Rodrigo: 00:06 Hello everyone and welcome to ReSolve's 12 Days of Investment Wisdom mini-series, where Michael Philbrick, Adam Butler, Jason Russell, and myself, Rodrigo Gordillo, will explore timeless evergreen principles that will help you and your clients achieve long-term investment success. From the importance of asset allocation, thoughtful portfolio construction, and maximum diversification, our aim is to offer you a comprehensive framework for a more thoughtful investment approach that may change the way you view the complex arena of investing altogether. We hope that you enjoy the series as much as we enjoyed putting it together.

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Mike: **01:10** Welcome back. We had in our last episode, put a whole bunch of tools in our back pocket, uh whole bunch of alternative sources of return, they had some complexity to them and they will have some interesting implications to putting them to work in the portfolio, and so Rod, what are we going to do with these alt premia that we've now developed?

Rodrigo: **01:31** Well as we discussed in the previous podcast, we are in a position where we're going to allocate to things that are slightly more complex, right? So we're going long certain asset classes and securities and short certain asset classes when you put that market neutral portfolio on, it has a three vol. A volatility profile at 3% annualized. What happens is that we apply leverage to that in order to hit a different volatility profile. This is volatility targeting, so these methodologies while complex, give us this wonderful extra tool that we call cash efficiency. The ability to have, to decide what level of impact that strategy is going to have in our portfolio, and so Adam, do you have any...

Adam: **02:14** Well just I thought it would be helpful to put that in, like give an example of how that works. So think about a typical market neutral strategy you've got. If you've just got a dollar long and a dollar short, you've got maybe a volatility of like you said, 3 or 4%, so what they do in order to provide a meaningful amount of risk and a meaningful amount of return, they, they double it so you've sort of two dollars long and two dollars short, and that's how you get to your 6 or 7% volatility but you're involving leverage now, right?

Rodrigo: **02:44** Mm-hmm (affirmative).

Adam: **02:45** You've got sort of four times the amount of capital exposed as you do invested, right? And so this, this is part of the trade off.

Rodrigo: **02:52** Yeah, but it's also a fantastic tool.

Adam: **02:55** Exactly.

Mike: **02:55** Well it creates, it creates those non correlated strategies that can be so beneficial to the overall portfolio. Again, getting that rubber on the road for whether it's a financial plan or an allocator with a pension fund trying to maximize the Sharpe ratio of the overall portfolio on behalf of the investors involved or investor involved.

Adam: **03:17** And at a level of risk and return that allows the investor to meet their financial objectives.

Mike: **03:23** Right.

Rodrigo: **03:23** And I actually find that there's not enough conversation around this, when we think about our options as our alternative liquid alt opportunities, what we discuss is the different factors, but we don't discuss, at all, these different levels of risk and how they could benefit the portfolio and what we're going to try to do today is really highlight how important that part of the portfolio construction process that is, and you know, we start off by if every time we sit down with an advisor and we talk about what their alternatives sleeve looks like, what do we got, like they have a 10 to 20% allocation to alternatives?

Adam: **04:00** Sure.

Rodrigo: **04:00** And so when they're thinking about allocating, they're trying to diversity their factors, diversify their managers. They're just thinking about factor diversification and not portfolio cash efficiency.

Adam: **04:12** And balance.

Rodrigo: **04:13** And balance, right. So there's a big different between adding 20% of your portfolio to alternatives in a market neutral setting where you're going to get 4 or 5% volatility to diversification, versus adding 20% to managers that are running at 15 to 20 vol.

Mike: **04:31** Sure, yeah. I think just to set up, the 60-40 portfolio is the default and the default alternative portfolio seems to be the 50-30-20, right? Is that sort of...

Adam: **04:41** Yeah so 50% stocks, 30% bonds and 20% alts.

Mike: **04:45** Right, and so within that alt, what should that look like, right? And there's a couple of approaches there. The one approach is to say well okay the 20% that I have in that portfolio, I'm going to take the portfolio Adam referred to earlier, that 8 vol portfolio and keep it simple, I'll just have that 8 vol represent that 20%. The challenge there can be that in a point of duress for the 60-40 portfolio where you're undergoing a normal course draw down or low series or returns, the 20% vol piece of your portfolio or the 20% allocation to alternatives has a 7 or 8 vol. So that 7 or 8 vol is going to contribute some returns but the returns aren't meaningful in the context of the entire portfolio. So could you then allocate 40% to alternatives? You could.

Rodrigo: **05:35** Nobody's doing that.

Mike: **05:36** Right because--

Rodrigo: **05:37** It's tough.

