

Alternatives in Asset Allocation

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Recent Papers in The Journal of Portfolio Management

Diversification and Asset Allocation in the Post-COVID Era

Kari Vatanen

KEY FINDINGS

- Declining interest rates and low inflation supported financial markets with a positive tailwind, and the correlation between bonds and equities was negative. The rise of inflation in the post-COVID era changed the market dynamics and the diversification effect weakened significantly.
- Systematic strategies and alternative risk premiums can be used as tools in portfolio construction to widen the possibilities to find diversifying elements. Additionally, investors can benefit from an artificial diversification effect of the smoothed and delayed valuation of illiquid asset classes.
- The author proposes a functional framework for asset allocation under uncertainty of correlation regimes. The framework exploits the characteristics of defensive and diversifying alternative risk premium strategies, as well as the artificial diversification effect of illiquid asset classes.

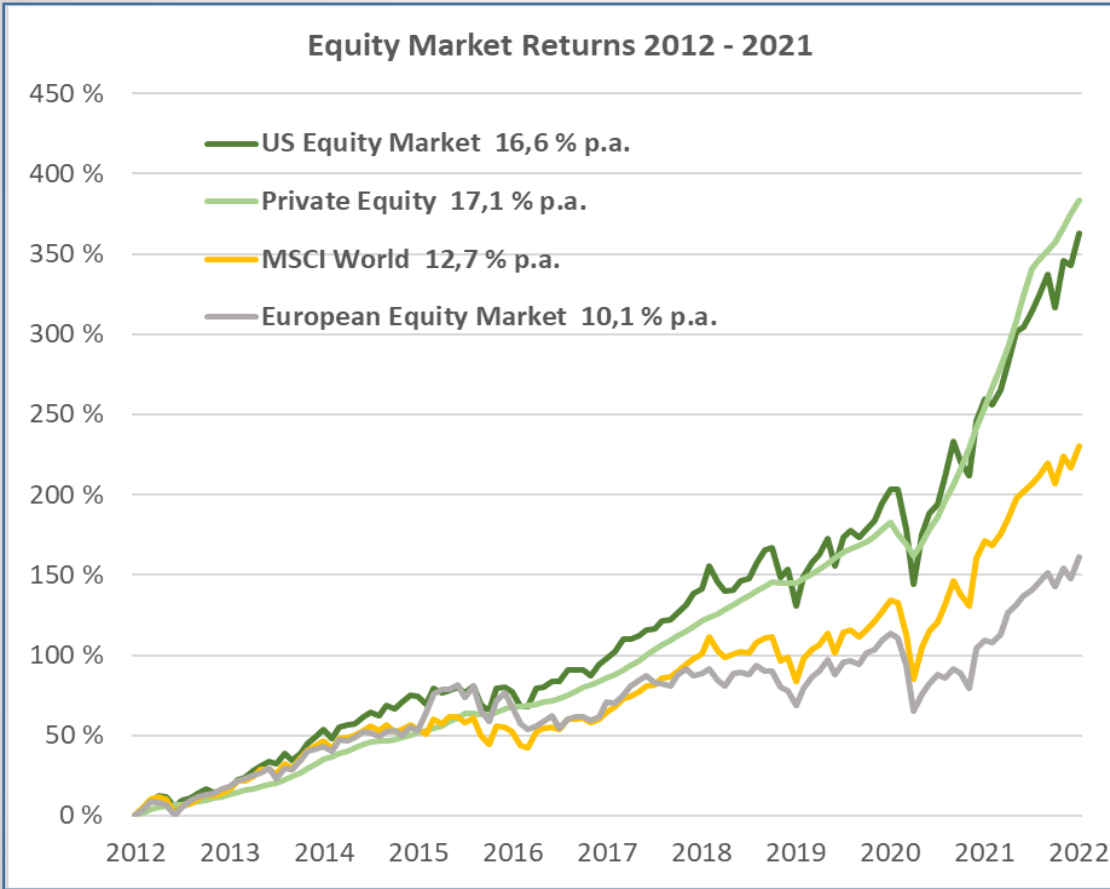
Do Alternative Risk Premia Diversify? New Evidence for the Post-Pandemic Era

Antti Suhonen and Kari Vatanen

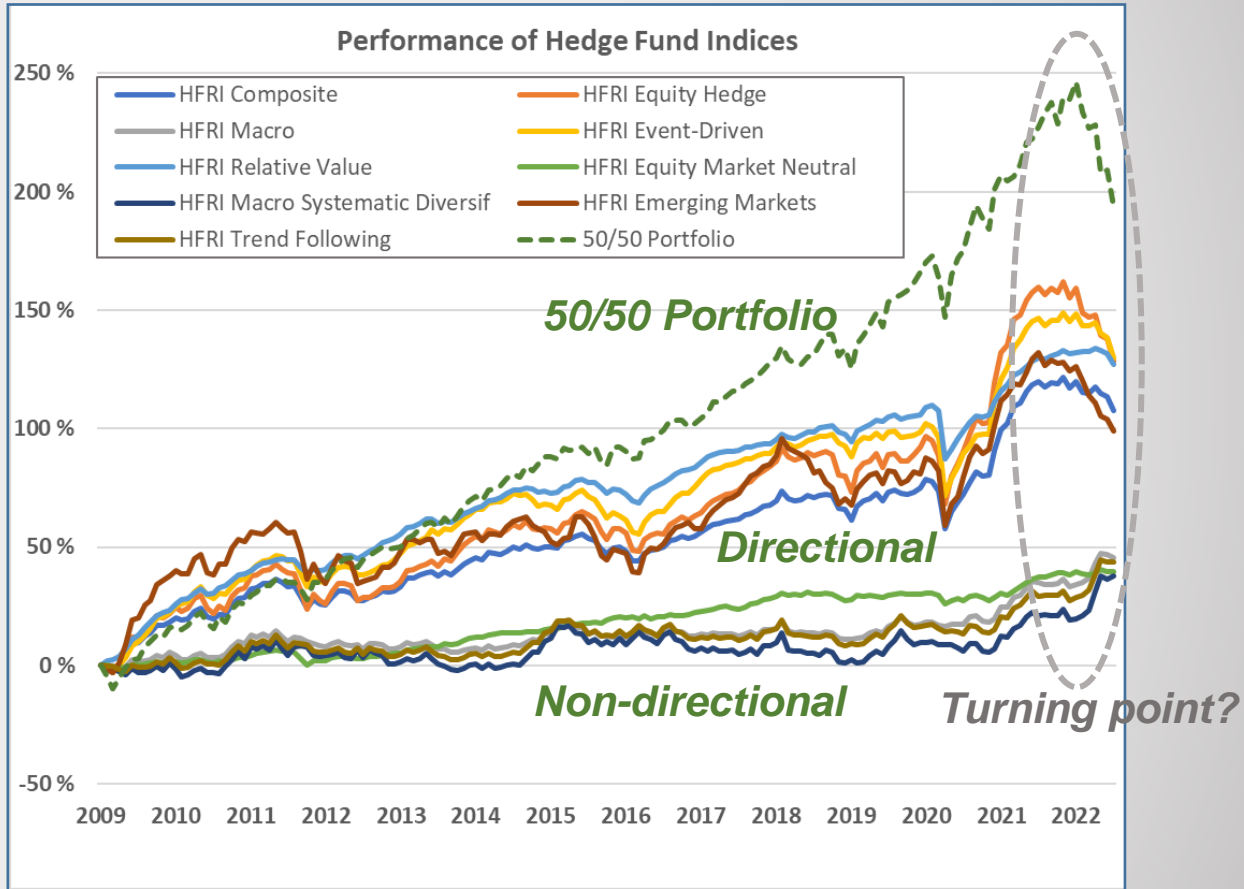
KEY FINDINGS

- The authors present a classification framework for multi-asset alternative risk premia (ARP) strategies using a novel database constructed from traded ARP strategies promoted by global investment banks. Most ARP strategies have tail dependencies to either equities ("offensive" strategies) or bonds ("defensive" strategies.)
- Most ARP strategies exhibit asymmetric, "wrong way" exposure to bond markets; that is, their bond betas increase during bond market sell-offs. Understanding such sensitivities is crucial for portfolio construction and requires analysis beyond linear and unconditional correlation measures.
- Trend-following strategies and certain commodity factors appear as the most promising candidates for portfolio diversification.

