The Role of Non-Traditional Betas in Portfolio Construction

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As alternative asset classes such as hedge funds, private equity and real estate become increasingly mainstream, we have devoted more time to uncovering robust new, but less familiar, investment opportunities which can generate attractive risk-adjusted returns with low correlation to traditional market returns and the corporate earnings cycle. We refer to these investments as non-traditional betas or "alternative alternatives", and believe that a basket of such strategies across areas such as consumer lending, power trading, appraisal rights, litigation funding and insurance/reinsurance can generate an attractive risk-adjusted return of 8-12% with little correlation to the return streams which currently dominate our clients' portfolios.

Development of Alternative Investments

Alternative investments are defined broadly as investments which fall outside the traditional asset classes of cash, stocks and bonds. Estimates of the size of the alternatives market vary significantly depending on classification, but McKinsey estimate that there are $9.5 trillion invested in alternatives across hedge funds ($2.8 trillion), private equity ($1.8 trillion), real assets ($2.6 trillion) and other liquid alternatives, representing about 14% of the $69 trillion in global institutional assets in 2014.

McKinsey estimates that the alternatives market has grown at 9.4% per annum, or 1.5 times the pace of traditional investments. The attraction to alternative investment was fueled by a growing disappointment with traditional asset classes and the difficulty of generating excess return given the intense competition and resulting market efficiency. Alternative asset classes grew as a source of superior risk-adjusted returns and their potential diversification benefits to traditional portfolios. But with ever more capital seeking to allocate to alternative investments, excess returns are naturally being competed away, just as they were with traditional asset class returns. In liquid markets, manager alpha is increasingly elusive as the best and the brightest are drawn to compete in a zero sum game. In private markets, the flood of capital has driven multiples (or cap rates) back to levels not seen since 2007 as more and more funds compete for the same deals. Clearly, the alternative investment universe is rapidly becoming a lot less alternative.

Exhibit 1: Alternative Investments have grown 9% p.a. since 2005 vs 6% for traditional investments

Broad categorizations such as *alternatives* or hedge funds or private equity fail to capture the range of strategies and underlying risk factors which asset managers can pursue. While we compartmentalize our universe into betas and asset classes to facilitate portfolio construction, our 55-pereson research team is unconstrained in the search of the most attractive investment opportunities. To the degree that we can uncover investment opportunities (which may defy traditional asset class categorizations or betas) which exhibit lower correlation to the rest of the portfolio, this makes them even more valuable from a portfolio construction perspective.

Defining a Non-Traditional Beta

We define non-traditional betas as investments which have underlying return drivers that are different and uncorrelated to what drives the underlying returns of the major asset classes, namely equities, bonds, property and commodities. We sometimes also refer to these as “alternative alternatives” as they take us beyond what have become more traditional alternative asset classes including private equity, real estate and hedge funds.

We refer to these as non-traditional betas as these strategies are generally paying investors for an identifiable risk with a large universe of repeated events that help to price that risk. There will be a component of alpha with respect to any of these strategies, but the majority of the return is usually related to the broad type of risk being taken. In our broader definition of “alternative alternatives”, we also include uncorrelated strategies which may be driven by a manager’s trading acumen in esoteric asset classes which also present the potential for an uncorrelated source of return.

We also distinguish non-traditional betas from what is increasingly referred to as “alternative betas”. This is the term commonly applied to “risk premia” or “factor exposures” which are commonly found in hedge funds and increasingly replicable in a low cost and liquid format. These include strategies such as merger arbitrage, convertible arbitrage, long short strategies and factors such as momentum, carry, quality and value

Diligence may be more challenging for non-traditional betas as these are typically asset classes which have not yet attracted hundreds of billions, or even trillions, of institutional investment capital as traditional alternatives have, although this does not necessarily mean that the markets are small or inefficient. Asset class data is typically more difficult to obtain (or even non-existent), requiring more creative approaches to undertaking due diligence. Deployment can also be challenging, as many of these strategies can be niche and capacity constrained. Understanding the market opportunity and the competitive landscape requires intense industry research to understand the value chain and the market participants. However, it is worth stressing that the size of the opportunity itself is not necessarily the driver of attractiveness, as even niche markets can become overpriced due to an imbalance between the demand and supply of capital.

The low correlation of non-traditional betas can be a function of either the *nature of the risk* (e.g., event risk related to non-financial/corporate events) or the *nature of the underlying asset* (e.g., ownership of an asset or lending against an asset where there is little correlation to traditional asset classes). Both of these elements can provide tremendous diversification benefits. Furthermore, these non-traditional betas also typically benefit from the lack of mark-to-market valuation, a phenomenon which is often more driven by investor sentiment than underlying fundamentals.

