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INSIDE

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listeningin

Replicating Hedge Funds

Dynamic Beta Cracks Code To Deliver Client-Friendly Performance

Andrew Beer isn't a man of modest ambitions. When your first job on Wall Street was working for Jim Wolfensohn and when one of your Harvard Business profs insisted you meet Seth Klarman — who hired you as a Baupost portfolio manager before the ink dried on you MBA — how would you even have a clue what modest ambitions are?

Andrew Beer

The co-founder and co-managing member of New York City and Paris-based Dynamic Beta Investments, Andrew did, however, surmount those formidable challenges, becoming a successful and serial hedge fund entrepreneur after about six years of immersion in Baupost's heady milieu. His finely tuned antenna for business trends led Andrew to start timely hedge funds in fields as disparate as energy futures and Chinese shares.

But improbably, it was a chance encounter with a quant that sent Andrew, a history major as an undergrad, into 15-plus years of deep research into the science and art of hedge fund replication strategies that have become his business and his passion. And his ambition, well, soaring: "We seek to outperform portfolios of leading hedge funds with less downside risk, equitable fees and daily liquidity."

Equally improbably, you might say, Andrew and his partner, Mathias Mamou-Mani now have a couple of ETFs and an UCITS fund powered by the replication engine they developed trading in the markets — all of which are meeting those high bars.

Andrew patiently explained it all — and why he's still aiming to land his white whales, institutional hedge allocators and their clients, in a call on Nov. 2. Listen In.
— KMW

Welcome to WOWS, Andrew. I'm thrilled to be speaking with you. And not only because our chat is sure to redeem a day that started with me spilling coffee all over my desk! It's all up from there.

Andrew Beers: Oh no. I can't match that, but I did I put zinc-based sunscreen on that little thing in my car in between the two front seats and the thing burst in the heat. When I saw that I was standing outside screaming, "Why God, why?"

Life throws these things our way to keep us humble, I guess. I hope it's not a brand new car.

Andrew: It is not. I have gotten the same car like

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four times in a row. Each one has had more annoying features than the last that I don't use. So I'm two years into this one, didn't just drive it off the lot, fortunately.

I hear you. Touch screen controls that you can't read in the sunlight are a personal "favorite." I'll stick with my 10-year old Acura, thanks.

Andrew: Oh, I need knobs. I will pay a premium for knobs. And I hate a car that wants to park itself. If there were a way to disable that, I'd do it. The only new feature I like is that my car is completely neurotic about checking if anyone is around when I go to change lanes — it has probably saved my life about 10 times. I tend to multitask and get distracted.

"In my second year at Harvard Business, one of my professors tapped me on the shoulder and said, 'You've got to meet this fellow named Seth Klarman.' …So I sort of accidentally went into the hedge fund industry and have been here ever since."

Even if you're not, blind spots are real. So I'm hearing you own up to relying on heuristics while driving — even though you've gone to great lengths to eliminate them from your investment process.

Andrew: I admit, I have certain habits. I always wear blue suits. There are mundane choices I don't relish making. I try to make some decisions as simple as possible.

Where are you based by the way?

I publish from my erstwhile beach house in Mattituck, out on Long Island's east end.

Andrew: Oh, lovely.

It's so much better — and more productive — than commuting from New Jersey to Wall Street and/or Greenwich, which I did for almost 40 years.

Andrew: I completely agree. It's transformational, at least in our business. I very rarely go into the office in Midtown. Pretty much only when we have to convene. So much has changed just because people are now so used to doing things online.

I didn't realize I was a pioneer when I started frequently working from home in 2001 or 2002, instead of driving to Connecticut daily. That was a truly awful commute.

Andrew: I lived in that area of Connecticut for a very long time, but I got remarried last year to a wonderful woman — and the running joke is that she came with a kind of lousy house in New Jersey. It's complicated and moving right now isn't an option. But when we do move, it's not going to be back to Westport or Central Park South — anywhere I used to live. It's going to be someplace much more fun and exotic. I spent a good part of last summer up in the Adirondack Mountains, and I now realize it's actually practical to work from there. It'll be someplace like that.

All you need is a good internet connection — and a whole house generator. But let's talk about what you're up to in the markets. I often start by asking an interviewee to explain what terrible childhood trauma drove them to Wall Street —

