SOLVING
FOR 2019

CONFERENCE SUMMARY

NEUBERGER | BERMAN

FRED INGHAM
MANAGING DIRECTOR, HEAD OF INTERNATIONAL HEDGE FUND INVESTMENTS

JOSEPH ROTTER
MANAGING DIRECTOR,
CIO—PRINCIPAL STRATEGIES GROUP

PETER DIFIORE
MANAGING DIRECTOR,
NB INSURANCE-LINKED STRATEGIES

RAY CARROLL
MANAGING DIRECTOR, CIO—BRETON HILL

KEY POINTS

- What is an "uncorrelated strategy"? It's not another name for a "hedge fund"
- They can generate returns by focusing on idiosyncratic risks (as in event-driven strategies)
- They can generate returns from systematic risks (such as alternative risk premia)
- They can generate returns from non-financial market risks (as in insurance-linked strategies)
- How portfolios are built is as important as where you invest

UNCORRELATED STRATEGIES FOR VOLATILE TIMES

"Just because they are uncorrelated, that doesn't mean that these strategies don't go through their own mini-cycles."

Fred Ingham

Fred, who manages portfolios of uncorrelated strategies, defined them as anything that has exhibited correlation of -0.25 to +0.25 with traditional markets over time. Returns can be split into three basic buckets, he explained: systematic market returns; alternative systematic or style-based returns; and alpha. Hedge funds are often categorized as alpha, but in fact many generate returns from all three of those buckets. Within the hedge fund world, genuinely uncorrelated returns are more likely to come from macro, trend-following, short-term trading, volatility and statistical arbitrage strategies, or from strategies with no structural links to financial markets at all.

Just because they are uncorrelated, that doesn't mean that these strategies don't go through their own mini-cycles, Fred warned. It is important to recognize that some of these strategies tend to be uncorrelated over all time periods, some become uncorrelated over longer time horizons, and some can exhibit very high correlation during tail events. Realistic risk-adjusted return assumptions are also important: a good Sharpe ratio would be 0.5 – 0.7, which means that a return of 5% over cash will likely come with 10% volatility and occasionally substantial drawdowns. More realistic return targets and thorough diversification should help to dampen different style mini-cycles, mitigating the temptation to abandon a diversifying strategy that has performed poorly for a few months.

Joseph Rotter

Joe manages an event-driven strategy that seeks to isolate exposure to particular corporate events, such as mergers and acquisitions or corporate restructurings. While event-driven trades are usually structured with both long and short positions, that does not necessarily make them uncorrelated. Joe explained that many event-driven strategies are managed with a long bias, which supports returns, but also introduces market risk, in the periods between the earnings announcements that provide much of their alpha opportunities. To make an event-driven strategy genuinely uncorrelated, Joe stressed the importance of identifying non-earnings related catalysts for the re-rating of companies, and thoroughly identifying and hedging out the systematic risks that individual positions are exposed to.

Ray Carroll

Where Joe seeks to hedge out systematic exposures, Ray's team seeks to identify and extract returns from them using quantitative methods. Investors gain exposure to an equity risk premium by investing in the equity market. Ray described other types of risk premia in markets, dividing them into the three basic buckets of carry, insurance and value. Carry is compensation for supplying capital to higher-yielding risks. Insurance can take the form of traditional insurance, or financial-market option strategies. Value is compensation for buying cheaply valued earnings.

Again, while these strategies are often structured with long and short positions, they can still exhibit market correlation, especially in tail events. Ray explained the importance of diversification to mitigate this, and also the advantages of a research-driven approach that continually aims to identify and integrate new datasets into the investment process, but he acknowledged that sometimes, as in 2018, an unusually large number of risk premia can perform poorly. It was encouraging to see investors continuing to allocate, he argued, as it showed an appreciation for their long-term diversification benefits.

Peter DiFiore

Peter's team manages strategies exposed to reinsurance risks, which have been increasingly opened up to capital markets investors since the late 1980s, in order to shift some of those risks from traditional insurers' balance sheets. These risks are low-probability but high-severity natural catastrophes such as hurricanes and earthquakes, and therefore not correlated with financial markets.

Nonetheless, Peter warned that uncorrelated returns are not always attractive returns. Both 2017 and 2018 were difficult for insurance-linked strategies. He argued that some of the potential downside can be mitigated by investing in private rather than publicly transacted markets, which allow investors to take much more tailored risks, enabling investors to focus on covering events that have recurred historically, generating readily analyzable data. Peter also cited 2018 as a healthy warning against trying to time entry or exit into the reinsurance market: entering aggressively in the belief that one can take advantage of the previous year's poor returns hurt investors last year, just as it did in 2005, he said.

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Neuberger Berman
Lansdowne House
57 Berkeley Square
London W1J 6ER
United Kingdom

www.nb.com