Mike: **05:37** It's difficult from the industry best practices perspective, it's difficult from the tracking or client perspective or for the pensioners in the uh allocated pension fund. So there's, there's definite challenges there. So what else can we do?

Rodrigo: **05:51** I think before we get into what we can do I really want to be crystal clear about what we mean by the benefit of diversification and that benefit of volatility sizing. So Adam came up with a nice teeter totter analogy that I think would be useful here.

Adam: **06:09** In the spirit of making it accessible imagine it a teeter totter. So a typical teeter totter has two sides of the beam on either side of the fulcrum and both of those sides of the beam are of equal length. So if you put 100 pound person on one side and another 100 pound person on the other side, then you've got pretty well perfect balance. So that would be a portfolio equivalent of having half your portfolio in asset A, half your portfolio in asset B, those two portfolios have the same volatility and therefore the portfolio is in good balance, right? Both of those assets are contributing their own diversification properties.

You've got diversity and you've got balance, but now consider a typical wealth client portfolio where you've got you know, 50% in stocks, 30% bonds, 20% alts, well, we're no longer in balance right because your alts sleeve is considerably smaller and so its bringing it back to the teeter totter analogy, now you've got a teeter totter where you've got most of the length of the beam on one side of the fulcrum and only a small amount of the beam on the other side of the fulcrum. So how are you going to create balance in that case? Well you've got to have a much larger weight on that side of the beam that is much smaller and the portfolio analog here is that you've, ideally to create balance, you need to have a sleeve with a much higher level of ambient volatility. So instead of like Mike discussed with the having an 8% or 7% market neutral fund in that 20% sleeve, instead try to consider a, an allocation with a much higher volatility at 12%, at 15%, maybe even at 20% volatility in order to strive to better balance those risks and create true diversification.

Rodrigo: **07:57** Again and this is again, something unique to these type of strategies. This volatility sizing is available and you can get, you can look around the universe and find all types of risk profiles. So all things equal, if you are looking to add that impact, that bang for your buck and you only have 20% of the portfolio to use, then you want to favor well thought out strategies that you have high confidence will continue to work with the higher volatility limits.

Adam: **08:25** Well speaking of bang for your buck, we absolutely should be talking about fee efficiency as well and we published an article on this and the guys at RCM, in their wisdom, carried it out into a really neat metaphor. So, the, the general idea is that yes these alternatives generally come with a higher fee. They're more complicated, they require a higher skill set to execute, more expensive infrastructure, more expensive data, et cetera and so they're, they come with a higher fee.

The question is, does the value that you expect to get from these alternatives exceed the higher fee and as you look across these alternatives, then you've got alternatives with different fee levels, but they've also got different risk levels and those things end up being a bit of a trade off and so the RCM guys came up with a really good analogy for milk in the grocery store.

So you go to the fridge in the grocery store and you can buy milk by the gallon or milk by the quart. A quart of milk is $2.99.

Rodrigo: **09:28** No a quart of milk is $1.50...

Adam: **09:30** (laughs) you take it.

Rodrigo: **09:31** And a gallon, a gallon is $3.00, right? So the analogy here is that human beings tend to want to go for the cheaper thing. You're looking, and we all do it, right? We're there, at the grocery store and we're like I know I should buy the big gallon but I'm going to go for the quart because I don't want to spend that much, but what we all should be looking at and very few of us do look at, is the cost, the amount of cents per ounce and in this case when you look at the gallon versus the quart option, you are paying $0.05 per ounce versus $0.02 per ounce. That's the magic, right? So we want, we think, fiduciaries and investors should look at their fee per unit of risk that they take. Fee per unit of diversification benefit.

Adam: **10:19** Yeah.

Rodrigo: **10:20** So you may find...

Adam: **10:21** Well that's actually a bit of a, that's a bit of a tangent. The diversification metric, right? That could be a whole other episode.

Rodrigo: **10:27** That's true. So lets stick to the fee per unit of risk, right. If you have two alternative managers and one is charging you 2% for a 7 vol product and another one is charging you 2% for a 14 vol product, all things equal, you're getting half the benefit on the low vol that you're getting for the high vol, right? And the truth is, in the liquid alt space, you're not seeing anyone charge more than 2%. So everybody is kind of lying around that 1.5 to 2% mark from true you know independent source or fact. We're not talking about smart beta here which is much lower because it's mostly beta. When we're talking about those true factor investors, you need to search out, not only the highest bang for your, the highest impact of diversification but the lowest cost per unit risk.