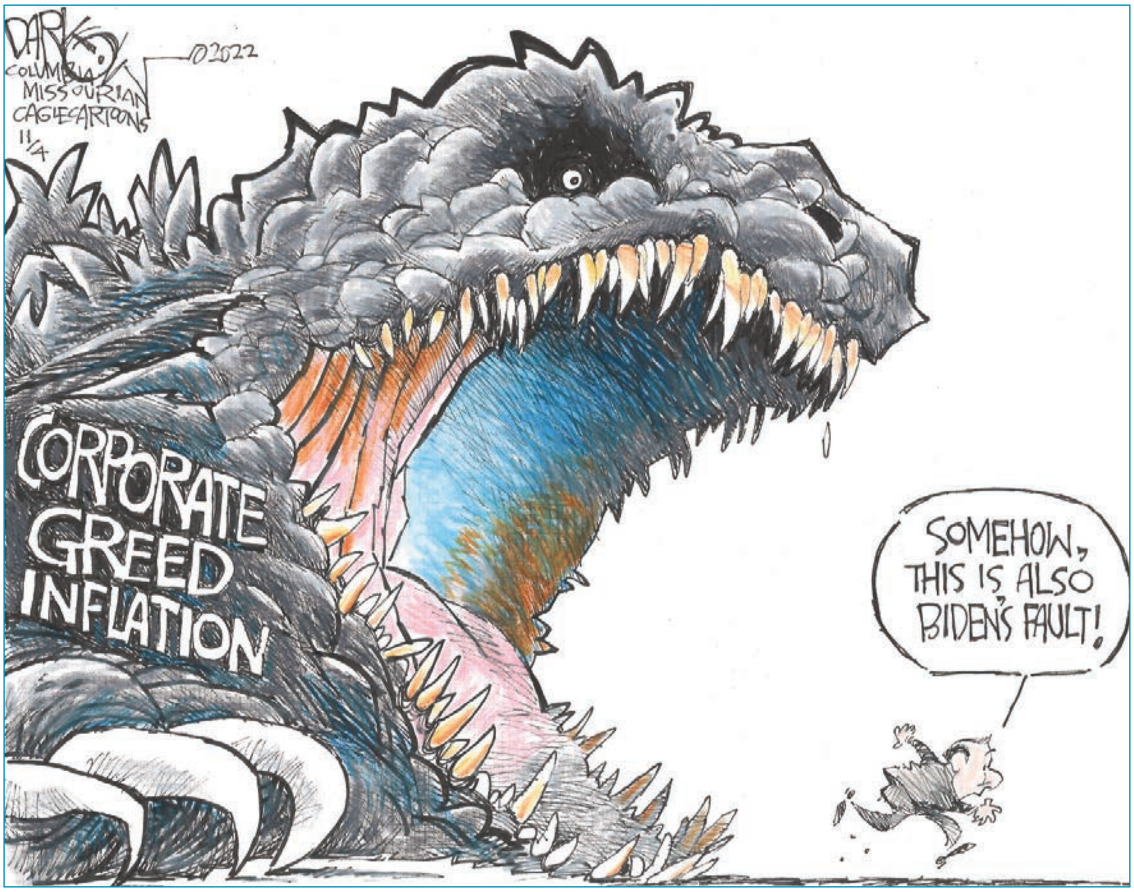
Andrew: That's funny. In my case, my path was sort of convoluted. I grew up thinking about going in probably three different directions. My family had a deep background in manufacturing — one of my mother's ancestors started the company called Corning Glass back in the mid-19th century.

No small accomplishment — or company.

Andrew: Yes, but then, simply because I grew up in Manhattan and also through my first marriage, I had affiliations with people on Wall Street. So I went to work for a guy named Jim Wolfensohn right when I got out of college —

***The* James Wolfensohn who was president of the World Bank in the late 1990s?**

Andrew: Yes, Jim was an investment banker but the cool renaissance version of an investment banker. So, I'd be working on a financial model, and then Jim would have Yo-Yo Ma in the office, dragging his cello in or out. Then I went back to Harvard for Business School. It was kind of the cool thing to do at that point — if you had any investment banking expertise — to go into private equity. So I thought I was going to be a private equity guy.



Monster Corporate Greed by John Darkow, *Columbia Missourian.com*

That was a close call. What diverted you?

Andrew: In my second year at Harvard Business, one of my professors tapped me on the shoulder and said, "You've *got* to meet this fellow named Seth Klarman." I asked, "What does he do?" He said, "He runs a hedge fund." I said, "I have absolutely no idea what that is, but if you say he's smart, I'd love to meet him." When I went for an interview, it was two hours of grilling and logic questions. But I had read up on Seth and I thought working with him sounded really, really neat. So I sort of accidentally went into the hedge fund industry and have been here ever since.

You hit the lottery. That was quite an introduction to hedge fund investing.

Andrew: Seth is wonderful. He's incredibly smart and he just has both feet so firmly planted on the ground. I think, if I could do it all over again — I don't think I fully appreciated at the time how uniquely smart he is. I was very young. I didn't really have a lot of investment experience. I was learning everything. There are so many lessons that I learned from him that still come back to me 25 years later.

I just didn't have the perspective to fully appreciate that, in the moment. It wasn't like I had worked for a lot of other guys and could say, "Oh my God, Seth is so much smarter than the five other guys I've spoken to." All I knew was working for Seth. But I did realize he is incredibly smart, and has this just incredible judgment and ability to dive right to the center of an issue. I was very, very lucky to spend a number of years working for him and learning what I could.