Glorious decade for Risk Takers – Lost decade for Diversifiers



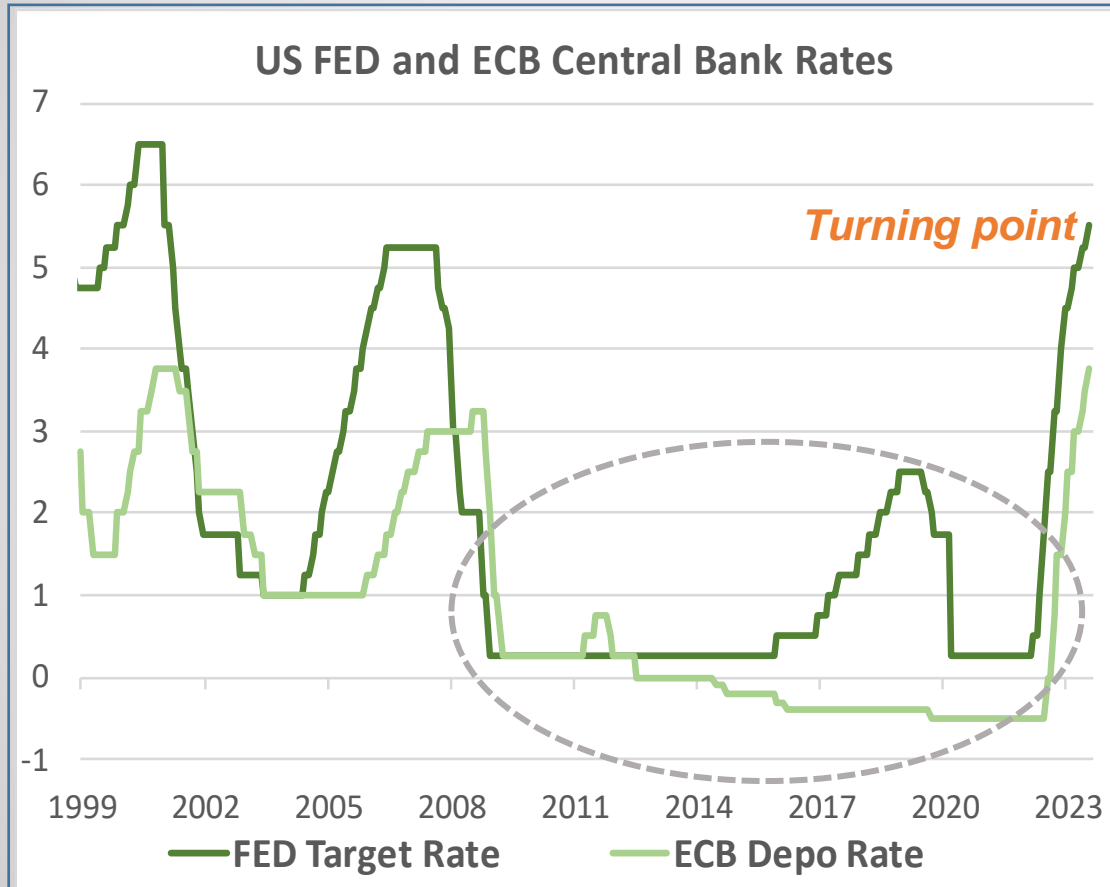
Source: Bloomberg



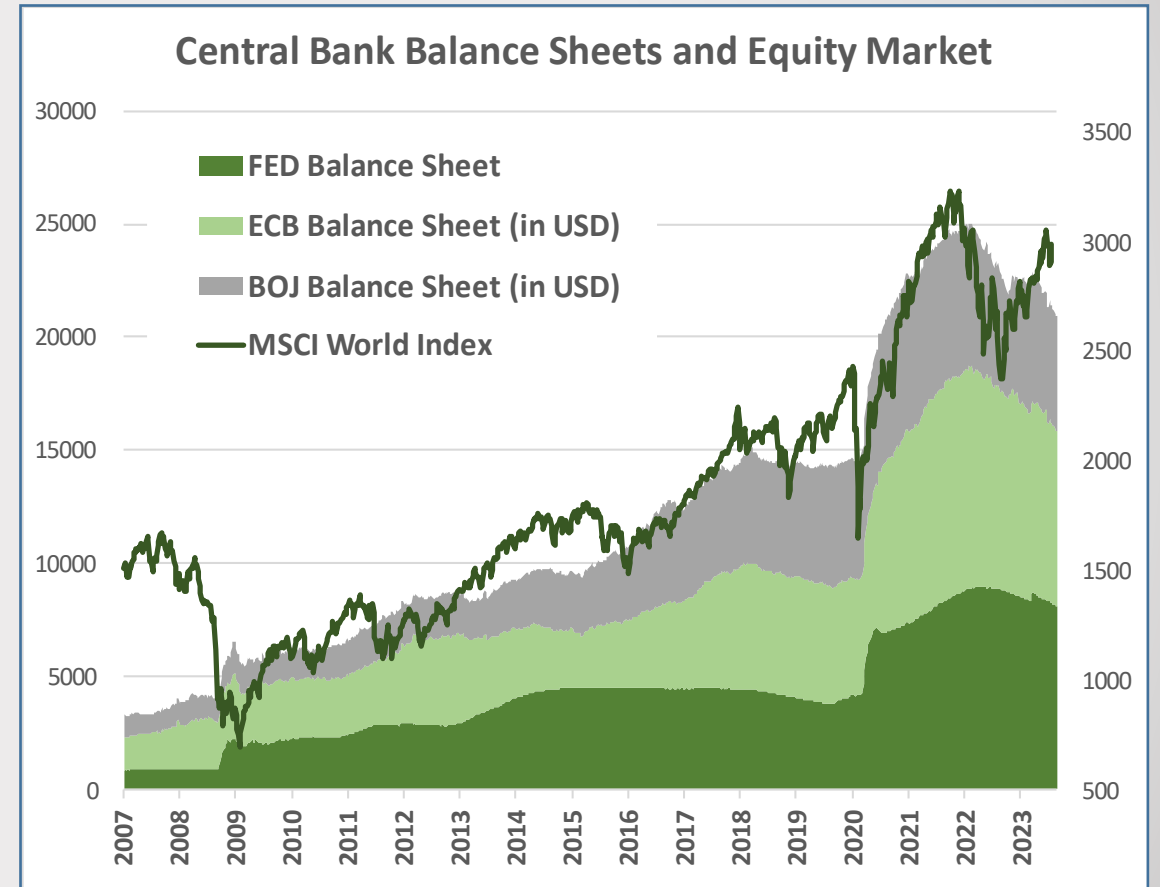
Source: Bloomberg

**Ref: Bollen, Joenväärä, and Kauppila (2020),
Hedge Fund Performance: End of an Era?**

