ABR Dynamic Funds' Portfolio Construction Series: Part 2

Fooled by the Wrapper

This is the first entry in what will be a recurring theme: a lot of so-called alternative investments really just provide core stock and bond exposure in an alternative wrapper. By "wrapper," we mean the category, the name, the investment vehicle, etc. Unlike the wrapper, it is the behavior of an investment that determines its effect on investor outcomes – <u>don't be fooled by the wrapper</u>. Throughout this series on portfolio construction, we will unwrap several of these so-called alternatives to expose simple core behavior driving their results.

In order to strip away the "alternative" wrapper and expose this hidden core behavior, we will recreate some of these investments using just two core portfolio investments, what we call "equity behavior" (SPY – S&P 500 ETF) and "interest rate behavior" (TLT – 20+ year U.S. treasury ETF). We will call these recreations "proxies" for the so-called alternative investments. The extent to which the proxy mimics the so-called alternative may be thought of as the extent to which the so-called alternative has just provided simple core exposures.

Before proceeding with a typical long/short equity strategy, we need to expand on why these so-called "alternatives" may be harmful to investors. The following explanation comes from ABR's white paper on portfolio construction.

Excerpt from ABR's white paper on portfolio construction

Perhaps most importantly, the proxies for typical forms of many of these asset classes and strategies use *reduced amounts* of equity behavior and interest rate behavior to achieve results similar to them. 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?

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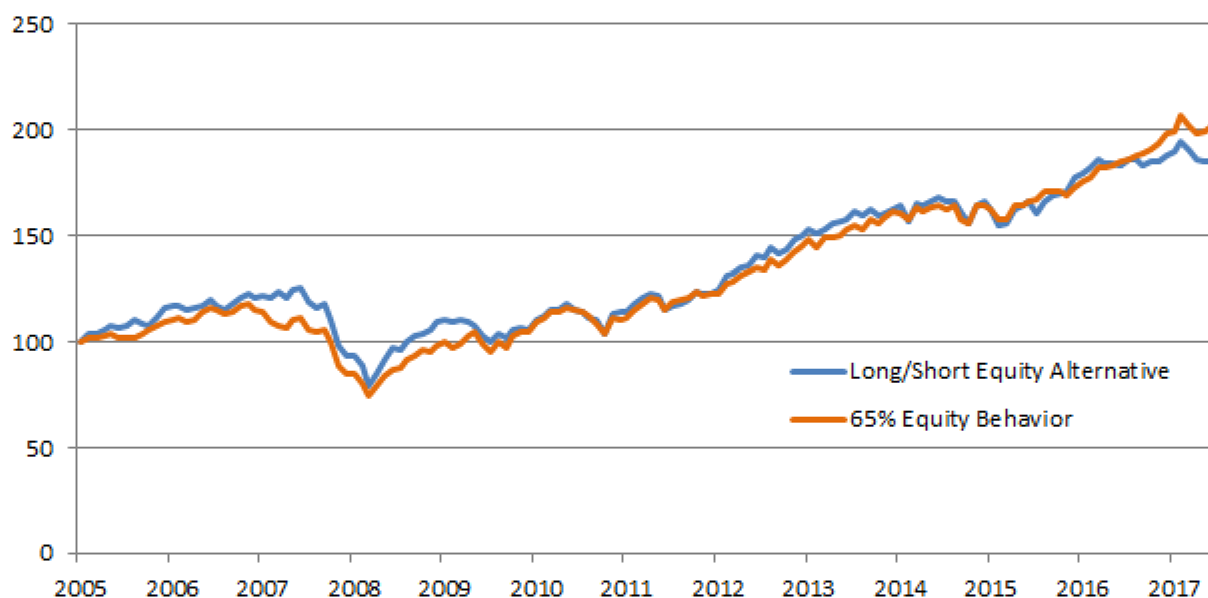
We wish to note that this example should not be taken to mean that all forms of long/short alternative strategies are bad. The ones that carry the features just discussed may be, but that is not intended as a criticism of the ones that do not.

Long/Short Alternative Strategies

Most of the returns for many long/short strategies, both equity and credit, are primarily driven by the net long exposure. The following graph illustrates this point for a long/short equity alternative strategy. Please recall from above that we are using "equity behavior" for the S&P 500.

- Long/Short Equity Alternative Strategy vs. Proxy
    - Proxy Allocations:
        - 65% equity behavior



The remarkable similarity between many long/short equity alternative strategies and simple equity exposure, illustrated in the above graph, means that those long/short equity alternatives are ill-suited to complement the equity exposure already dominating the core of most portfolios. In other words, they are poor choices for alternative investments for the reasons detailed in the above bullet points.

Next week's preview: The historical performance ranking is a nearly worthless criterion for selecting an investment.

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