Now tell me what you *really* think — no, seriously, Seth is an incredible investor — and one heck of an interview. Challenging and brilliant.

Andrew: Absolutely. I've always had a very eclectic mix of interests. Something that I found fascinating at Baupost — and have ever since — was not just the way hedge funds invest, but also how the hedge fund industry itself and its investor base change over time. After I left, I did two very different things. I was a co-founder and part owner of a commodity-focused fund of hedge funds called Pinnacle Asset Management. That was really based on the contrarian idea that commodities had really become a backwater by the early 2000s. I remember seeing an article in the *Economist* that said, "Oil is at $11 a barrel. It's going to $3." I thought, "Maybe *this* is the time to get into the space."

But you were a mite premature?

Andrew: What I was able to figure out pretty quickly was that there may have been a great opportunity to invest in commodities but that there was also this institutional business angle — people would be looking for ways of getting exposure to commodities. So, as you do with these things, you feel your way around the space and try to learn about it. We eventually ended up starting a firm to invest in what ultimately became the outfits who used to print money year in year out in Enron or one of its competitors.

Energy traders?

Andrew: Right, then after all those businesses collapsed, those people were sitting in Houston with no idea what to do next. So the firm that I started and a bunch of others would go around and basically say, "You should reconstitute yourself as a hedge fund." Then, around the same time in the early 2000s, I also got interested in China. On the China side, I ended up teaming up with a guy who was the head of proprietary trading at HSBC in Hong Kong, and a guy that he had worked with for a long time in the U.S. We created Apex Capital Management, which was one of the first institutional long/short hedge funds focused on the Greater China region. We basically decided that there was a great opportunity to trade stocks in the China region — but we decided to do so via arbitrage.

Because you couldn't invest directly in the Chinese companies?

Andrew: That was part of it. We decided to focus on finding ways to arbitrage the differences between the prices of those stocks in local China markets and how they were trading in other markets — listed in the U.S. or elsewhere as stocks or ADRs. Again, there was this big macro theme. Whether it was that commodities will come back and be important, or whether it was that China was going to become important. And the manifestations of those themes in those hedge funds were just based on how we thought we could make those businesses work. I have to say that we were very lucky in those endeavors in that they took off very quickly.

And my current business is an outgrowth of a chance meeting I had with a quant back in 2006.

Wait. Your hot hedge strategy ETF owes its existence to a *chance* encounter?

Andrew: Yes. To be specific, that's how my current business, Dynamic Beta Investments, which is the sub-advisor to the iMGP DBi Managed Futures Strategy ETF, originally got interested in working on what's now our Dynamic Beta Engine — our proprietary quantitative model — designed to identify the main drivers of performance in a diversified portfolio of the largest managed futures funds, and in the case of our other ETF, the iMGP DBi Hedge Strategy ETF, in a pool of large hedge funds. So that we can replicate them.

So tell me about your close encounter with that quant — in English, please.

Andrew: Let me be completely clear. I am anything but a quant. I was a history major in college. But I had that chance meeting with a quant who basically described a way of using a risk model to figure out how hedge funds are positioned *today*. This was soon after Andrew Lo at MIT had published a paper that basically said, "You can use certain risk models to figure out the major features of certain hedge fund portfolios."

As I (dimly) understand it, Professor Lo was making waves then by somehow using Professor William Sharpe's Nobel Prize-winning work to peer into how hedge funds were making their secret sausages?

Andrew: Yes. His strategy, called hedge fund replication, was an expansion of Sharpe's returns-based style analysis. This quant I happened to meet with was looking for somebody to basically back him in a new business using that strategy — and another quant had asked me what I thought of the idea — from my perspective as a guy who had grown up in the hedge fund business, but on a very different side of it.

You must have liked it —

Andrew: What I said then was, "Well, if the readings are accurate, it should work." So I asked that quant, "What would your model show you today?" He said, "Actually, I'm surprised. It would show a *really* big allocation to emerging markets."

Which told you — what?

Andrew: As I told him, "Then it definitely works. Because if you talked to any equity stock picker, or any macro guy, at that point, they were just obsessed with the BRIC trade." [Brazil, Russia, India, China] We saw this in our own China business that was growing very fast. I think the favorite hedge fund position at that time was Cemex. People were saying things like, "Look at how many cranes there are in Beijing. Everybody needs concrete. Cemex probably has an order book going out 10 or 20 years." When stock pickers looked around, it was easy for them to say, "Boy, I'd rather own that company than one of the stocks recovering from the dot-com fiasco or the telecom fiasco."

The BRIC trade came and went, as all fads do. What intrigued you enough to pursue the guy's model?

Andrew: I liked it as a business idea because I'd observed that one of the great struggles for institutional hedge fund allocators over the prior 20 years had been trying to get exposure to hedge fund performance i*n a more client-friendly package.*

Isn't a client-friendly hedge fund an oxymoron? Even the biggest winners require clients to assume virtually all the risk for paltry shares of the rewards.