Excessive Stimulus has Supported Market Valuations

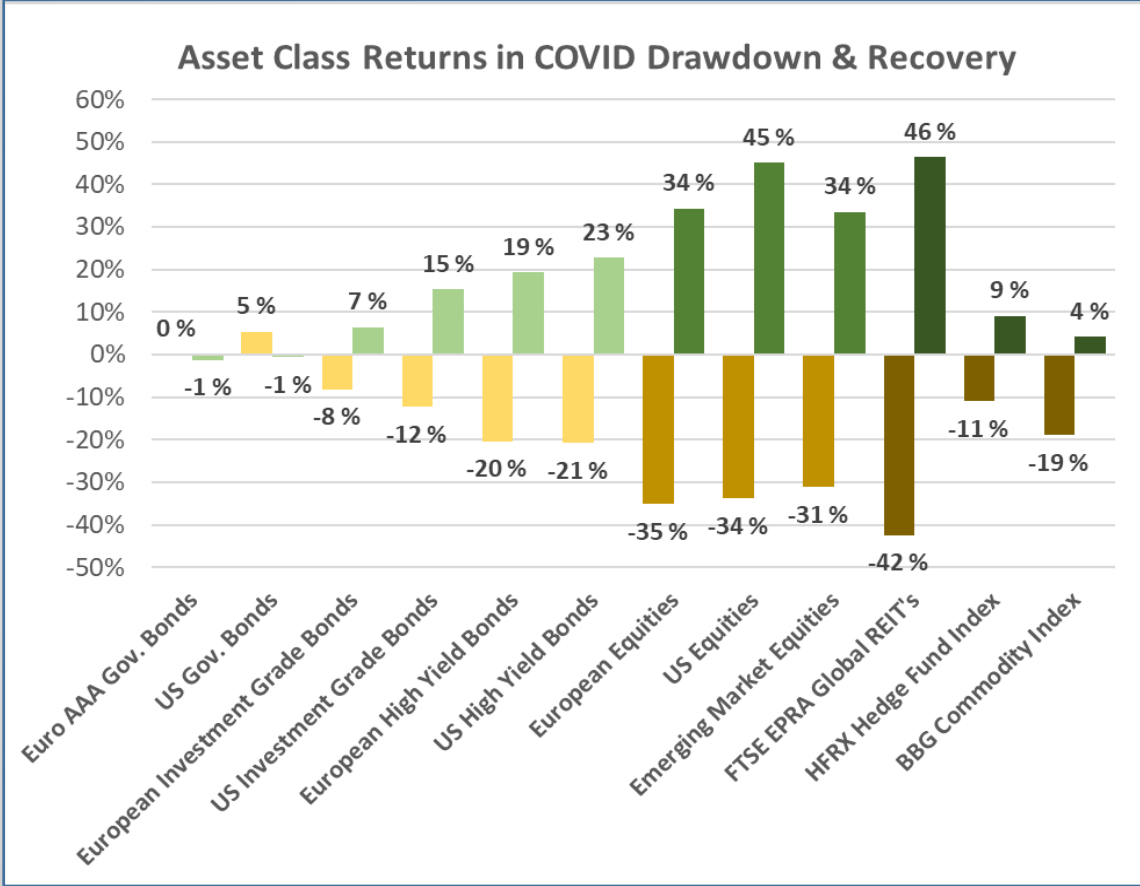


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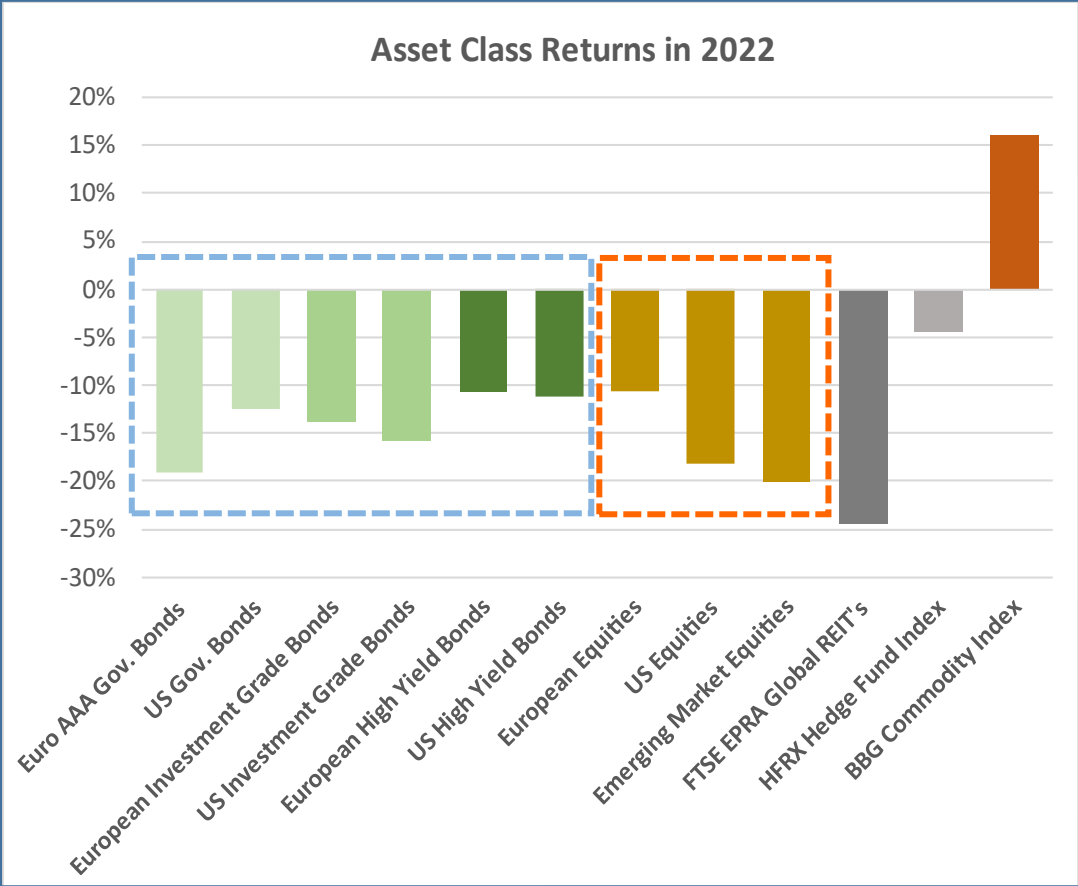


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Diversification between Asset Classes has Disappeared

