How Can Investors Avoid Beta?

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The current market environment could give active managers a chance to shine, but absolute returns could throw shade on strong relative performance.

Consider the results of the fourth quarter of 2018: If a long-only manager outperformed their S&P 500 benchmark by an eye-popping 300 basis points, they would still be down about 10.50%. That probably feels like watching your favorite football team cover the spread, but still lose to their archrival by a touchdown. Sure, they exceeded expectations, but it doesn't give you any bragging rights.

Such predicaments highlight the need for strategies that can capture alpha while reducing beta exposure. It's a rare combination that only a handful of strategies possess, but that proves valuable when the market backdrop is ripe for active management but returns look poised to fall. There's reason to believe this type of environment could persist.

Volatility is welcome; negative returns are not

Active managers welcome volatility for a few reasons. A correction in overvalued stocks can reward active managers for adhering to valuation discipline. Separately, active managers can use market dips as attractive entry points to buy favored stocks. Third, when volatile markets last for an extended period, the dispersion in individual stock performance tends to widen, providing more opportunity for stock pickers.

We may be experiencing a period in which volatility lingers as many of the factors that caused volatility in recent months (i.e., U.S. and China trade relations, concerns about global economic growth, Brexit negotiations and concern about the Federal Reserve's monetary policy) are all likely to remain an overhang for markets. VIX futures markets also point to expectations of prolonged volatility.

While volatility might be favorable for relative performance, it comes with a catch. Periods of extended volatility also tend to lead markets downward. And that negative total return often matters more to clients than the relative result.

KEY TAKEAWAYS

- Market volatility highlights the need for strategies that can capture alpha while reducing beta exposure.
- Volatility can reward active managers for adhering to valuation discipline, provide attractive entry points to buy favored stocks and widen dispersion in individual stock performance.
- Beta is hard to strip away; market neutral funds are one of the only strategies that fit the bill.

Market neutral funds are one of the only strategies that can fully strip away beta.

Beta is hard to avoid

The simple fact is, market beta is tough to strip away. A long-only equity portfolio manager must invest in stocks, and while he or she may pick stocks that outperform relative to an index, they are still beholden to the direction of the market. Similarly, when interest rates rise, no bond portfolio is spared. Even while many alternative strategies may diversify a total portfolio or reduce market exposure, few can fully strip away beta.

Market neutral funds are one of the only strategies that fit the bill. A market neutral fund will have similar aggregate long and short exposures within the portfolio. That positioning offsets its exposure to general market trends (beta). If stocks rise broadly, the losses in short positions are offset by gains in long positions. More important, if the market drops, gains in the short positions aim to offset losses in the long holdings.

With broad market exposure muted by a balanced long and short portfolio, the manager's performance comes down to the spread between their long and short positions. The manager is rewarded for correctly identifying those specific stocks poised to rise or fall, without being penalized by the general market direction.

In an environment that may provide favorable conditions for active management but provide headwinds for absolute returns, such strategies warrant consideration. As the adage says, "you can't spend relative returns."

For additional viewpoints: Call 866.361.1720 or visit 361capital.com.

About 361 Capital

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