Andrew: By a "client-friendly package," I mean we don't want to get gated and suspended at the wrong time. We don't want to pay huge fees one year and not get a penny back when you incinerate our capital the next year. We want daily liquidity if we can get it, because we have other parts of our portfolio we need to manage. So, the conclusion that I came to was that if this hedge fund replication strategy worked well, then it would solve this institutional quest for a client-friendly index-like version of hedge funds.

And now that I've been doing this for 15-plus years, we can say definitively that my investment thesis was 100% right. People have tried a lot of things in the meantime. They have tried to take hedge fund strategies and implement them through mutual funds, or by setting up managed accounts — or by doing all sorts of structural gymnastics. But this simple factor-based hedge fund replication strategy approach has worked far better than anything else.

I'm sorry, I'm reflexively skeptical when someone says they've found the keys to the kingdom.

Andrew: Oh, don't get me wrong. Our strategy works only in limited circumstances. You cannot replicate — and one *should not even try* to replicate — what a Millennium Management, or a Citadel, for instance, does. But if you take a bunch of equity long/short guys, or of managed futures guys, we can often replicate them very well.

But what I *completely* got wrong was how threatening our business model would be to the whole industry of providing allocation services to institutional investors in hedge funds.

Sure. Replication upends the myth of hedge funds as repositories of supernatural investment acumen, which has long been a centerpiece of the culture. The hugely successful hedge fund creators *actually were* an exceedingly rare — and pathologically discreet — breed of genius back in the 1970s when we gathered the likes of George Soros, Walter Mintz and David Wilson around *Barron's Investment Roundtable*. Not so today, when a large swath of every MBA class enters the business. But that aura of extreme exclusiveness was foundational to the allocators' business model — "providing access to the anointed."

Andrew: So, I missed that. But I invested in that hedge fund replication business strategy almost immediately after I took that chance meeting — We launched our first product in May of 2007. We were called Belenos Capital Management at that point. But we hit an absolute brick wall of resistance when we tried to sell our replication strategy to allocators for institutional investors.

That came as a surprise?

Andrew: Actually, yes, because I had realized by then that virtually every fund of funds at the time was running a very big, and very obvious, asset/liability mismatch. All you had to do to see it was to talk to them. They were deathly afraid to hold onto any cash, for fear of falling behind in the performance derby. Yet they were allocating their clients' money out to hedge fund guys who were asking for *five-year lockups* — at the same time they were offering their institutional clients *monthly* liquidity.

Completely and utterly nuts.

Andrew: It was such an obviously bad idea. But, as Chuck Prince famously said before the mortgage crisis, "As long as the music is playing, you've got to get up and dance." So they were dancing and refusing to "penalize" their performance by holding cash. My expectation, going in, was that the funds of funds — which *needed* something that had daily liquidity desperately — or at least some of them — would say, "Well, if this replication strategy works, it solves our asset/liability mismatch problem. We can dial up or down our exposure as we need it. We don't have to race to put money out on the first of each quarter."

But what I didn't anticipate was that if you're running a fund of funds, you've *sold* all of your clients on the *mystique* of hedge funds. Worked hard to convince them, "You need a shepherd to guide you through this dark, scary forest of hedge funds."

I had an amazing conversation around that time with a certain southern billionaire who had a portfolio of hedge funds which had done very badly. I was saying we could solve a lot of his problems by using our replication strategy. He basically said, "I understand what you're saying. It makes perfect sense. But I'm still not going to do it — because it's so valuable to me just to be able to talk to these guys."

WOW.

ANDREW: That's when I realized it didn't really matter whether his hedge funds made 5% per annum, or 8% per annum, hit it big — or liquidated. That was all sort of noise. It was about his very human experience of investing with the managers. Being able to call them up and hear interesting viewpoints on the world, read their investor letters. On the fund of funds side, you had guys who had told all their clients that there were these exceedingly masterful characters running hedge funds. And only they, the allocators, had the expertise to be able to identify the best. Only they could find them. And only they could get the hedge fund geniuses to take them as clients.

So you can imagine the reactions I got when I came along with this *robot dog* of a product. I would start having conversations with an allocator and they would say, "Yes, yes, yes. We really *need* something to help us with the asset/liability mismatch. But wait a second. What if we put 10% of assets into this strategy and clients asked us why it's there? What happens if that 10% allocation that you say would cost us only 75 basis points, or at most, 100 basis points — with no incentive fees — out-performs our other managers, whom we are paying 400 and 500 basis points to?"

The allocators were going to look *really* bad.

ANDREW: Ultimately, the allocators' rejections provided lessons for me in the ways an existing business can circle the wagons.

For instance?

ANDREW: Well, we saw some academics publish papers — guys whose chairs or departments or research was funded by asset managers who have large hedge fund allocation businesses — saying, "This replication strategy couldn't work."

Shocking, not.