Examples Of Non-Traditional Betas

The concept of non-traditional betas or “alternative alternatives” is not entirely new. Over our 15 years of investing, these investments have crossed our doorstep from many entrepreneurial investors. We have broadly classified these opportunities into the five categories below, although we acknowledge that several could belong in more than one category, and that several may defy our efforts at categorization. However, all of these qualify to some extent against the criteria of having return drivers that are different from those that drive the returns of other traditional and more common alternative investments. These also tend to be somewhat idiosyncratic, constitute smaller “micro markets,” and are somewhat off the beaten path.

Insurance-Related	Financing / Claims-Based	Financing / Claims-Based	Collectibles	Other Real Assets
Catastrophe Bonds	Litigation Finance	Pharma Royalties	Art	Public Infrastructure
Industry Loss Warranties	Consumer/P2P Lending	Film and Music Royalties	Vintage Cars	– Healthcare
Reinsurance	Trade Finance	Natural Resource Royalties	Fine Wine	– Transportation
Retrocessional Reinsurance	Microfinance	Professional Sports Teams	Coins	– Education
Life Settlements	Film Financing	Social Impact Bonds	Stamps	– Water Treatment/ Distribution
Lloyd's Syndicates	Art Financing	Aircraft Leasing	Musical Instruments	Alternative Energy
Insurance Run-Off Portfolios	Healthcare Financing	Railcar Leasing	Diamonds and Gemstones	Timberland
Weather Derivatives	Factoring / Receivables	Equipment Leasing	Vintage Watches	Farmland
	Appraisal Rights	Shipping	Antique Furniture	Intellectual Property
	Tax Liens		Antique Books	Internet Domain Names
	Ground Rents			Bitcoin/ Cryptocurrencies
	Sale / Leaseback Strategies			
	Consumer Collections			

Insurance-Related. Insurance is one of the most long-standing of the non-traditional betas. Investors receive premium in exchange for the risk of loss from events including accidents and natural disasters (e.g., general insurance or property and casualty), morbidity risk (e.g., health insurance), and mortality risk (e.g., life insurance). Investors can also underwrite longevity risk (the risk of people living longer than expected) through investments in life settlements. These insurance-related investments are exceptionally attractive from a portfolio construction standpoint because the risk underwritten has no correlation to GDP growth or other return drivers of traditional asset classes within the portfolio. As the industry has developed, institutional investors have an increasing range of investable options including catastrophe bonds, industry loss warranties, Lloyd's syndicates, reinsurance and retrocessional reinsurance. Within non-financial event strategies we also include weather derivatives which can be used by companies in the utilities, agricultural, insurance and leisure sectors to hedge adverse weather events. A deep understanding of weather, when combined with the rise in renewable energy and a deep understanding of the power industry can also provide an attractive uncorrelated source of alpha in power/electricity trading.

Financing / Claims-Based Strategies. Default risk is the primary driver of financing or claims-based strategies. Most default rates and related loss ratios in corporate credit strategies are typically correlated with events in the general economy and the corporate earnings cycle. But to the extent that the default risk is driven by idiosyncratic factors other than corporate earnings, and to the extent that a loan is collateralized

by assets which have low correlation to corporate earnings, private debt strategies can offer many of the characteristics of non-traditional betas.

The universe of potential asset-backed lending strategies is broad to the extent that any asset can serve as collateral for a loan, with increasing attractiveness based on the uncorrelated nature of the value of the underlying asset. The underlying collateral for asset-backed lending strategies can include receivables, intellectual property, royalty streams, various real assets (including real estate, infrastructure, timberland and farmland), royalty streams, and fine art. An example of an asset-backed lending strategy which has been in existence for thousands of years is trade or commodity finance, where the underlying collateral is fungible commodities or export contracts. The World Trade Organization estimated that 80-90% of global trade still relies on some form of trade finance, yet increased bank regulation and deleveraging is restricting the supply of capital.

We also consider claims or rights to be an interesting area for non-traditional betas. While credit-related claims such as non-performing loans, receivables or bankruptcy claims are more common strategies, there are other forms of more exotic claims. One such area is litigation, which represents a claim on a potential judicial settlement or ruling. The outcome of a litigation finance strategy is thus ultimately driven by a share of the settlement or legal award as determined by a judicial process. In a similar vein, appraisal rights reflect the potential claim on the true value of a company at the time of a merger or acquisition transaction, as determined by a court of law. For instance, a Delaware court ruled in May 2016 that the Dell takeover price of $13.75 significant undervalued the company, which after 2.5 years through the appraisal process resulted in an awarded price of $17.62 plus statutory interest, resulting in a 16% annualized gross return over the period.

Finally, we also favour alternative financing strategies which are exposed to consumers as opposed to corporations, banks or governments, as this risk is typically absent from most institutional investment portfolios. This encompasses strategies such as direct lending to consumers (which is increasingly accessible through online marketplaces) and consumer bankruptcy restructurings, known as individual voluntary agreements in the UK or Chapter 13 bankruptcy in the US. The US economy and many developed market economies remain predominantly driven by consumption, which in the perennial struggle between capital and labour may prove more resilient than corporate earnings at certain points in the economic and political cycle.