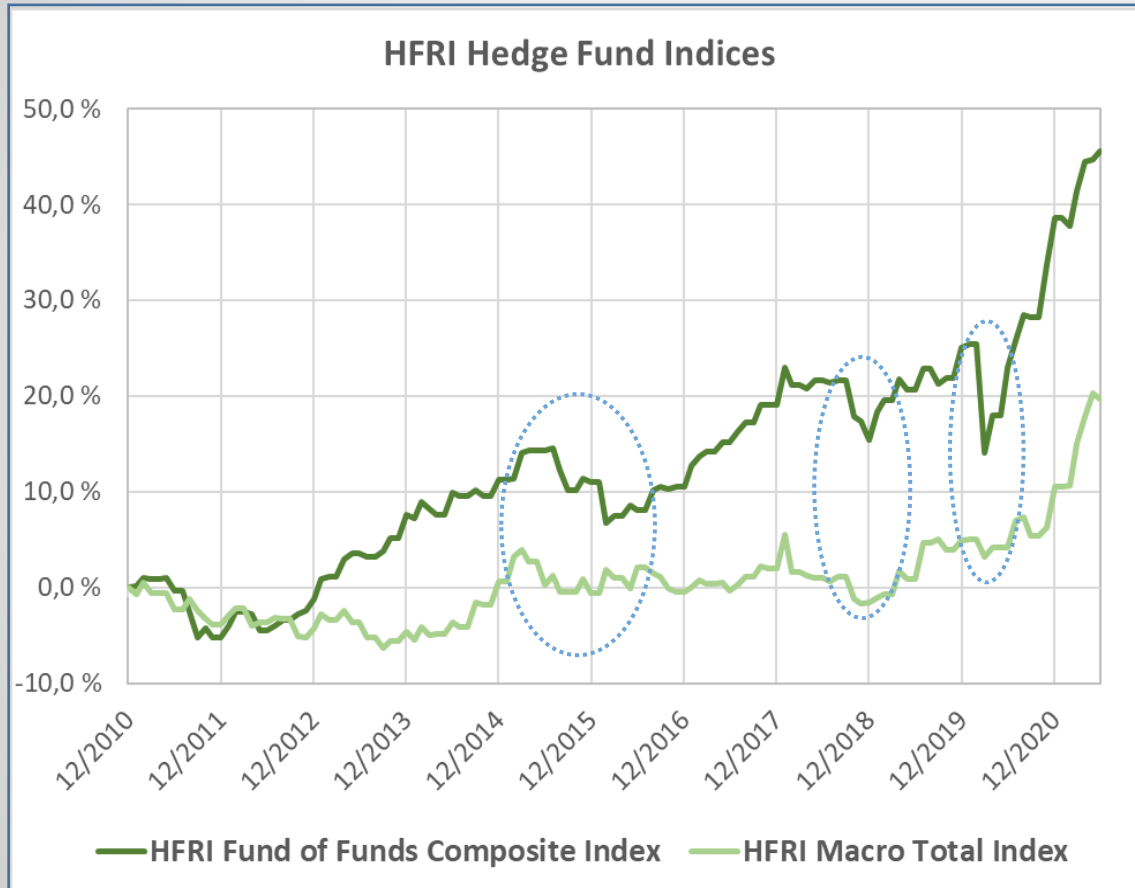


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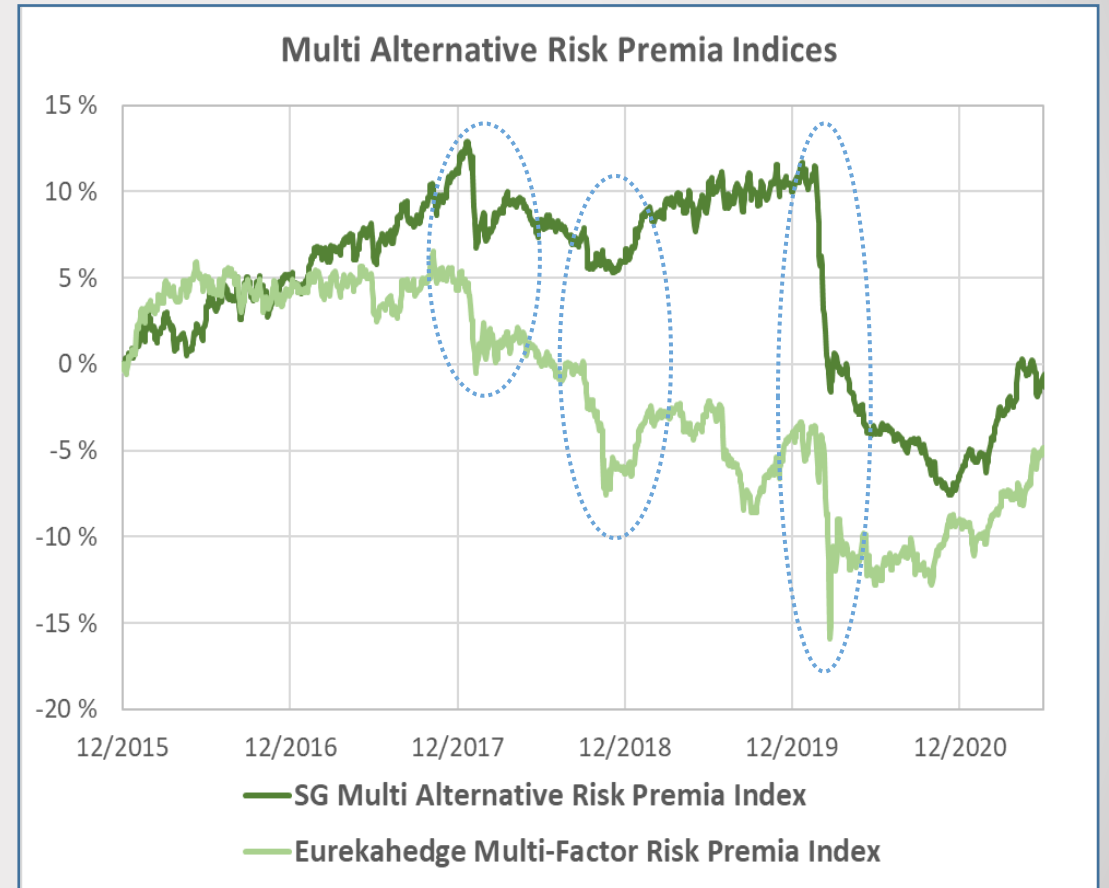


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Hedge Funds or Alternative Risk Premia didn't Help Either

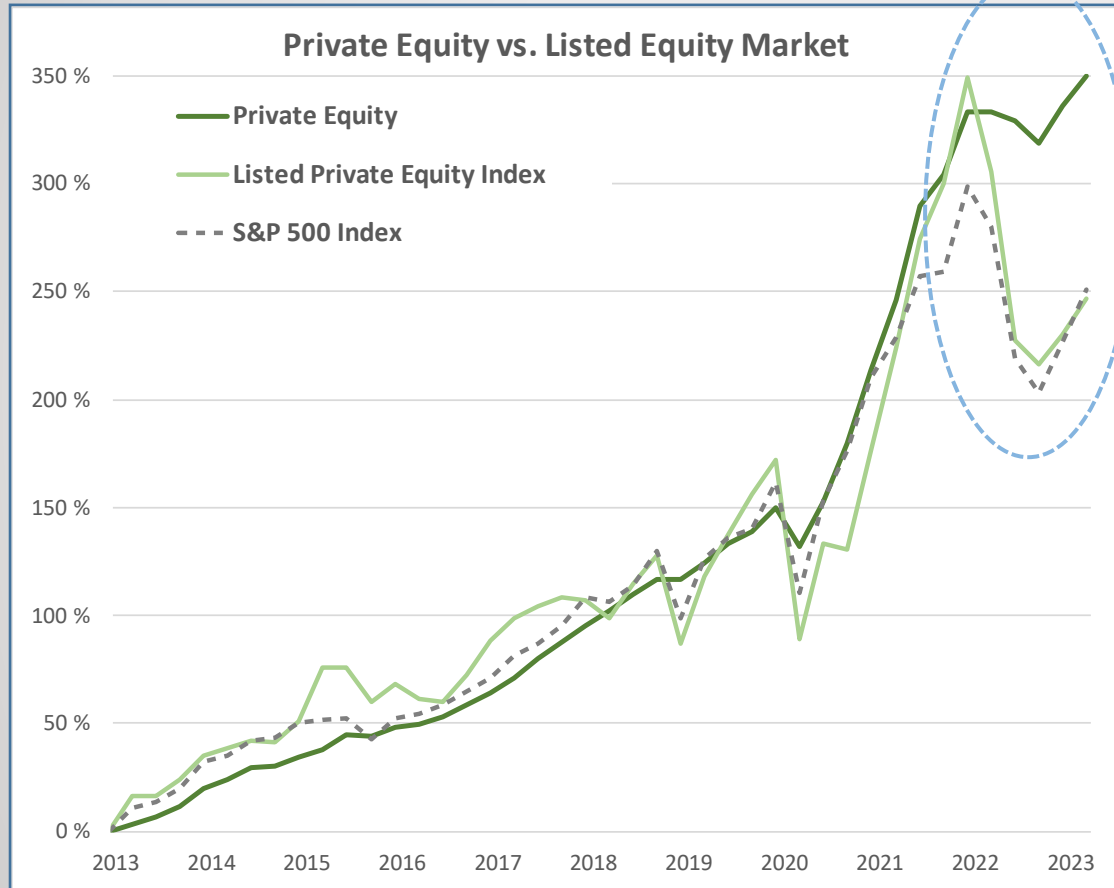


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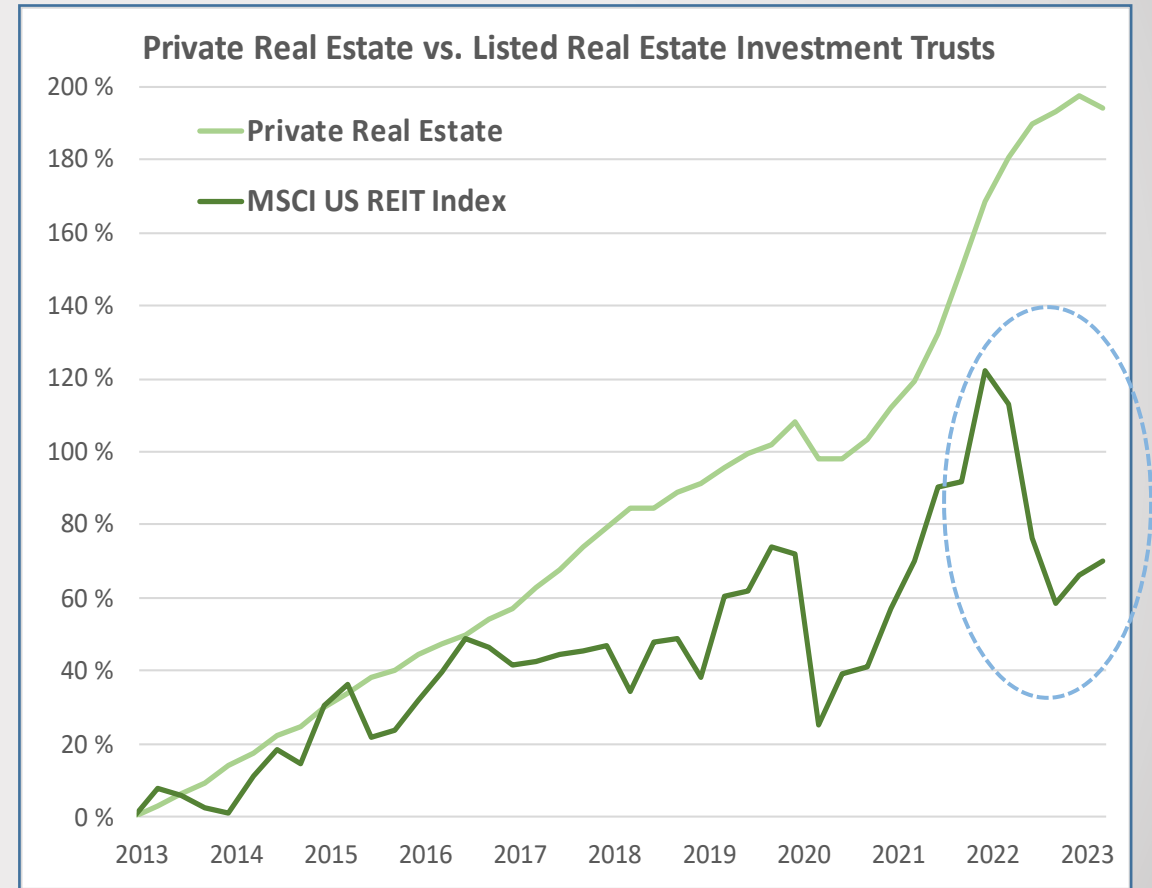


