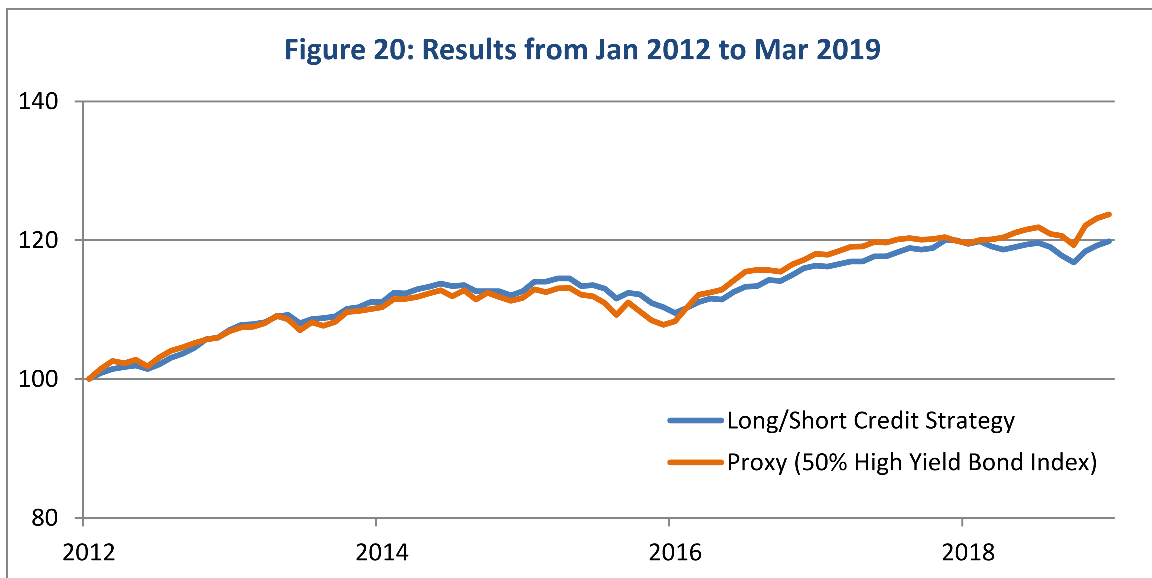
Fooled by the Wrapper VII:

Many long/short credit strategies have effectively just been long-only bond allocations

Many long/short credit strategies have been driven primarily by their net long exposure. As a result of primarily providing a net long exposure, these long/short credit "alternatives" have behaved much like simple long bond exposure. **In other words, many long/short credit "alternatives" have mostly just provided expensive core exposure.** In this way, they are analogous to many long/short equity strategies, which have mostly just provided simple long equity exposure, covered in installment 2.

As in previous "Fooled by the Wrapper" installments, we will seek to strip away the wrapper and expose the underlying behavior by recreating the strategy in question with a proxy of just simple core allocations. For many long/short credit strategies, only the iBoxx Liquid High Yield Bond Index (the index underlying the HYG exchange-traded fund) was needed.

- **Long/Short Credit Alternative Strategy vs. Proxy**
  - Proxy Allocations:
    - 50% high yield bond index
    - 50% idle capital



Source: ABR white paper (data from Bloomberg)

The long/short credit strategy was *effectively* a long-only high yield bond strategy with almost no diversification benefit. Furthermore the proxy left fully half of its capital completely idle. The following excerpt from ABR's white paper on portfolio construction discusses the shortcomings of so-called alternatives that can easily be mimicked with core exposures, especially with reduced amounts of core exposures. It will be familiar to readers who have been following this series on portfolio construction. Readers need only substitute "high yield bond behavior" and "the high yield bond index" where they see "equity behavior" and "the S&P 500," respectively.

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Excerpt from ABR's white paper on portfolio construction

Perhaps most importantly, the proxies for typical forms of many of these "alternative" strategies use *reduced amounts* of core exposure to achieve results similar to the "alternative" strategies. This feature, while touted by some managers as a benefit in the form of volatility reduction, is actually quite detrimental to investors.

For example, consider an "alternative" that always moved half as much as equity behavior (0.50 beta), in the same direction as equity behavior (1.00 correlation). This hypothetical alternative:

- Tied up twice as much capital as direct exposure to the equity behavior it mimicked.
  - That capital should have been hard at work elsewhere. Diluting exposure to equity, or any other, behavior only serves to tie up more capital and require more leverage to reach the target exposure level.

- Provided no diversification value whatsoever to the equity behavior it mimicked.
  - It lost every time equity behavior lost, totally eliminating the only free lunch in investing.

- Generated a diluted return compared to the equity behavior it mimicked.
  - Diluted equity returns may have been a luxury investors could afford in a raging bull market, but what if future S&P 500 returns are much lower? How will investors feel about diluting already low returns?

We wish to note that this example should not be taken to mean that all forms of long/short credit strategies are bad. The ones that carry the features just discussed may be, but that is not intended as a criticism of the ones that do not.

Next Week's Preview: Over the next several installments, we will begin to construct sample portfolios, beginning with a baseline of 60/40 and moving into more diversified portfolios. We will compare the results and offer some observations.

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