ABR Dynamic Funds' Portfolio Construction Series: Part 5

Fooled by the Wrapper II: Your "Market Neutral" alternative may be just SPY and TLT

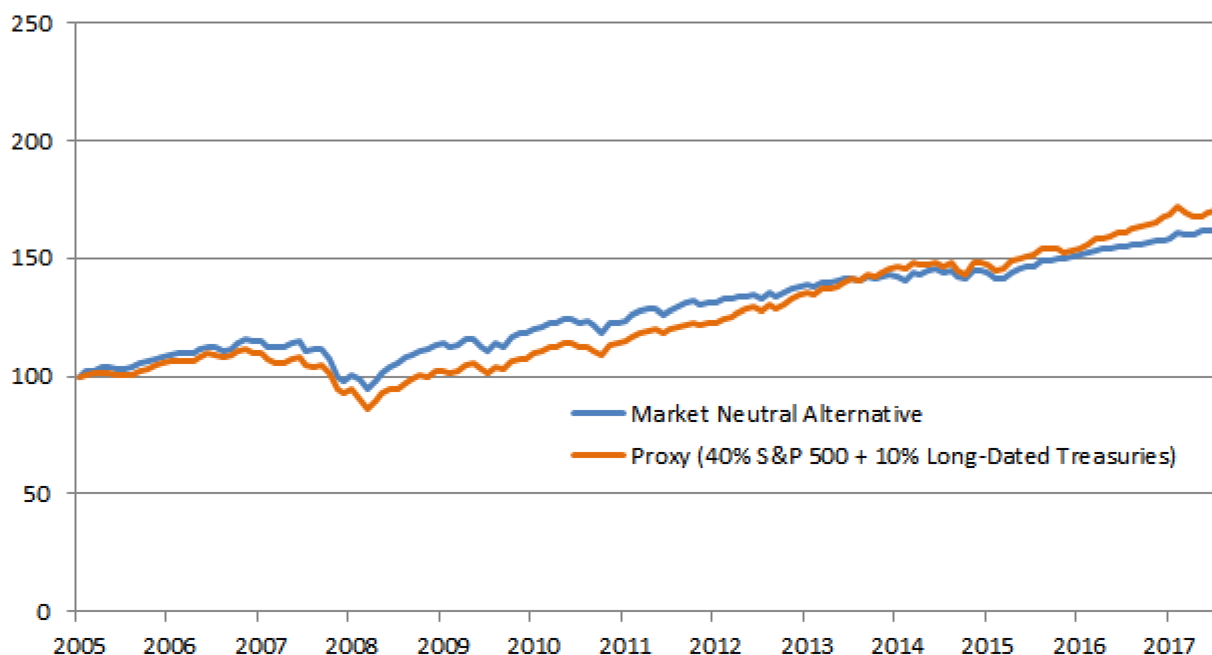
In the second installment of this series on portfolio construction, we showed how some long/short equity alternative strategies have provided little more than expensive beta. In this installment, we will continue this theme by stripping away the wrapper on some market neutral alternative investments to expose the core stock and bond exposures dominating their returns. 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>.

In order to strip away the "alternative" wrapper and expose the core stock and bond behavior, we will create a proxy for a market neutral alternative strategy using just two core portfolio investments, what we call "equity behavior" (SPY – S&P 500 ETF) and what we call "interest rate behavior" (TLT – 20+ year U.S. treasury ETF). The extent to which this proxy mimics the market neutral strategy may be thought of as the extent to which the so-called alternative strategy has just provided simple core exposure.

As the following graph illustrates, much of the return from some market neutral alternative strategies is primarily driven by investments that already make up the core of most portfolios: stocks and bonds.

- **Market Neutral Strategy vs. Proxy**
  - Proxy Allocations:
    - 40% equity behavior (SPY – S&P 500 ETF)
    - 10% interest rate behavior (TLT – 20+ year U.S. treasury ETF)
    - 50% idle capital

Figure 21: Results from Jan 2006 to Jun 2018



Source: ABR white paper (data from Bloomberg)

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The Proxy required only half the capital to achieve very similar results. 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 since the second installment.

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 market neutral 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.

Next Week's Preview: You've heard of risk-adjusted returns, of course, but have you considered risk-adjusted expenses? It's a counter-intuitive and important idea.

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