Source: Bloomberg

Blessing of illiquidity: Diversification to Private Assets

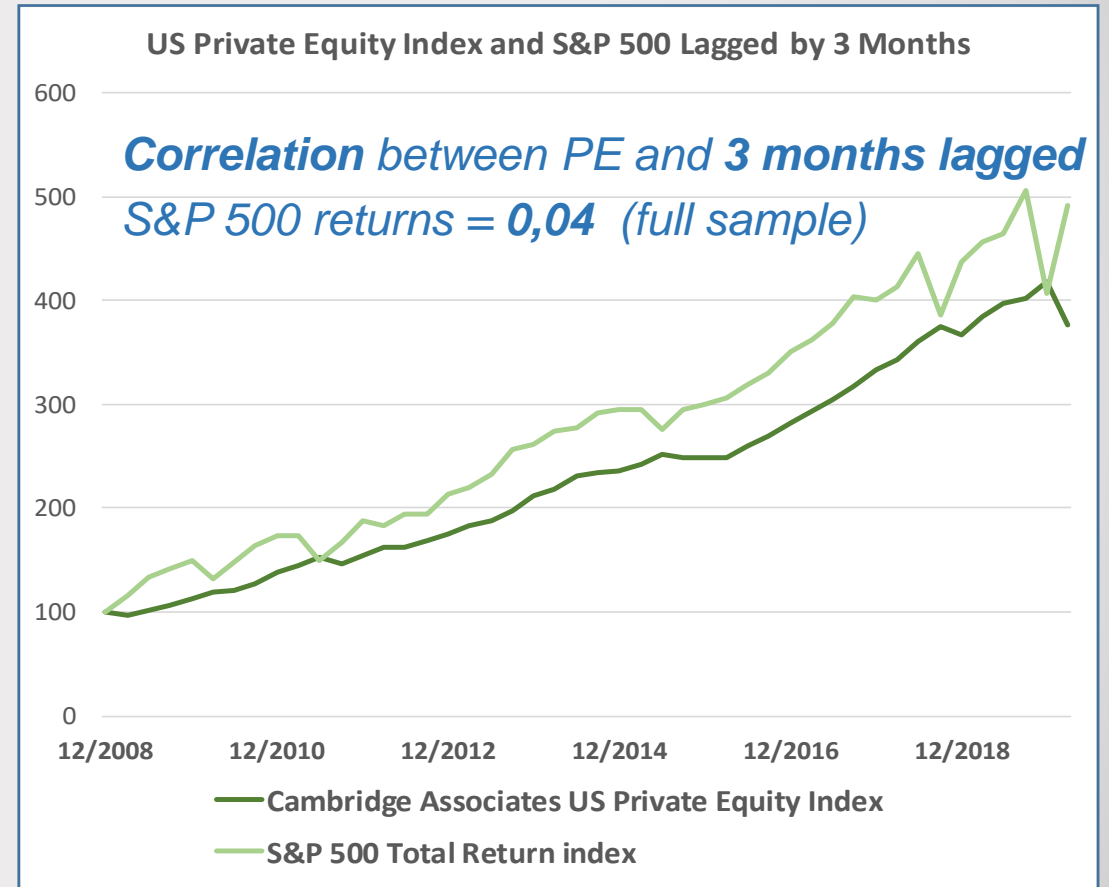
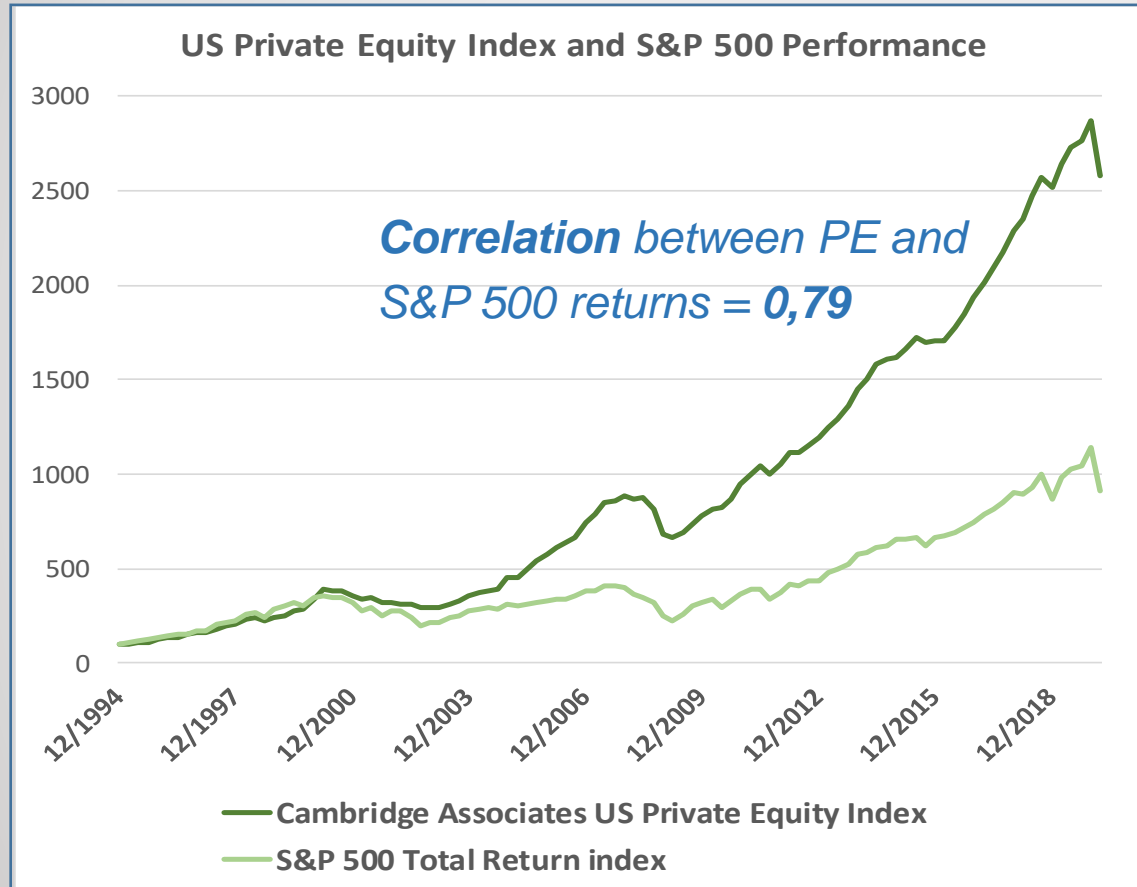


