



Confessions of a beta jockey

December 16, 2019 | by [Tom Fletcher](#)

(Forgive me stewards, for I have sinned.)

I admit it! I am a beta jockey. Beta may not be the most glamorous racehorse, but it gets the job done in meeting long term investment objectives. I am in a unique spot in this industry; heading a specialized team at Russell Investments helping clients add whatever beta exposures they need, whenever they need them using capital efficient derivatives.

Everyone gets excited about finding alpha, and a large part of my clients' time is spent searching for it. For lack of time, data or interest; beta often lacks the attention it deserves. You've probably read plenty of articles about *closet beta* and how you should not pay for it. This is generally a dig on active managers passing off structural beta exposures as alpha, or excess return. It's not that beta does not have value. It is clearly the dominant driver of risk and reward in nearly all institutional portfolios. But in general, beta should carry a lower fee than pure alpha, and a mixture of the two should be transparent about the content of each and price accordingly.

What is beta worth? That depends on how you access it. If you want a conforming Large Cap U.S. equity passive mandate, that beta is probably close to free from an index provider—at least from a fee perspective. The cost comes down to scale, as the more that is managed in the same fashion, the less it should cost per unit—classic product economics.

Unfortunately, a passive equity manager focuses only on tracking a single benchmark, representing only one of many asset classes in the investment policy. The context of the entire portfolio is often lost and most investment staffs do not have the resourcing to monitor and manage it tightly without outside assistance. For the same horse, running against the same field of competitors; a more skilled jockey improves the chances of success.

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I would argue that beta is worth considerably more when bundled in a customized overlay solution, rather than in a standardized product. For example, *policy implementation* is a common mandate, where clients engage firms like us to overlay unintended cash in addition to maintaining an asset allocation within tolerance to policy. Each client has a unique setup, has unique tolerances and policies, and uses a unique subset of available derivative instruments as needed to complete their investment exposures. A specialized overlay provider also has systems built to efficiently monitor custody data daily. **Depending on client size, we have seen clients gaining 10–100 times the fees they pay for this service by capturing returns that would have otherwise been lost to operational inefficiency.**¹ This is a disciplined, well-designed program to improve returns and reduce risk to policy at the same time – anything but cheap beta!

As much as we try, there are times that we miss opportunities to do even better for our clients. We ask our clients' help and attention, as any additional portfolio moves or cashflows create situations that could otherwise create material over/under exposure relative to policy. Every extra basis point gained improves performance measures that investment staffs are judged upon. Every foregone gain—even in cases where no one might be shining a light on this missed opportunity—robs unnecessarily from that same performance. Those with a steward mentality manage these risks better than their peers, and often delegate as much of the heavy lifting to their overlay provider as possible.

Three ways to get the most from overlay providers

- 1. When any project has potential to impact investment exposures, think of your [overlay provider](#) as a first call.** Part of the value a best-in-class overlay provider adds is by acting as a sounding board for their clients. If providers are brought in early, the good ones can craft a workable timeline and order the project in a way that enables proper risk control throughout. This will maximize the chances they can add value for their clients with the overlay. We believe best-in-class providers will staff their overlay teams with enough portfolio management capacity to thoughtfully consult and project-manage in this way.
- 2. Communicate major cashflows to your overlay provider proactively.** Failure to communicate could cause a full day or more of improper exposure, until custody data catches up. The fact that a risk could work for or against you is only valid with very small movements that average out over time. **Larger risks that ultimately work against you have material impacts on performance that can be noticeable for years to come.**
- 3. With physical moves, consider hiring a transition manager.** Whether it is a formal [transition management](#) provider or another of your investment managers trading, make sure to communicate this activity with your overlay provider to properly offset risks.

In all likelihood, you may not be using your overlay to the full extent you could be. Pick up the phone and express this challenge to your overlay provider. Make a resolution to engage your provider to improve the program's efficiency regarding return capture and risk reduction. You hired your overlay manager with a premise of a notable return enhancement over time relative to the cost of the service. Push them for more and that value proposition only gets better.

Okay, I admit there was a bit of preaching in there, but what good is a confession without a little sermon?

Disclosures

¹ Over a full market cycle as there are shorter periods where this program could lose money.

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AI-27969-12-22