Since the Global Financial Crisis of 2008–09, one of the most significant developments in the asset management industry has been the development of risk-based allocations. Investors and asset managers realized that optimal asset allocations which depend on forecasts of expected returns are entirely unreliable and the promised diversification benefits tend to disappear exactly when investors need them the most. Risk-based asset allocation models rely far less on forecasts of expected returns, if at all, and since parameters that are useful for predicting risk tend to be more stable, risk-based models tend to produce more robust allocations. The first article of this issue provides an extension of these risk-based approaches.

In the article titled "Expected Shortfall Asset Allocation: A Multi-Dimensional Risk Budgeting Framework," Jurczenko and Teiletche develop a generalized expected shortfall risk-budgeting investing framework. They empirically illustrate the methodology by proposing a risk-based strategic allocation for a multi-asset portfolio made up of traditional and alternative assets with different degrees of liquidity. The framework presented makes it possible to deal in a simple and flexible way with various risks beyond volatility, namely valuation, asymmetry, tail, and illiquidity risks.

Kaminski and Molyboga study the impact of fees on the performance of multi-manager portfolios within managed futures by quantifying the relative performance of traditional and pooled fee structures for multi-manager commodity trading advisor (CTAs) portfolios. The article titled “The Impact of Performance Fees on Multi-Manager CTA Portfolios” uses net-of-fee monthly returns of CTAs and their fee structures as reported in the BarclayHedge database, to estimate time-series of gross returns. The authors find that fees represent approximately 50% of gross performance, on average. This is an important result because the relative impact of these fee structures is not obvious. Databases of CTA returns not only suffer from several biases, but returns are reported net of fees. This net fee return may not be applicable to a host of investors that can negotiate different fees and fee structures. The results of this article are important to investors who wish to make informed, net return-maximizing decisions regarding fee structures and fee-related characteristics for multi-manager CTA portfolio investments.

In recent years, hedge funds investors have sought to reduce and change the hedge funds’ fees and their structure. In response, hedge fund managers have proposed alternative structures in order to better
align their interests with those of their investors. In “The Myth of Hedge Fund Fee Diversification” Meng, Saunders, and Seco examine a fee structure that has received some attention in recent years: the first-loss structure. Under this structure, the manager receives a higher performance fee in return for providing some downside protection to investors by insuring some of their losses. Combinations of these fee structures have also been proposed, with the possibility that investors may benefit from some diversification among the fee structures. By considering the investors’ risk-reward tradeoff, the authors show that there is in fact very little benefit from such fee diversification.

What are the underlying assumptions of CTAs’ value proposition? Hutchinson and O’Brien examine the validity of three key assumptions in “Testing Futures Trading Strategy Assumptions.” There is a growing literature examining futures-based trading strategies and the performance of CTAs. In this article, the authors test the validity of three key assumptions used in these studies. They review the evidence on the level of transaction costs to test the cost model used in modeling a futures-based trading strategy and study the assumption that CTAs generally charge a management fee of 2% and an incentive fee of 20%. In addition, the trend over time in the structure of fees is presented. Over the full period, the average fee levels were measured at 1.82% and 20.2% which is close to and not significantly different from the levels used in the literature.

While the previous article focuses on costs assumptions underlying studies of CTA performance, the article “The Long and Short of Trend Followers” by Agerback, Gudmundsen-Sinclair, and Peltonäki examines risk-return properties of long and short positions of CTAs. The authors of this article propose the use of short and long portfolios of trend-following strategies to analyze their risk and return characteristics. They find the profitability of trend-following strategies is asymmetric with returns to their long side being more profitable. They also find that the exposures of CTAs to the long and short sides of trend-following strategies have become more biased towards long positions. The main lesson of the study is that the long and short sides should be differentiated in the analysis of CTAs performance and their place in a diversified portfolio of traditional and alternative asset classes.

The recent experience of the investors with Argentinian bonds highlights the importance of being able to hedge the tail risk of emerging markets bonds. The penultimate article in this issue is titled “Hedging High-Yield and Emerging Market Bond Tail Risk with VIX Futures.” Liu and Xie suggest a different approach to hedging tail risk in certain segments of the fixed income market. VIX futures, which are based on the implied volatility of equities, are not an obvious choice for hedging the tail risk of bonds. Nevertheless, the authors show that there is a negative correlation between returns for credit-focused bonds and VIX futures, and the strength of the inverse relationship increases during down markets precisely when the hedge is most needed. Therefore, VIX futures become a viable alternative hedging instrument for bonds with significant credit risk. Because there are significant roll costs associated with VIX futures during non-stressed periods, a static hedge will create a drag on returns, but a dynamic hedge can effectively reduce credit-focused bond losses during times of stress.

Carry trade is the foundation of many relative strategies, especially those performed by global macro funds. In “Carry On,” Czasonis, Pamir, and Turkington examine properties of the carry trade, which is known for delivering positive returns on average, and for occasionally suffering large losses. The authors find that interest rate differentials on their own are not enough to identify conditions in which currencies exhibit attractive return and risk attributes reliably. While these characteristics prevail on average across time and currency pairs, the authors use three variables—valuation, crowding, and volatility—to identify periods and cross-sections of currencies in which the carry trade performs best.