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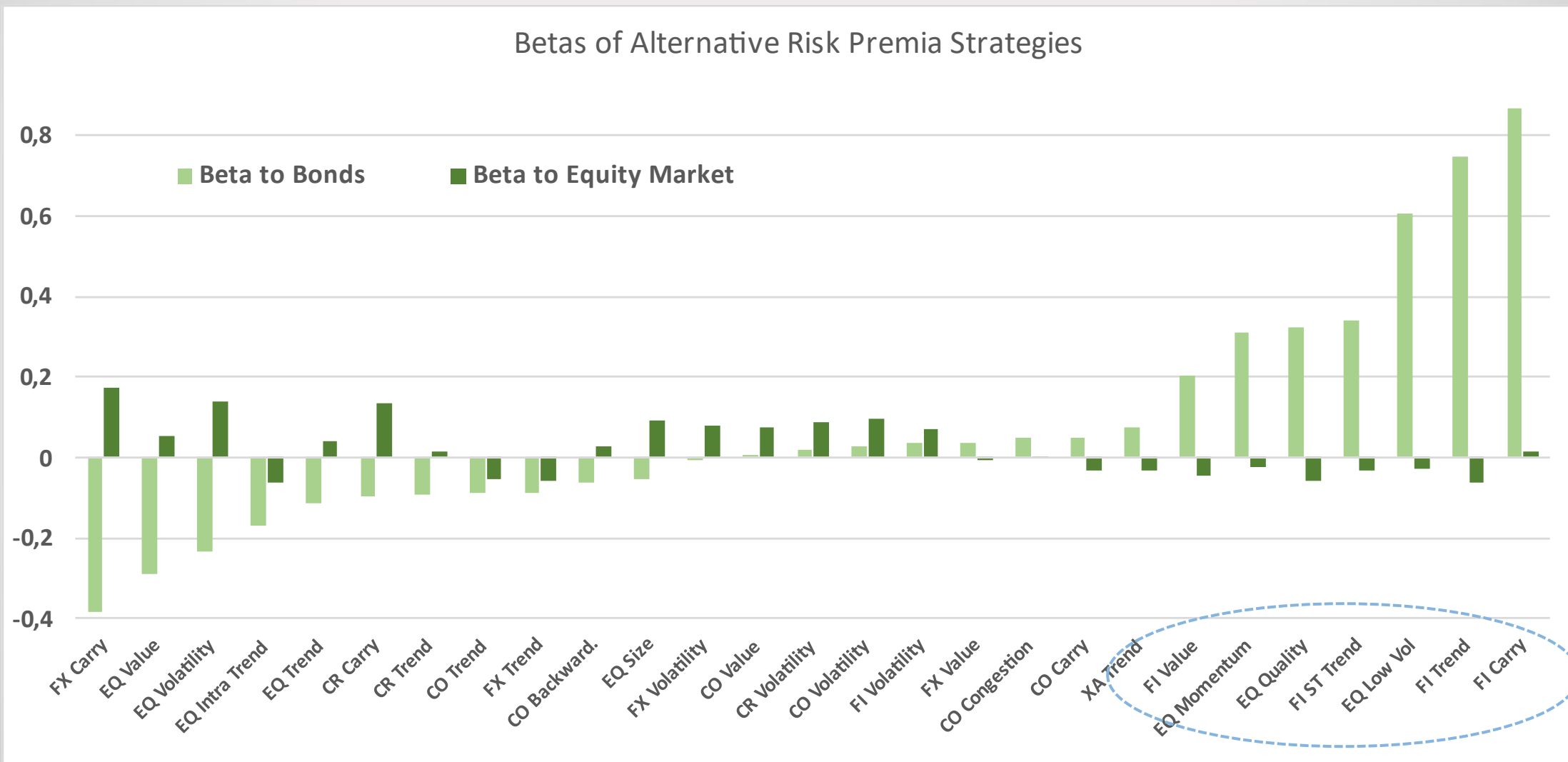
Artificial Diversification Effect by Delayed Valuations



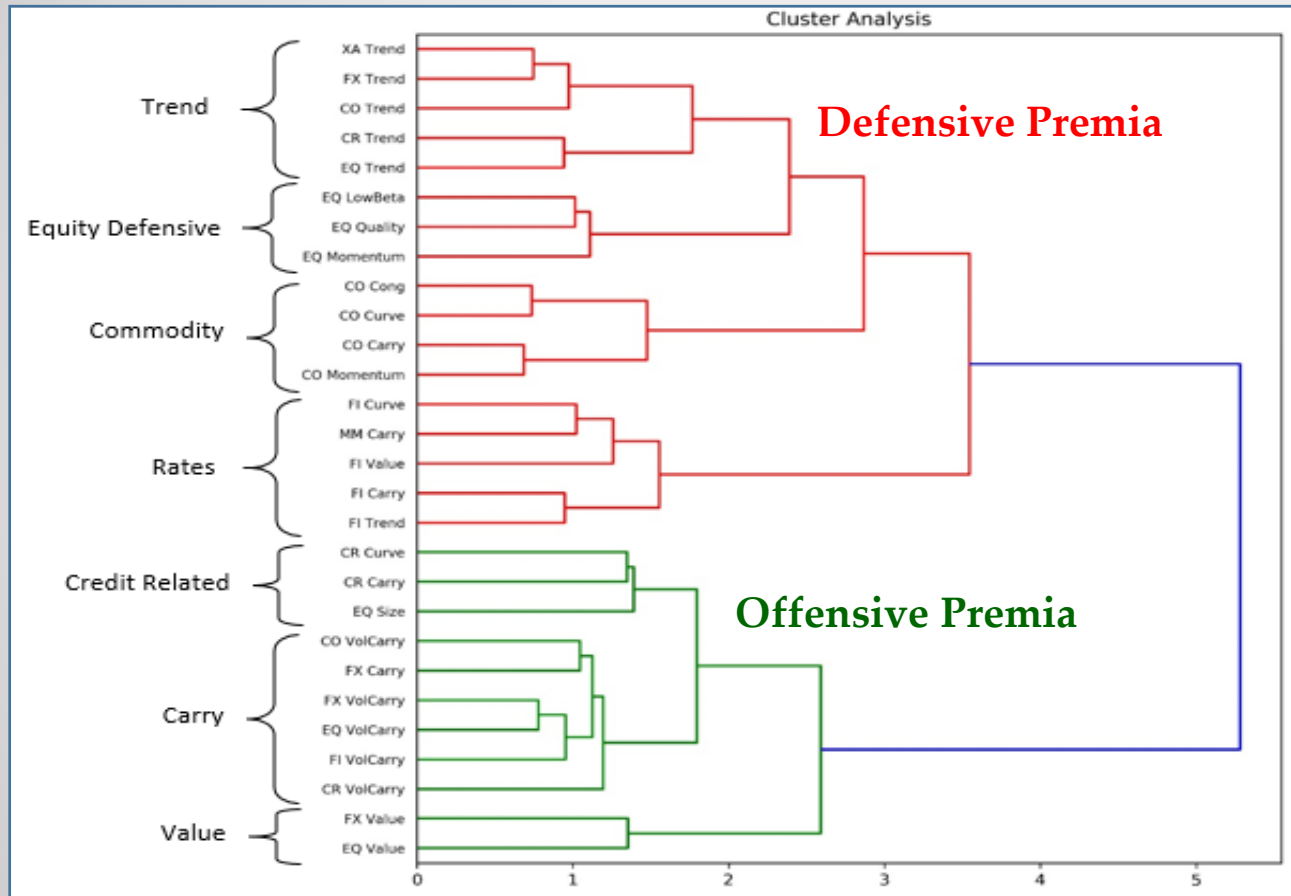
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Diversification with Alternative Risk Premia



Most ARP are Tail-Correlated with Equities or Bonds



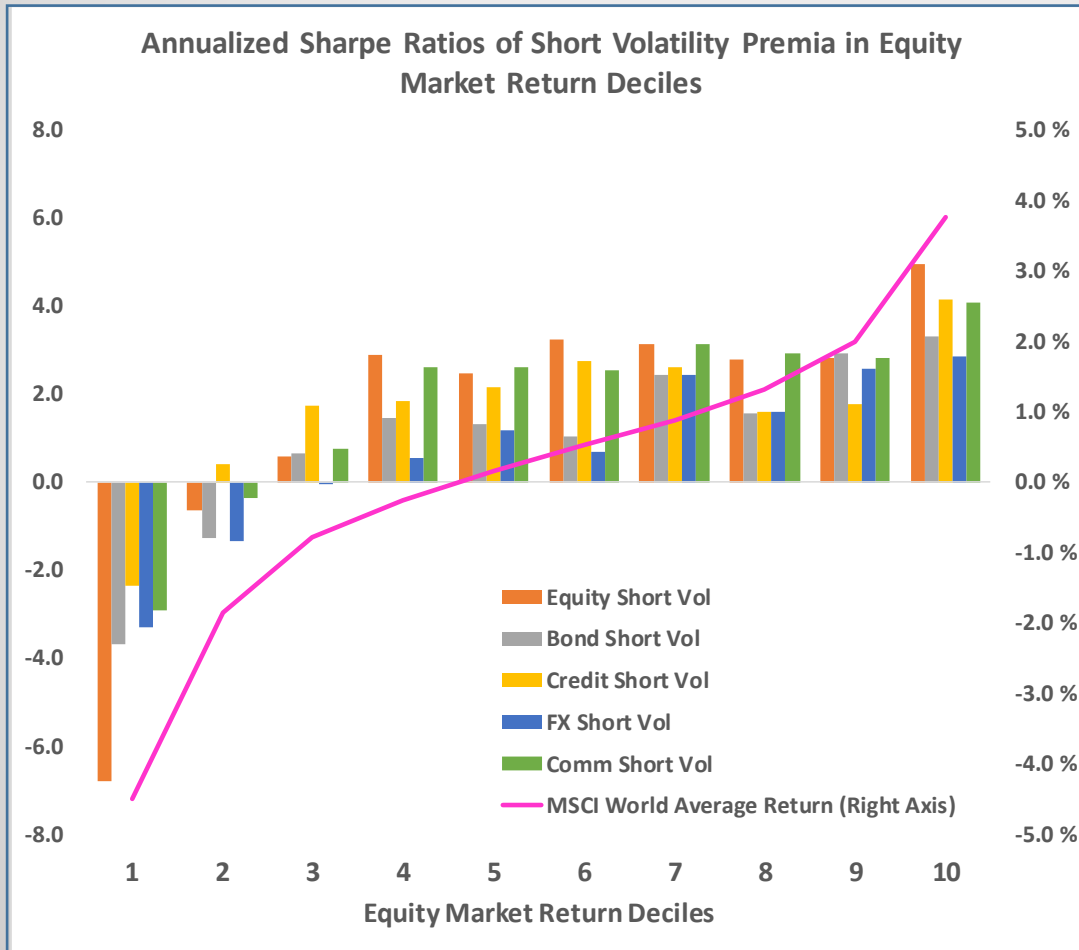
Robustness decreases but diversification Increases