Adam: **11:12** But let's actually put it in on a return basis, right? So let's imagine you've got two products, they're going to provide exposure to the same risk source and we're going to talk about some of the fiduciary implications about this later, but exposure to the same risks source

		or return source, one of them comes in at an expected vol of 6% and has a fee of 1.25%. Another comes in at an expected vol of 12% and comes in at a fee of 1.75% and you're expecting let's say they both have a Sharpe ratio of one, just to keep the math easy. Well now you've got your lower vol strategy or product has expected returns of 6% pre fee, minus 1.25% is now you're looking at a 4.75% net of fees and then you've got your second product which has an expected pre fee return of 12% minus 1.75%, now your net total return is 10.25%. So your after fee expected value from the product is very substantially higher from the higher vol strategy even though it has the higher fee.
Mike:	**12:26**	And your Sharpe ratio is higher. Your resulting Sharpe ratio is higher. Your net Sharpe ratio is higher and if that strategy is in fact a diversifier and non-correlated, the net adjusted Sharpe ratio of the portfolio is also higher.
Adam:	**12:41**	Exactly.
Mike:	**12:42**	And that Sharpe ratio is higher per dollar of fee of that portfolio as well. So there's a domino effect. A knock on effect through the entire portfolio that comes from thinking about the capital efficiency in the 20% of alternatives.
Rodrigo:	**12:57**	And this is something that's catching on in the institutional space, right? When we deal with the institutions we don't offer our strategy, one strategy, we offer the base strategy at different volatility targets. Anywhere from 6 vol to 25 vol, and our fee scales with that so we, we actually charge beeps per unit of risk and it's identical throughout. It scales.
Mike:	**13:18**	Yup.
Rodrigo:	**13:19**	Now the ultimate fee, the percentage amount goes up, but the fee per unit of risk stays constant, right? So I think we're going to see more and more of this especially in the futures space because futures driven allocators think about the space in that way.
Mike:	**13:35**	Oh yeah of course. If you think about having your alternative bucket has a Sharpe ratio of X and correlation to the portfolio of Y and that correlation is low or you know maybe slightly negative, you want a higher and higher vol, I mean that's the whole point of diversification is to put together these portfolios so that you can continue to hold your 50-30, right? So you can continue to hold your stocks and bonds and not have to sell. As we talked about in the beginning, one alternative is well I'm just going to hold more alternatives. Well those alternatives, that's not a decision in and of itself by itself. What it means if you are pulling money away from your balanced portfolio which is giving you risk premia. So you are losing some risk premia in order to benefit in the risk premia and the alt sleeve, with capital efficiency what you're allowed to do is leave the, the beta premia that you know and love, that everyone is addicted to and just own that and then by increasing the volatility of your alternative portfolio, with non-correlation hopefully, it allows you to hold this basket.
Rodrigo:	**14:49**	Well investors even now have an option to get capital efficiency from their 60-40 portfolio. There's a product out there that is what is it 90-60.

Mike:	**14:49**	Yeah, 90-60.
Rodrigo:	**14:58**	90-60, right? And the goal there is that you take I don't know, 10% of your 60-40, add this 90-60, and now you've created more room to add alternatives and not suffer from tracking era at the same time.
Mike:	**15:11**	Another very thoughtful way for educated consumers and purveyors of investment products to do a really great job for those who have capital put to long-term purposes like the capital put in endowments and pensions and retirement funds.
Rodrigo:	**15:30**	And I'll add that people may see this as we are adding more volatility and therefore adding more risk to our clients and therefore it is going to be, we're not going to necessarily meeting the risk targets that the client signed up for, but the reason that we came up with a 20% volatility profile for our institutional strategy is because we were going, we went to, I went to the Managed Futures Association and every panelist was demanding a 20% volatility target for their strategies because they were, they're inundated with 10 vol targeted alternative strategies that when put together, volatility collapses at two or three or four. And so they want this sleeve to have an impact. They want non correlated managers. They put them together they're getting no impact. So they're putting together a series of 20% volatility managers that are non-correlated to each other that as a combination, that sleeve now becomes a 10 vol sleeve. That 60-90 strategy increases the volatility of the portfolio on a stand alone basis but once you add those alternatives--
Adam:	**16:32**	It allows you to add vol.
Rodrigo:	**16:33**	That portfolio level volatility might even get lower, right. So these are, again, counterintuitive but very important concepts to grasp.
Mike:	**16:41**	I think this is an important place if we can jump off into the actual responsibility of a fiduciary because I think this is kind of a natural point to think about that. So we hear a lot of talk about fee based advisors acting like fiduciaries acting like those pension boards who act as fiduciaries for their pensioners and those endowment board members and so if that's the case, let's just review the fiduciary responsibility, okay. Sort of top to bottom. You need to understand the risk tolerance of the client. The client can be an individual or a pension pool of assets et cetera, you need to put the needs of that client first. You must act in the best interest, you must be knowledgeable, you must create and maintain a documented process of manager selection, investment selection, monitoring, updating investments, and they've got to be appropriate for the plan. Further, and most importantly, fiduciaries are expected to have advanced level knowledge of products and the, and the intra workings of those products and that means that the new prudent investor rule requires that the, the fiduciary is responsible for the portfolio level vol, Sharpe ratio and results. They are not responsible for the line item risk. They're not responsible for that. In fact, that's the antithesis of what their responsibilities