Contractual Cashflows. Non-traditional betas can also come in the form of contractual cash flow streams such as royalties associated with drug sales, technology licensing revenue, entertainment (music and film) sales, and royalties from the production of natural resources. Some of these, such as drug and entertainment royalties, are supported by strong secular tailwinds which have proven to be resilient through past economic cycles.

Leasing strategies also represent contractual cash flows which are related to specific assets such as aircraft, ships or railcars. While the underlying risk is typically that of a creditor to whom the asset is leased, the underlying asset is driven by its own demand and supply fundamentals which may not be correlated to the broader economy and the corporate earnings cycle.

Finally, we would also include other esoteric strategies in this category which are able to generate attractive cash flows such as social impact bonds which are tied to measurable social outcomes, and professional sports teams where returns are dominated by the team's competitive wins over time, whether it is a Formula One team or professional basketball team.

Collectibles. Many investors already view collectibles including fine art, vintage cars, antiques and fine wines to be part of their alternative investment portfolios. Over the years, a small number of third party funds have been launched to attempt to make collectibles an institutionally investible asset class. None have really gained much traction as the funds have been too small to attract institutional investors. The size of third party funds has been challenged by the embedded conflicts with dealers and individual owners seeking to maintain the highly informal and opaque nature of trading in such assets. The growing scale of these assets may soon improve this outcome, but we tend to shy away from asset classes where there is no income stream and no economic utility. All that you are buying is the hope that someone will want to pay more for it later on. However, even today collectibles can still provide diversifying sources of collateral in lending strategies.

Other Real Assets. While infrastructure is classically considered part of the traditional alternative investing complex, certain types of infrastructure investments have return drivers that are less correlated to the

broader economy. These tend to be public sector infrastructure investments where the returns are driven by government-guaranteed revenues tied to public usage or government subsidies. Hospitals, schools and transportation are the best examples of those investments where the economics are quite independent of what is happening in the economy, and the risks are primarily related to changes in government policies. We generally view infrastructure as relatively poor non- traditional beta investments to the extent that they are typically relatively low returning, extremely long term and illiquid, and often do not pay returns that justify the risks of changes in government policy.

Finally, real assets such as timberland and farmland have garnered growing interest from sophisticated institutional investors over recent years. The attraction of timberland has been the certain and uncorrelated driver of returns being the natural rate of growth of trees, while for farmland it has been the growing population and demand for food and limited supply of arable land.

Implementation Considerations

Many of these non-traditional assets classes remain a fraction of the size of more mainstream alternatives. We estimate that institutional fundraising for private debt reached approximately $100 billion per year in 2015, compared to $600 billion for private equity. In many cases, the market size may be large but the penetration of institutional investors remains limited.

For example, global insurance capital amounts to an estimated $4.2 trillion, but institutional investors account for only an estimated $70 billion of that capital. Likewise, we estimate that global online consumer lending has reached $60-80 billion in 2015, although the US consumer credit market alone is almost $3.5 trillion excluding mortgages.[1] Some markets remain exceedingly niche, such as life settlements (estimated $11 billion market opportunity) and litigation funding (estimated $1.5 billion of institutionally managed capital). While some emerging opportunities may be scalable, the flow of capital into capital constrained sectors can rapidly distort pricing. We are, therefore, wary of the growing interest in these sectors which may result in lower future return potential.

In the table below, you will find examples of some of the non-traditional betas in which we have invested, are currently investing, or are looking to deploy further capital, with a summary of their risk/return characteristics. These include consumer lending, power trading, litigation funding, insurance/reinsurance, life settlements and appraisal rights.

As we see increasing headwinds to the equities asset class, we recommend that clients consider a basket of these non- traditional betas which should generate a highly uncorrelated and diversified return of 8-12% with little correlation to our core market betas or asset classes.

Figure 2: Non-traditional betas are expected to generate higher than average equity returns

Asset Class (non- traditional beta)	Expected Returns (thru the cycle)	Certainty of Return (thru the cycle)	Volatility of Return in any given year	Liquidity	Correlation with traditional betas
Consumer Lending	8-10%	High	Low	Medium	Medium
Power Trading	5-15%+	Low	High	High	Low
Litigation Funding	15%+	Low	High	Low	Low
Insurance	8-12%	High	Medium	Medium	Low
Reinsurance	10-15%	High	High	Medium	Low
Life Settlements	10-15%	Medium	Medium	Low	Low
Appraisal Rights	5-15%	High	Low	Medium	Low

Note: strategies may include use of leverage.

[1] Federal Reserve: Consumer Credit Outstanding: http://www.federalreserve.gov/releases/g19/current/default.htm

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