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Editor's Letter

Financial Innovation: Old Wine in New Bottles?

The financial industry and the alternative investment industry, in particular, are known as innovative industries. Individual and institutional investors' needs change through time, and since the financial industry is highly competitive, there are no shortages of innovators who will step forward to meet these needs. In the last 50 years, we have seen the introduction of index funds, new hedge fund strategies, target-date funds, ETFs and ETNs, BDCs, CDOs, CLOs, CDSs, exotic options, risk budgeting and risk-parity, factor investing, smart betas, liquid alternatives, and crowd funding just to name a few.

However, some of these innovations have not met investors' expectations and, therefore, financial innovations have received their share of bad press. For example, CDSs and CDOs were blamed for the 2007-2008 financial crises. Some would go even further and argue that most financial innovations are nothing but new schemes by the investment industry to create new sources of revenue through higher fees at the expense of savers and investors. Paul Volcker shared his skepticism about financial innovations by stating "the ATM is the only useful financial innovation in the last 30 years."

Let's focus on two recent innovations in the financial industry. First, the concept of using a risk-parity approach to portfolio construction. The idea seems quite appealing. The weights of the portfolio must be selected so that each asset class makes the same contribution to the total risk of the portfolio. This sounds interesting, but there is no theoretical reason for this portfolio to outperform other allocations all, or even most, of the time. Once people looked at these portfolios more closely, they soon realized that risk-parity allocations were nothing but a bet on fixed income securities continuing their 20-year bull market. Proponents of the approach have suggested that because risk-parity portfolios require some leverage in order to generate reasonable returns going forward, risk-parity portfolios provide a return for leverage risk and since not everyone can employ leverage, the return from assuming leverage risk is high enough to make risk-parity a viable approach. This still seems to be a leveraged bet on fixed income. Next, we have the smart beta approach to asset allocation or, as some have pointed out: Smart Beta = Dumb Beta + Smart Marketing

In this approach, the hope for generating alpha is given up, and now investors are told that they must accept some (beta) risk to earn a premium. This is a good start. Finally, investors are told the truth that there are very few free lunches in the financial markets. However, smart beta goes one step further, and similar to the risk-parity approach, argues that return to these smart betas will dominate returns to more traditional betas most of the time. It seems that no thought is given to the fact that some asset classes (e.g., fixed income) or smart betas (e.g., value or momentum) may become too expensive at some point and, therefore, will underperform the overall market.

These two approaches have one thing in common: They propose asset allocation strategies that do not depend on price. In other words, the performance of these products is typically compared to the S&P 500 Index or MSCI World Index, which are cap-weighted indices, while risk-parity and smart beta approaches propose asset allocations that deviate from market cap approach.

In an insightful recent paper titled "The Surprising Alpha From Malkiel's Monkey and Upside-Down Strategies," Robert Arnott, Jason Hsu, Vitali Kalesnik, and Phil Tindall show that asset allocation approaches such as minimum variance portfolios, fundamental index portfolios, equally weighted portfolios, and other smart-beta based portfolios outperform the cap-weighted benchmark. More surprisingly, they show that even the Monkey portfolio (i.e., a portfolio of randomly selected stocks) and a portfolio with allocations inversely related to smart betas outperform the cap-weighted benchmark. What is going on here?

Because these strategies deviate from market caps, they will have a strong tilt toward small-cap stocks and some tilt toward value stocks. Small-cap stocks are both riskier and less liquid, and therefore, should offer a higher return in the long run. Again, we see that there is no free lunch and beta exposure, whether it is smart or stupid, means risk exposure.

It is important for investors to ignore the marketing material, and first learn about the risk exposures of the investment strategy. Second, they need to find out if they have too little or too much exposure to those risks. Third, they need to decide whether the market provides adequate compensation for bearing those risks. Unfortunately, the answer to this last question is fairly difficult to obtain, and it is bound to be highly time-dependent. For example, is the compensation for the size factor adequate? While small-cap stocks tend to outperform large-cap stocks over long periods of time, there are fairly long periods of time over which small-cap stocks underperform large-cap stocks. Finally, investors have to decide on the most efficient method of obtaining the exposures provided by a product. For example, rather than using expensive and less transparent products such as smart-beta and risk-parity, investors can obtain exposure to small-cap or value stocks through less expensive and more transparent products such as index funds or ETFs. Sometimes, it might be wise to remember John Kenneth Galbraith's observation that "The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version."

Hossein Kazemi, Editor

Call for Articles

Article submissions for future issues of *Alternative Investment Analyst Review (AIAR)* are always welcome. Articles should cover a topic of interest to CAIA members and should be single-spaced. Additional information on submissions can be found at the end of this issue. Please email your submission or any questions to **AIAR@CAIA.org**.

Chosen pieces will be featured in future issues of *AIAR*, archived on **CAIA.org**, and promoted throughout the CAIA community.

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By Joachim Klement and Oliver Dettmann

ABSTRACT: In this article, the authors investigate the cyclically adjusted PE-ratio (CAPE) for 38 countries around the world. Their analysis suggests that there are significant regional differences in valuation and long-term equity market outlook. While the overall outlook for equity markets over the next five years is very positive, there are some countries — in particular the United States — where risks are clearly elevated. The authors analyze the relationship between CAPE and future drawdowns and find that CAPE predicts future returns and risks quite reliably.