are. And so I can just see as we talked about the first half of this podcast, a whole bunch of fee based type of advisors rolling their eyes saying there's no way I could get a client, there's just no way. It's not happening.

I challenge you, if you are truly a fiduciary and you take that role to heart, then these are the expectations. It's not just that you can buy the lowest cost fee product. It's not just that. Its what's the value are you getting for the fee.

Rodrigo: **18:51** Can you justify that fee.

Mike: **18:52** Right, and what's the implication to the portfolio level vol? So at you know the 60-40 portfolio, if you add let's say a trend following CTA, we've got you know, 100 years of evidence that suggests, that shows higher Sharpe ratios decade by decade across the board.

Rodrigo: **19:09** Highly defensible.

Mike: **19:10** Very defensible. In fact, it would be difficult to defend not having it in there other than recency bias, home country bias because it hasn't done well over the last five years and I'm comfortable with what I have in my portfolio.

Adam: **19:23** There's a chorus of advisors, you know, screaming in my mind about the fact that their investor base won't understand what those strategies, what's going on in those strategies …

Rodrigo: **19:33** You've got to keep it simple for them.

Adam: **19:36** What's the fiduciary rule say about that?

Mike: **19:37** Well the fiduciary rule says again, you're responsible for portfolio level vol and that you're responsible to do what's right for the client. Put the best interest of the client forward. Which means yes there's an education process.

Adam: **19:51** But what about a pension plan? I mean a pension plan is, uh, the pension board is a fiduciary, do all of the beneficiaries of the pension plan understand all of the complex investments that are inside the pension plan?

Mike: **20:01** Absolutely not. Categorically not.

Rodrigo: **20:02** Nor are you required to is the key thing here, as a fiduciary.

Mike: **20:07** Correct. So I can feel some of the angst and tension growing in some of the listeners at this moment in time. Let's just take a breath, in through the nose, out through the mouth and let's just relax for a minute and understand. This is an opportunity for a significant point of difference in your businesses. This is an opportunity to do true good, both through better long-term risk adjusted returns for the portfolio where the rubber meets the road for those people achieving those goals, but it's going to be a little bit harder. It's going to be a little bit more difficult.

It's going to require a little bit more education to the client and it's going to require the fiduciary embrace the fact that they've got to educate themselves well, that they have to be confident in their bones of the factors that they're, they're harnessing so that they can harness them for 20 years because when we get into these strategies that are a little bit more esoteric and we don't understand, well we have the propensity to maybe give up and we're going to give up not when the returns are really good, we're going to give up when they're low, accepting the risk and not getting the return. So this is really, you know, if you're out there saying I'm a fiduciary, then you need to understand the real core of what the fiduciary is, the fact that you have to have advanced level knowledge, that you're responsible for the portfolio level vol, the new prudent investor rule dictates that and that all of the discussion that we had at the very outset of this podcast, it's hard to understand.

Yeah, it does stretch the mind.

Rodrigo: **21:40** And the options available to us today were not available to us 20 years ago so it definitely has become harder. We are now held to a higher standard and we need to, and it's, it's something that requires more time and effort than it ever did but it also means that we have tools available to us that were only available to institutions that we can pass along to our client base today, and that's a wonderful thing.

Adam: **22:05** It may be a more important time to consider these types of tools than at most other points in history.

Rodrigo: **22:12** Given how expensive everything is. Great point.

Adam: **22:14** Given where we are in the cycle and the options that are available to investors in terms of returns. And we're going to talk very specifically about why the current environment is perhaps the most challenging investment environment that investors will see in the cycle and why it may be more important than ever for us to think outside the box in terms of how to meet those investor objectives and there are no easy choices, so, investors need to get comfortable with being uncomfortable in one way or another.

Rodrigo: **22:46** Fantastic.

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