Achieving Target Returns in a Low Rate World: Can Beta Still Save the Day?

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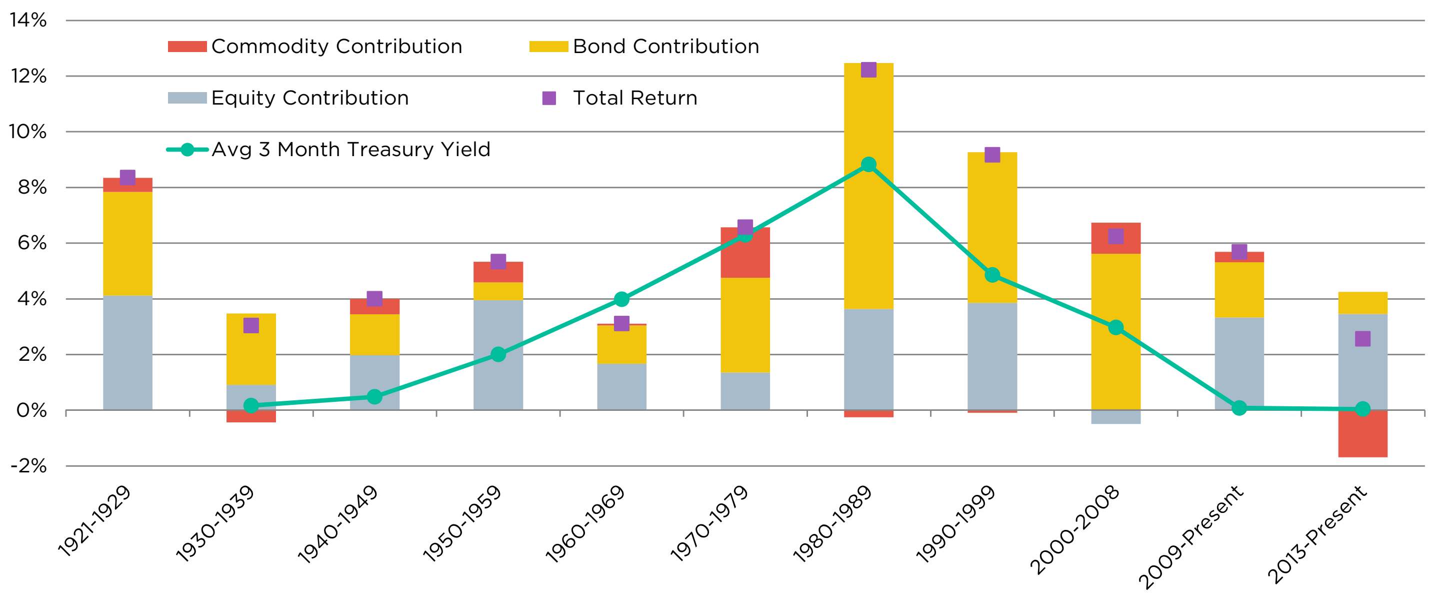
Institutional asset owners are under tremendous pressure to provide for their beneficiaries. In many cases, they must meet high spending rates, improve their funding status, and grow capital to provide for future generations. They must meet these challenges without incurring excessive risk that could jeopardize the long term stability of their asset base. These goals are challenging enough under most circumstances, but in an era of zero bound interest rates, low growth and global deflation, the task is even more daunting.

The Current Challenge

The last several years have underscored the challenges that asset owners face. Over that time, equities and fixed income have struggled to provide sufficient returns, while commodities and real

Exhibit 1: History Repeating Itself?

Average Annual Returns of a Typical Balanced Risk Portfolio[1]



Source: Robert Schiller, Bureau of Labor Statistics, Bloomberg

[1] Average 3 month Treasury yields for 1930-1939 are approximated using data from 1934-1939, due to lack of available data.

assets have experienced a sharp selloff. This has raised fears that balanced risk strategies, which have generally performed well, will not continue to produce the returns needed by asset owners.