	Fundamental Premia	Behavioral Premia	Structural Premia
Defensive	<i>Bond & MM Carry Equity Defensive</i>	<i>Trend & Momentum</i>	<i>Commodity Strategies</i>
Offensive	<i>Volatility Carry FX Carry Credit Related</i>	<i>Value</i>	

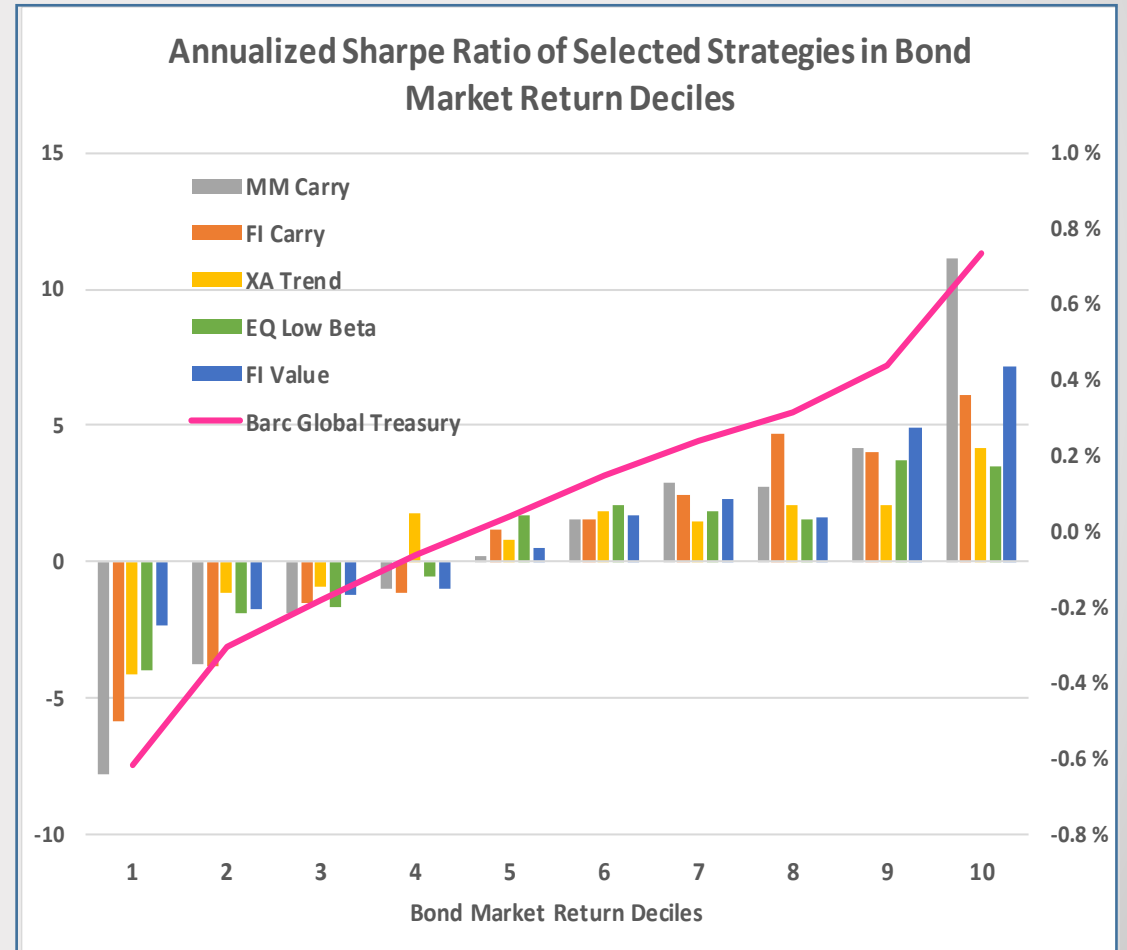
Ref: K. Vatanen and A. Suhonen (2019), *A Framework for Risk Premia Investing: Anywhere to Hide*

Examples of the Risk Characteristics of Risk Premia Strategies

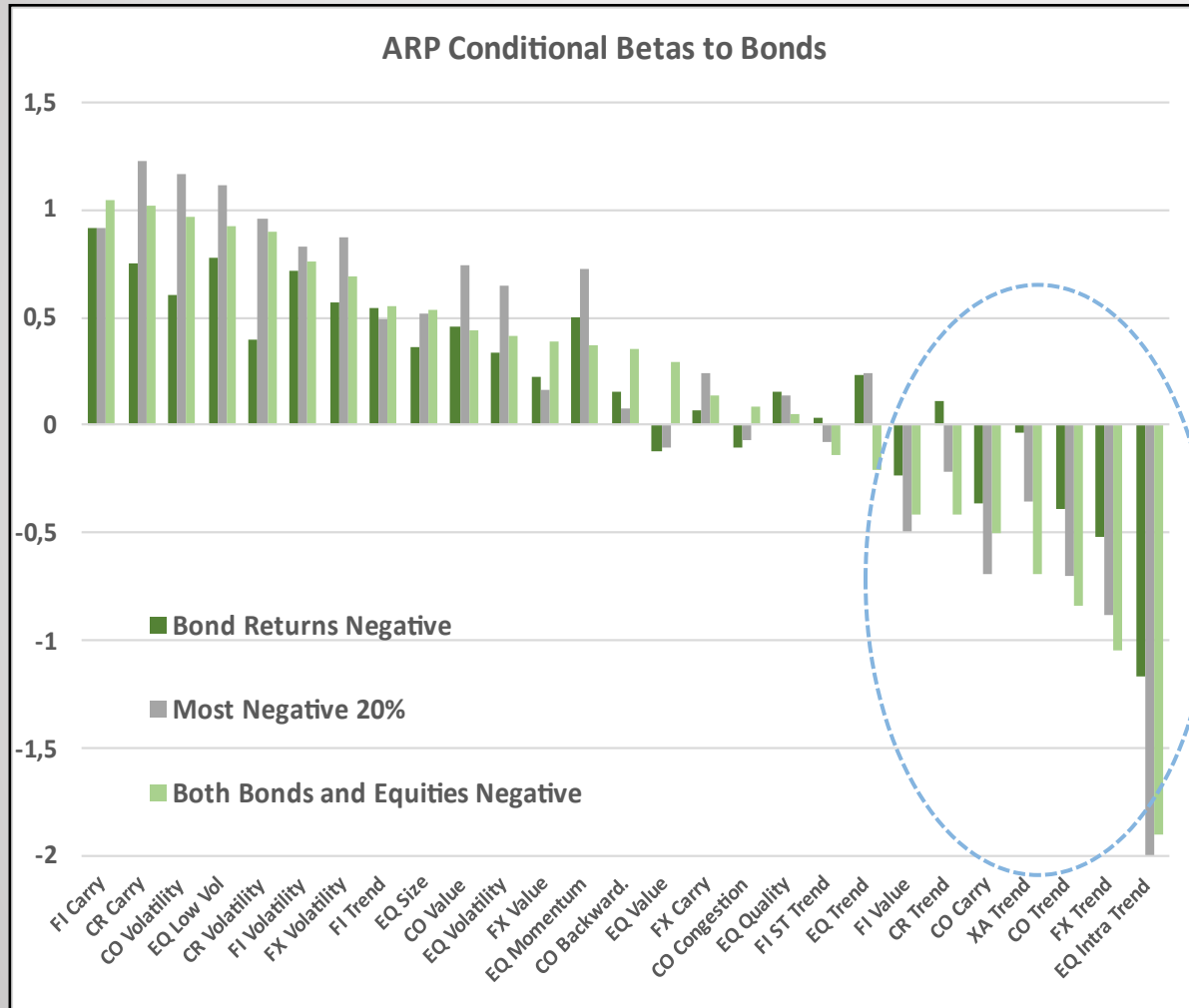
Return Profile of Volatility Carry Premia