ANDREW: You also had consultants writing papers saying it couldn't work. I'm even aware of at least one hedge fund that ran the strategy internally for a while to see if it would work. When it did work, very well, they shut it down and didn't tell their clients.

They all had *non-robot* dogs in the race.

ANDREW: I was very naïve about that. Even to this day, we can show that replicating a group of hedge funds often basically performs better than the real thing on many different dimensions. But institutional allocators have an extremely difficult time buying into something like this. As one of my friends says, "It's like you're John Bogle sitting in a kiosk in the lobby at Fidelity in 1982. No one walking in and out of Fidelity's headquarters wants to hear what you have to say."

Jack had *a lot* of patience. But he didn't waste time trying to sell passive indexes to rival mutual fund purveyors. He went straight to small investors.

ANDREW: Right. So we realized we had to change our business plan. We needed to focus on an area where we could not only deliver a lot of value to allocators, but where *they also wanted that value*. That has turned out to be in the wealth management space.

Today, we're at a bit over $2 billion dollars in assets under management — and we really are doing largely the same things we've been doing for the past 15 years. If you look at the track records of our strategies, they're almost embarrassingly good. Our very, very simple, futures-based replication strategies have outperformed 95% - 98% of hedge funds over the lives of those strategies. And it is for a very, very simple reason: When we replicate what hedge funds do, we replicate as much of their *pre-fee returns* as we can — *and simply charge less*.

You charge fees *dramatically* lower than the hedge funds you replicate.

ANDREW: It's a key part of our strategy. Our low cost means we usually start January with a 400 or 500 basis point performance advantage over the hedge funds —. and there's just not enough alpha rolling around the average hedge fund to compensate for that difference. What's happened now is that we've basically realized that our constituency consists of wealth managers, RIAs, who want exposure to hedge fund strategies — but need it in an ETF wrapper or need it in a UCITS fund. They care about liquidity. They care about predictability, about *not* blowing up. And they don't have teams of people trying to identify the next great hedge fund.

This change of focus has been really instrumental to our growth. We've found an audience that values our approach. What I suspect is going to happen as we expand and as we grow this way, is that we will also start to see some adoption of our strategy in the institutional investment community. But this is a space where retail is leading. The institutions will come around, but only eventually, as in many circumstances our approach just proves obviously better.

So you still hold some hope that institutional investors will overcome their inherent distaste for "retail" solutions?

ANDREW: Yes. One thing I've learned — have you read Thomas Kuhn's *"The Structure of Scientific Revolutions"*?

Ages and ages ago. They come in cycles.
Andrew: I read it a long time ago, too, but one of the things I thought about when I read it was what it meant in relation the investment industry. Our own industry's reaction to change — even Machiavelli wrote about how ruthless people can be when they're trying to protect an existing paradigm.

Totally. Just look around.
Andrew: But I think there is a changing of the guard in process in the investment business. Think about the typical hedge fund allocator in the first decade of the 2000s. They were hot as hell. They were getting huge salaries. There was enormous demand for them. It was a very, very cool area to go into. I know people who were making multi-million-dollars-a-year salaries for doing nothing but picking hedge funds in the early 2000s — *adding no value*. It was not like they were picking the *best* hedge funds. They just knew how to do something in a specific area undergoing explosive growth.

And, if you ask somebody who grew up in the industry in the 2000s, they'll tell you that part of the way that the fund of funds industry and consulting firms sold hedge funds was that they made up really good stories about hedge funds that they thought made sense. "They're masters at shorting stocks." Why? "Because Jim Chanos shorted Enron and then David Einhorn shorted Lehman." They were *stories*. Or, "They're great market timers. They do interesting macro trades. Look at what Soros did to the pound."

They could cherry pick their narratives. It didn't take much imagination.
Andrew: The upshot was that their whole businesses were built on promulgating these stories. What Kuhn talks about is that when you have this paradigm that's built around this idea, then slowly the underlying assumptions start to break down.

So, people slowly realized nobody actually makes a lot of money on the short side, or certainly across the industry, shorts don't make a lot of money. Then, gee, hedge funds don't tend to be terrific market timers, either. So, a lot of the myths have broken down. So what you now have is actually a newer and much more open-minded generation of investors replacing the old guard.

We spent about two years working with one consulting firm. Their head of research is a *very* smart and very, very candid guy. Over those two years, we basically showed them we can replicate their prized best-ideas portfolio — and generate higher returns, with less risk, low fees and daily liquidity.

Did he ask you to hire him?
Andrew: No. He said, "When you first came in and talked to us about your replication strategy, we thought it was preposterous. Then about six months into it, we started to get worried that you were right. Now, two years into it, we've realized you're right — and we're still not going to do it."

I said, "I appreciate your candor."

Very civilized of you. It's a good thing I never went into sales!
Andrew: Well, they ended up finally investing in something that met their criteria of daily liquidity and lower fees — but ended up doing disastrously over the next several years. Those consultants probably cost their clients a billion dollars by doing that.