Why is the Shiller CAPE So High?. 15
By www.philosophicaleconomics.com

ABSTRACT: This blog post provides a detailed discussion of why the current levels of CAPE might be so high. One reason is that stock prices are currently high based on historical standards. However, as the post explains, there may also be other factors at work.

Research Review

On the Possible Impact of a Commodity Transaction Tax on India's Commodity Derivatives: An Empirical Study 26
By Sanjay Sehgal and Wasim Ahmad

ABSTRACT: In this article, the authors examine the potential effects of a Commodity Transaction Tax (CTT) on commodity and futures markets. They investigate the relationship between bid-ask spreads, trading activity, and intra-day volatility using futures data on five commodities (gold, copper, crude oil, cardamom, and refined soya oil) from 2006 to 2010. The empirical results suggest that while higher transaction costs may decrease trading activity, they may also increase price volatility. Therefore, policy makers should pay close attention to the possibility of distortions in market microstructure should a CTT be imposed in India.

Featured Interview

Jason Scharfman on Hedge Fund Operational Due Diligence 37

ABSTRACT: *AIAR* interviews Jason Scharfman, Managing Partner of Corgentum Consulting, author of several books on private equity and hedge funds, and expert in the field of hedge fund due diligence and governance. The discussion includes remarks on operational due diligence, Jason's observations on the Japanese hedge fund industry, and the value of the CAIA designation.

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News and Views

Crowdfunding: A Threat or Opportunity for University Research Funding? 41
By Rachel F. Baskerville and Carolyn J. Cordery

ABSTRACT: Crowdfunding is a disruptive technology of financial intermediation that may be applied in university research settings. The question addressed in this study is: Does crowdfunding represent a threat or an opportunity to more traditional research funding sources for the university sector? The article reviews recent research in the evolution of crowdfunding, assesses the legislation governing this new form of financing, and examines select university crowdfunding sites that have been used to generate funds for staff research and student projects. The study concludes that the Ivory Towers are alive and well, but crowdfunding has traction in the marketplace; further research on this phenomenon is encouraged.

CAIA Member Contribution

An Alternative Take on Alternatives: Not Just Adding a Slice, But Rethinking the Whole Pie 53
By Peter Chiappinelli, CAIA

ABSTRACT: At GMO, we have a deep appreciation for alternative asset classes. We manage nearly $10 billion in hedge funds and have an experienced team offering timberland and agriculture investments. Yet we are nervous about the increasingly uncritical embrace of all things alternative. Just as with traditional assets, investors must always ask the key question: Is the asset priced well? Rather than embracing alternative assets, we believe investors should embrace an alternative way of thinking about the investment equation.

Investment Strategies

Seeking Fully Investable and Optimized Exposure to Alternative Assets 59
By Philip Boigner and Gregory Gadzinski

ABSTRACT: How does one construct a portfolio of alternative assets that fulfills the requirements of modern portfolio theory and achieves at least comparative performances to traditional investments? This article explores the problem of optimizing and managing a portfolio composed of diverse alternative asset classes. The authors consider eight different optimizing methodologies based on a universe of hedge funds, private equity, real estate, and exotics. Using both traditional and alternatives indices, the results highlight the importance of including carefully selected alternatives in order to achieve outstanding performance.

Perspectives

Reducing Your Reliance on Risk Models: Another Look at Active Share 72
By Michael Hunstad

ABSTRACT: Risk models play a key role in quantitative equity management. While they are generally good predictors of ex-post portfolio volatility, at times, these models are subject to significant misspecification. In this article, the authors demonstrate that for any given risk model misspecification, the width of a portfolio's confidence interval is a positive function of its active share. Monte Carlo simulation shows that these confidence intervals grow nonlinearly with active share. Thus, the higher a portfolio's active share, the less confidence we have in its risk measurements. Understanding these dynamics will help to generate new views on risk management practices.

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IR&M Momentum Monitor

IR&M Momentum Monitor 79
By Alexander Ineichen, CAIA

ABSTRACT: Risk is often defined as exposure to change. Spotting change, therefore, is important. There are essentially three approaches to change: 1. Displaying complete ignorance, 2. Having a wild guess as to what it means, or 3. Measuring it in a systematic fashion with an applicable methodology and adapting to it. The author recommends choice number three.

Momentum can be perceived as a philosophy. The author recommends the Momentum Monitor (MOM) as a risk management tool. If risk is defined as "exposure to change," then one ought to spot the change.

VC-PE Index

VC-PE Index 82
By Mike Nugent and Mike Roth

ABSTRACT: Through the first three quarters of 2014, the private equity industry looks to be on pace to have a strong year of distributions. This could be an indication that the "smart money" thinks now is a good time to look at locking in gains and cashing out.

The IPD Global Intel Report

The IPD Global Intel Report 86
By Max Arkey

ABSTRACT: Unlisted real estate in Houston provided investors with an annualized return of 10.4% over the past 10 years, outperforming other major U.S. cities over the same period as well as other major asset classes. By Q4 2014, Houston's performance had slipped below the IPD U.S. Quarterly Index for unlisted property. This paralleled a slide in oil prices, a commodity closely tied to the city's economy. Houston property owners may be left to wonder, how secure is my investment here, especially my income stream? In this issue, we mine MSCI's IPD Rental Information Service (IRIS) to investigate.

These articles reflect the views of their respective authors and do not represent the official views of AIAR or CAIA.