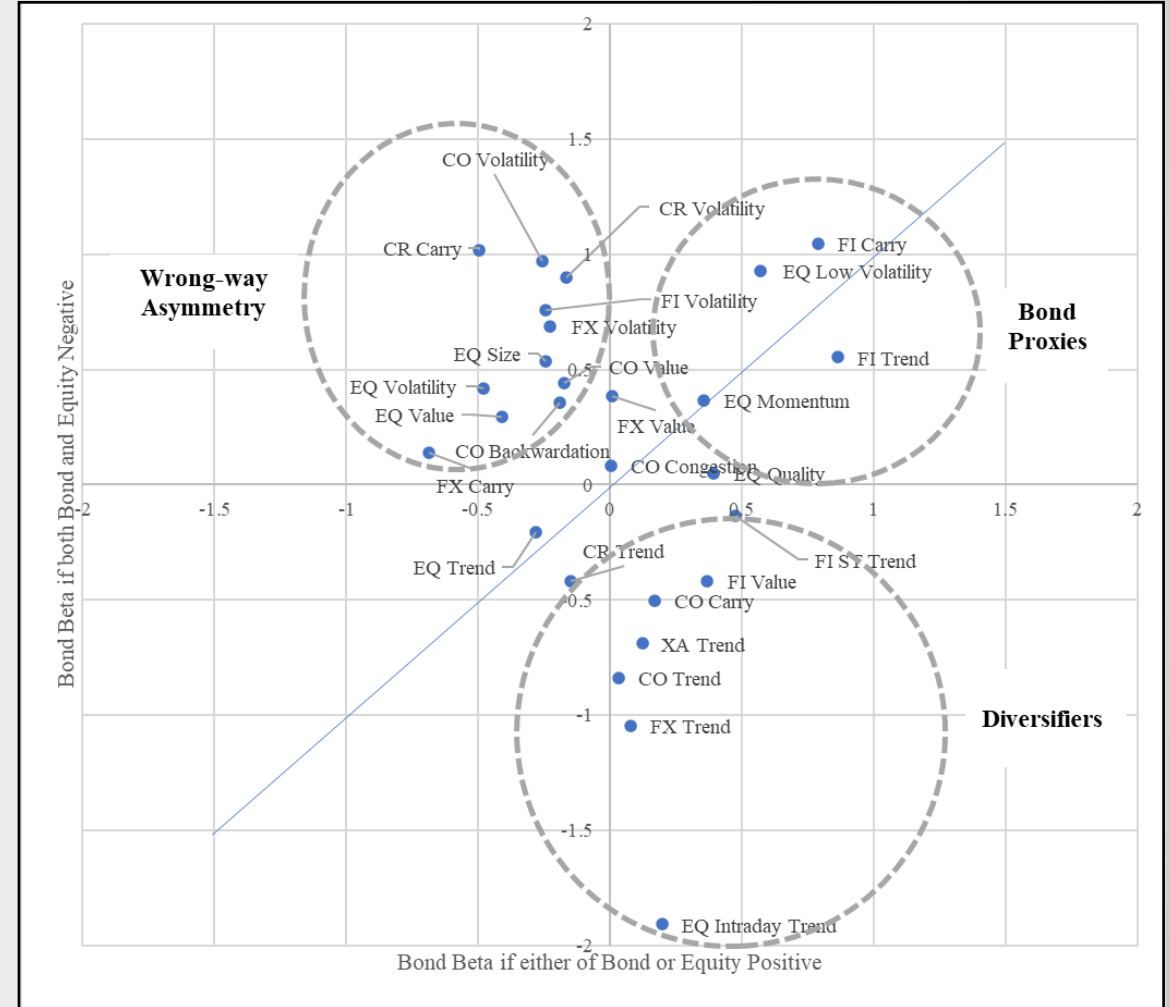
Return Profile of Some Defensive Strategies



ARP Conditional Downside Betas to the Bond markets

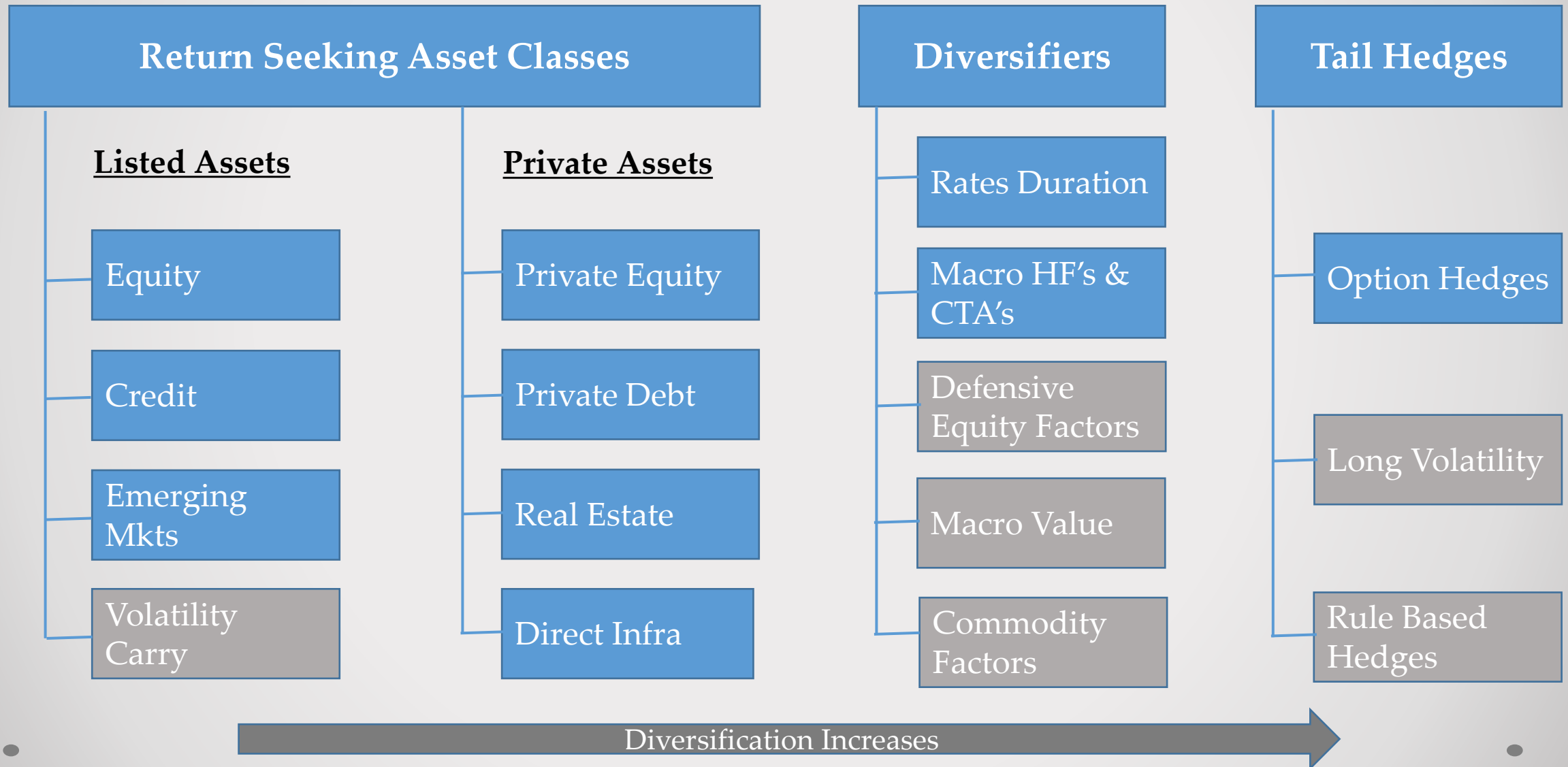


Unconditional and Conditional Bond Betas of Pure Factors 2007-2022



Ref: A. Suhonen and K. Vatanen (2024), *Do Alternative Risk Premia Diversify? New Evidence for the Post-Pandemic Era*

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Thank you! + Q&A

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