I feel your schadenfreude. But what put them off?
Andrew: A client who had come up on that side of the business later explained to me something that I hadn't understood about the consulting industry, because I didn't have that experience. Basically, he told me that the consulting firms get paid like 30 - 35 basis points of assets for advising on a hedge fund portfolio. But they only get paid around 8 basis points for doing that on stock and bond portfolios.

Again, why would you pay somebody 30 - 35 basis points, on a non-discretionary basis, to just basically give you their list of recommended hedge funds? They're not assuming any control, just giving advice.

That's what the market will bear?
Andrew: What my consultant client explained to me was, "We don't think it adds value, but it's cheap insurance." When I pressed, "How is 30 - 35 basis points 'cheap insurance'?" He said, "Well, look, from our perspective, if something goes wrong, we can blame the consultants. Obviously, if something goes wrong with the underlying funds, we can say, 'We followed their advice.' They show us these hugely detailed reports... and that's 'cheap insurance' because we're already paying 400 basis points or more to the hedge fund."

So everything is relative, clearly. And institutions clearly believe in paying for CYA insurance.
Andrew: Yes, that's when I realized, "Okay, so even though the consultants are not getting paid by the hedge funds, their business is absolutely an-

chored to those incredibly expensive products."

If the consultants were to adopt an 85-basis-point-fee-product like ours, what could they charge for their insurance "value?" I've also seen that on the investment bank side, and on the wealth manager platform side as well. There's always this tension. I understand the reason that certain firms raised so much money right after the GFC was because everyone wanted a share of the revenues. You basically had wealth management platforms which controlled client capital — but which also had an economic incentive to sell them really high-cost products — which is the same thing they are doing now with private equity and private credit.

Welcome to Wall Street, I'm afraid.

Andrew: The thing is, it's very, very hard for the tens of thousands or millions of individual clients to have the sophistication and expertise to ask, "Why are you selling me *this* product? Do you really think this is *the best* private equity fund? Exactly what are *your* economics on putting me in this — and how would that compare to putting my assets with everybody else doing it?" These are obviously very confrontational questions. But you also really have to understand — have deep expertise in how the economics and the plumbing of those businesses work — to even start formulating those kinds of questions.

Don't get me started on the Street's abhorrence of being held to fiduciary standards. Many prefer using a little razzle dazzle on clients — and always disclaim responsibility.

Andrew: Okay, I won't get you started. The point of *my* long story is that I just completely misjudged how difficult it would be to succeed with a product that was disruptive and threatening — *not to hedge funds* — but to the people who allocate other people's capital to hedge funds on a professional basis. We're disruptive to the people who share in hedge fund industry revenue stream in return for participating in raising that money.

So why are your hedge fund replication ETFs now "overnight" hits —

Andrew: I think what's happening now is that by going down the route of launching ETFs in the U.S. run by our Dynamic Beta Engine, we're targeting an entirely different financial sphere. The typical ETF buyer that we're talking to never got entranced with investing in hedge funds because there were no good hedge fund offerings accessible to them —in ETFs, or in other channels, for that matter.

Explain, please, for readers who may have been just a tad distracted by other minor events this year, how your managed futures ETF became a moonshot amid the bear market .

Andrew: Right. We run this managed futures ETF [the IMGP DBI Managed Futures Strategy (DBMF)] that started the year at $60 million. It's at around $1.1 billion in AUM today.

Did you hitch a ride on one of Elon Musk's rockets, or what?

Andrew: We launched the managed futures strategy, listed on the NYSE as an ETF, in late May of 2020. Really, the people who began buying it first were investors who understood managed futures as a category — but who also generally had bad experiences investing in mutual fund or hedge fund products. They tend to be very independent investors or investment advisors, RIAs. And they tend to skew younger than the average. They tend to be very focused on investment outcomes. And the way we talk about our approach to this space — "seeking to outperform portfolios of leading hedge funds with less downside risk, equitable fees and daily liquidity" — really resonated with them.

What's more, for them, saying a strategy is more passive or index-like isn't a pejorative. When we say that Dynamic Beta specializes in an advanced form of factor-based hedge fund replication that seeks to replicate 90% or more of the pre-fee returns of leading hedge funds — and deliver alpha through fee disintermediation — that language doesn't spook them. Then too, I have to admit that it didn't hurt when somebody called me "the John Bogle of hedge funds" on a podcast. For some people, there's no higher compliment. For some others, it's a pejorative —

Mostly Wall Street denizens feeding on byzantine layers of opaque fees. Jack swam against that current his entire career.

Andrew: His whole life. When people tell me, "Don't worry, you've been doing it for 12 years — it took Jack 25 years to triumph." I'm like, "That is *not* comforting." But that is where we are.

I think our managed futures ETF is something of a category killer, in the sense that there's always been this idea that you can't run a good hedge fund product within an ETF — because of some of their structural constraints. Because they have to be liquid and because ETFs have to disclose their positions.