In response, some asset owners have moved out on the risk curve, but this solution is dangerous because it leaves investors susceptible to drawdowns that may jeopardize their portfolio's long term stability. For example, consider a pension fund that must reinvest its fixed income portfolio in a low interest rate environment. One option is to extend duration, while another is to move into riskier assets including credit and equity. In either case, the risk needed to meet target returns may be intolerable, especially if interest rates and expected returns remain low for a long period of time. Such a scenario could be disastrous for asset owners as liabilities rise and assets fall. Some investors have expressed concerns that this scenario may come to pass, while others have dismissed these concerns, believing that a portfolio of betas will continue to deliver the necessary returns. However, **Exhibit 1** suggests that investor concerns may be warranted.

A Historical Analog

To illustrate this point, **Exhibit 1** shows the average yield on the 3 Month Treasury Bill and the average annual return on a portfolio that approximates a balanced risk portfolio. The chart spans several time periods from 1921-present, and the portfolio is composed of 65% 10 Year US Treasury Bonds, 20% S&P 500, and 15% commodities.[2] The last two bars span overlapping periods for illustrative purposes. Over the last several decades interest rates have fallen considerably, and we now find ourselves in a rate environment that is reminiscent of the period from 1930-1969. **Over that time, interest rates were persistently low, and this portfolio did not receive large return contributions from fixed income. This stands in stark contrast to the period from 1970-2008, when high interest rates, followed by falling yields, provided a tailwind for fixed income returns.** Given that current nominal yields on the 3 Month Treasury Bill are hovering near 0%, it appears that fixed income returns may be meager for the foreseeable future.

In light of this, the question becomes: can other beta assets provide sufficient returns for asset owners? If history is an analog, there is little reason for optimism. In fact, a typical balanced risk portfolio only managed to produce average annual returns of 3.87% over the four decade period from 1930-1969, well below the 5-8% returns needed by many asset owners. To address this, asset owners may consider adding risk to equities or commodities. This, however, might be suboptimal because it has the potential to disrupt the portfolio's balance and leave investors susceptible to short term dislocations. For example, the chart shows commodities have contributed an annualized -1.68% to portfolio returns since 2013. Another option could be alternative beta strategies, but in many cases these risks are not truly diversifying, and do little to improve risk adjusted returns. One final option could be increasing portfolio leverage, and while this may help investors inch closer to target returns, it comes at the high cost of increased portfolio risk. **In short, in a low interest rate environment, a portfolio of betas may not deliver adequate risk adjusted returns for many asset owners.**

Solution: A More Efficient Portfolio

Rather than incurring excess risk to achieve target returns, asset owners may

[2] Commodity returns are proxied using: Gold from 1921-1926, PPI from 1926-1956 and CCI Index from 1956-Present. Treasury returns are calculated using the change in monthly yields, and an assumed weighted average duration of 8.7 years.

portfolios' efficiency. To do this, they should consider adding a new asset class that has a low correlation to traditional betas, namely alpha.[3]

Alpha's positive expected return and low correlation to traditional betas mean that it has the potential to be a valuable portfolio diversifier. **When integrated into a portfolio of betas, alpha may boost the portfolio's risk adjusted returns.** As a result, asset owners may have equal returns at less risk, or higher returns at equal risk. By improving their portfolio's efficiency, asset owners may increase the likelihood that they will provide the risk adjusted returns needed to meet their unique objectives.

For additional information, please contact us or visit us on our website at www.gweiss.com.

AUTHORS
Charles S Crow IV
ccrow@gweiss.com

James Kelly
jkelly@gweiss.com

NEW YORK OFFICE
320 Park Avenue, 20th Floor
New York, NY 10022

HARTFORD OFFICE
One State Street, 20th Floor
Hartford, CT 06103

INQUIRIES
Gillian Tullman
Director, Investor Relations and Marketing
gtullman@gweiss.com
+1 212 390-3451

Jena Roche
Vice President, Investor Relations and Marketing
jroche@gweiss.com
+1 212 390-3445

[3] "Alpha Unmasked – Disentangling Portfolio Returns", Weiss Multi-Strategy Advisers LLC, November 2015