

PERSPECTIVES

# BREAKING DOWN YOUR BETA

September 7, 2018

Topics: [Taxable Portfolio Management](#) / Contributors: [David G. Eichhorn, CFA](#), [Richard R. Ratkowski, CFA](#)



Like visiting the doctor periodically, it is important for an investor to assess the overall health of her portfolio from time to time. At times, some of the most seemingly mundane parts of the checkup, for example a routine blood test, can be the most important and impactful.

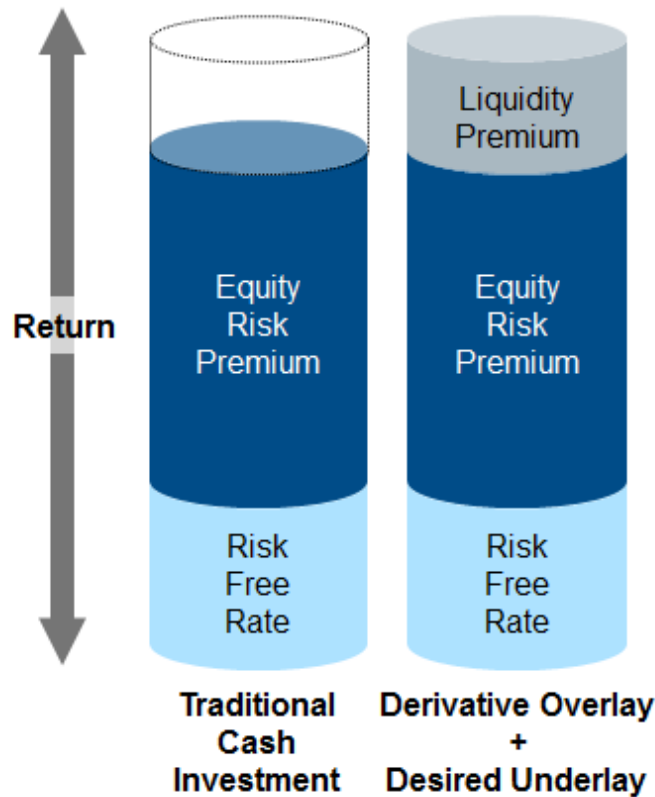
With that in mind, now might be a good time to revisit the “health” of every portfolio’s key organs: asset classes (sometimes referred to as beta exposures). Even for these most elementary of portfolio components, there have been some developments that offer asset owners opportunities to improve the overall fitness of their portfolios.

When an asset owner determines her asset allocation, she makes decisions about how much to allocate to various beta exposures (e.g., equity, fixed income, commodities, etc.). Each of these exposures serves a strategic purpose in the portfolio: capital appreciation for equity, liability hedging or diversification for fixed income, and so on. Once the allocation is determined, the asset owner will then allocate capital to active or passive managers with the goal of achieving the desired exposures.

Unfortunately there is a drawback to this seemingly straightforward approach: the exposure the asset owner wants may be accompanied by other exposures she does not. For example, consider a pension plan with a large allocation to passive equity. This plan is a long term investor with no intention of selling equity any time soon. Yet generally speaking, since equities can be sold at a moment's notice; they are thought of, in fact, as a very liquid investment.<sup>1</sup> This liquidity comes at a cost in the form of lower expected return – a foregone “liquidity premium.” Put differently, the asset owner is paying for a feature – liquidity – that she may not intend to use. To be clear, asset owners need liquidity, but our example assumes a “large” equity exposure to indicate that this is likely more liquidity than the asset owner may need. Given the recent migration of many institutional asset owners to passive large cap domestic equity, this is likely a situation most asset owners are currently facing.

If the plan could instead achieve its desired equity exposure while simultaneously managing to an acceptable level of liquidity (or illiquidity), it could theoretically enhance its performance by earning a liquidity premium. The more liquidity a plan is willing to give up, the more it may be able to enhance returns. This may be a particularly attractive source of additional return since, unlike an increase in market beta, the investor is ‘selling’ liquidity to the market that values it more dearly than the investor. The exhibit below illustrates this concept.

## Theoretical Passive Equity Return



This graphic is for illustrative purposes only. Risk free rate is used in the academic sense and is not intended to predict future outcomes.

This framework for evaluating exposures is key. The question an asset owner needs to answer is, what does she want from a given asset class? Is it simply the beta? Alpha from active management? A targeted amount of liquidity? Or (more likely) a combination of factors? Either way, asset owners don't need to just accept "prepackaged" asset classes as-is. To the extent they have unique needs and preferences, asset owners can customize the profile of the asset class to meet their objectives.

Thankfully, this is not just a theoretical exercise. While concepts like "portable alpha" have existed for some time, the proliferation and increased ease of use of derivatives has opened the door to alternatives where investments are broken into component parts: an "overlay," or headline exposure, and a customized "underlay," or committed capital. Doing so enables asset owners to separate asset classes into their constituent parts and allows them to more freely pick and choose what they want. Utilizing these choices and structuring investments accordingly may enhance returns—a promising development.

Our next post will dive into the mechanics of the overlay/underlay approach and illustrate some of its practical applications, both old and new.

<sup>1</sup>It is important to note the distinction between liquidity and valuation. A prime example of this distinction occurred in December 2008 – An asset owner may not have liked the price if they were selling stocks, but they could find a buyer readily.

*Disclaimer: By accepting this material, you acknowledge, understand and accept the following:*

*This material has been prepared by NISA Investment Advisors, LLC ("NISA"). This material is subject to change without notice. This document is for information and illustrative purposes only. It is not, and should not be regarded as "investment advice" or as a "recommendation" regarding a course of action, including without limitation as those terms are used in any applicable law or regulation. This information is provided with the understanding that with respect to the material provided herein (i) NISA is not acting in a fiduciary or advisory capacity under any contract with you, or any applicable law or regulation, (ii) that you will make your own independent decision with respect to any course of action in connection herewith, as to whether such course of action is appropriate or proper based on your own judgment and your specific circumstances and objectives, (iii) that you are capable of understanding and assessing the merits of a course of action and evaluating investment risks independently, and (iv) to the extent you are acting with respect to an ERISA plan, you are deemed to represent to NISA that you qualify and shall be treated as an independent fiduciary for purposes of applicable regulation. NISA does not purport to and does not, in any fashion, provide tax, accounting, actuarial, recordkeeping, legal, broker/dealer or any related services. You should consult your advisors with respect to these areas and the material presented herein. You may not rely on the material contained herein. NISA shall not have any liability for any damages of any kind whatsoever relating to this material. No part of this document may be reproduced in any manner, in whole or in part, without the written permission of NISA except for your internal use. This material is being provided to you at no cost and any fees paid by you to NISA are solely for the provision of investment management services pursuant to a written agreement. All of the foregoing statements apply regardless of (i) whether you now currently or may in the future become a client of NISA and (ii) the terms contained in any applicable investment management agreement or similar contract between you and NISA.*