Disclosing positions is entirely *verboten*

according to hedge fund lore —

Andrew: That is generally correct — unless your strategy doesn't depend upon knowing each one of the hedge funds' underlying positions. If, like our managed futures replication strategy, you are only investing in the deepest, most liquid, managed futures contracts, then I don't really care if somebody can see whether we're short the 10-year Treasury or long crude oil. It's just impossible to front-run or arbitrage. I think what's going to happen because of DBMF's rising visibility and success now — it's going to fundamentally change this notion that you can't run a good hedge fund strategy or an inverted hedge fund strategy through an ETF.

When people accept that *it's possible*, that will open up the trillions of dollars of assets now held in ETF-based model portfolios — run by individuals, RIAs and the like — to the possibility of adding some very valuable diversifiers to their portfolios for the first time.

So DBMF's $1 billion-plus in AUM is but a start, even though you've been working on your Dynamic Beta Engine, for what — 15 plus years?

Andrew: To be clear, we've only launched three replication strategies in 15 years. We are the polar opposite of a product mill that launches all sorts of strategies to see which ones "stick to the wall." The reason we've only launched three products is because 19 of the 20 or so ways that people have tried to do hedge fund strategies in a mutual fund wrapper or as ETFs just haven't worked. In fact they have been awful — doing maybe 1.5% annually, for a decade — after fees that were higher than that.

I want to dial this back to Seth for a second. One of the things that I learned from him, on Day One, is don't do marginal ideas just because you're bored. If you don't have great ideas that you are incredibly confident about, save your arrows. So after 15 years, Dynamic Beta's reputation in the industry is, yes, we're a research-driven innovative investment firm focused on providing liquid alternative and hedge fund portfolio solutions for institutional and other investors — but we're also known for telling clients, "Guys, I don't think it's going to work." Often much to the chagrin of other serious firms that are trying to float innovations in this space.

Can you give me a for instance?

Andrew: There was a whole wave of proposals, as I recall, that were intended to make the fund of fund phoenix rise from the ashes back in 2012. People started launching all these, basically, multi-manager hedge fund products — as mutual funds.

But a guy named Michael Weinberg who was then teaching part-time at Columbia and I — He was a protégé of mine — we wrote a research piece saying, "It's a lot more difficult than you think to successfully put these strategies into a mutual fund." Yes, an investor may save a bit in fees, but he/she is going to give up that and more, for a host of reasons.

We have just a very different way of looking at investments, doing research on them. But I also identified very, very early on, that the whole more recent wave of quant-based "liquid alt" products that were promulgated by the likes of AQR, BlackRock and others as a way to generate liquid, low-cost, uncorrelated returns, was *not* going to do what they said it was going to do.

They looked spectacular at first — until they disappeared into the blackness like shooting stars.

Andrew: It was the worst quant fiasco of the past decade, in my view. I mean, you tell somebody the product is going to make 6% per annum with a 6% standard deviation — and three years later, it's down 30% or 40%. That's like a stock picker picking four frauds in a row and then saying, "But *this one* looks great."

He should be laughed out of town. But too often, the investment mills just move on to their next new things.

Andrew: Yes, you shouldn't get to start again after you've had those type of drawdowns. Paul Krugman — whether you like him or not — came up with a great line about "zombie ideas." It's incredibly difficult to kill bad investment ideas. They just persist forever. What I'm saying is that I've basically written a lot of research on why various investment ideas and products *aren't* going to work.

So let's focus on the three strategies you've been excited enough to actually launch since 2007.

Andrew: Let me circle back a bit. Our research at Dynamic Beta is all about targeting *pre-fee* performance, minimizing single-manager risk, keeping fees reasonable, providing position-level transparency and daily liquidity — and combining all of those into customizable solutions of our clients. The portfolios we structure via our Dynamic Beta Engine, all seek to match or outperform the portfolios of leading hedge funds.

Not by placing spies on their trading desks —

Andrew: Scarcely. Our proprietary Dynamic Beta

Engine allows us to identify and invest directly in the key drivers (factors) that explain the recent pre-fee performance of the hedge funds we are replicating. It is based on more than a decade of research into the primary sources of returns for equity long/short, managed futures and multi-strategy hedge funds. The portfolios we construct consist solely of highly liquid futures and/or ETFs.

Just to clarify, for me — you don't attempt to match the porfolios you're replicating, position for position?
Andrew: Right, investment research tells us we don't have to. Factor tilts explain the majority of hedge fund returns, so we only need to get the big moves right — and using only highly liquid futures to replicate those hedge fund positions gives us lots of flexibility.

Okay, so your trio of core strategies are —
Andrew: We have one tracker that goes back to 2007, which came out of the original idea of replication, basically, "I want to replicate the whole multi-strategy hedge fund industry." It's a little bit of equity long/short, a little relative value, and a little event-driven, and we put it all in one big blender. It is sort of the equivalent of one of the hedge fund indexes.

The next product we launched is equity long/short, which came out in 2012, and then managed futures, which we started in 2015.

Everything we do today stems from that lineage, though sometimes we have to implement them a bit differently to deal with constraints — for instance, in an ETF structure versus a hedge fund. Or combine them into portfolios to meet specific client objectives. But the basic idea is that those are the only three replication strategies we've found work really well.

And the *crazy* thing is, if you look at those replication strategies relative to how actual hedge funds have performed over those periods of time, we beat 95% of them.

That sounds pretty incredible. And you don't directly invest in the hedge funds you're replicating?
Andrew: Nope. The managed futures replication strategy that we launched in mid-2016 is a very, very simple idea, which is that if you run a Bill Sharpe/Andrew Lo risk model on, say, 20 of the top -performing managed futures hedge funds — and do it sensibly and well, employing good quants to execute it — you can figure out quite accurately how those funds are positioned — and what's driving their returns. So if that analysis shows they're short the 10-year Treasury, and that position is the difference-maker, you just go out and short the 10-year Treasury futures in your strategy. That way, you can cut out all of the trading costs that those funds incurred when their people were buying and selling coffee and cocoa and lumber, 10-year Treasuries and gilts and everything else.

You can sometimes cut out hundreds of basis points in trading costs and cut out 300-basis points or more of management fees.

Why are you doing all the work to apply your risk model analysis to a large group of hedge funds. Why not just replicate the best-performer?
Andrew: We don't replicate single funds. Top performers rarely stay on top. More importantly, by replicating the risk profile of a diversified portfolio of hedge funds, we can minimize what's known in the trade as "single manager risk."

A nice way of saying a single manager *might* be Peter Lynch, but he *could* also be Bernie Madoff.
Andrew: Unfortunately, yes. So what this managed futures strategy basically does is perform 400 basis points better, on average, than the hedge funds in that space, when they are fully loaded down by fees. And it does so by taking much less risk. So it's as though you have a multi-strategy vehicle with a little exposure to each of 20 or 24 of the biggest managed futures hedge funds. But it employs a very simple strategy, one that invests in just 10 futures contracts and rebalances only once a week. We charge 85 basis points for this strategy in the U.S. Yet when you look at its whole track record, we have outperformed every single one of the 20 largest flagship, brand name, hedge funds since inception.

Using just ten highly liquid futures contracts? The funds you're replicating go into all sorts of exotics looking for an edge —
Andrew: Right, but we don't trade coffee, cocoa, greasy wool futures — any of that. Our research says we don't have to. In hard commodities, we trade gold and oil futures. On the rates side. it's the 2-year, 10-year, and 30-year Treasury futures. In equities, its the S&P 500 futures, non-U.S. developed markets futures and the emerging markets. And on the currency side, it's just the dollar/yen, the dollar/euro. Again, the futures contracts. That's it.

Lots of hedge fund quants talk endlessly about how they're so diversified. How can you replicate a position in — I don't know — palladium? And generate uncorrelated returns with so few positions?
Andrew: Well, our approach is very different. We are a quant-based firm that has a non-quant ethos to it. Quants love complexity. They love to build complicated things. They love to change them a lot over time. Tinker constantly. If they find a new feature, they want to plug it in. Our ethos, by contrast is to build the simplest, most-efficient model we can build. One that, *we hope*, is so robust that we don't have to change it over the next five or 10 years.

So if we tried to run our model within an investment bank, we would be fired for being lazy.

Because they wouldn't recognize the genius in its simplicity?
Andrew: And because there's not a lot of money to be made off of implementing it. The trading costs our products generate amount to 10 basis points a year.

You called your quant strategy engine a robot dog earlier. Can you take me through the mechanics of what you do?
Andrew: Brace yourself for simplicity. It's slightly more complicated than this, but I'll use a very simple example. On Monday, we walk into the office. At noon, we now have a daily index of how the 20 largest managed futures hedge funds performed the preceding Friday. It's a daily index, so we also know how they did on each of the 19 days before that. When that index gets reported, it's an average of the performance of all those underlying hedge funds.

Now, when those hedge funds report, their performance numbers are net of all of their fees and expenses. So, although that performance number for all of last year was up 6.4%, the underlying hedge fund portfolios were up 11.5% or 12% — before deducting all the funds' fees and expenses. And it is that higher, pre-fee performance, that we consider to be our replication target. That's what we're trying to do — replicate the returns, pre-trading costs and fees, of those hedge funds.

That sounds extraordinarily aspirational — outperform, on the cheap?
Andrew: Well, what do we mean by replicate? We know from experience, due diligence, lots and lots of testing and analysis, that the 10 futures positions we monitor are going to explain 95% to 105% percent of their returns over time. I think, more than 100% often, because the incremental positions they have sometimes also cost them money. They don't necessarily always make them money. In any event, what we know is how each hedge fund we are replicating did on each of those 10 futures contracts, on each of the past 20 days. So this is where our Dynamic Beta Engine comes in. This risk model can basically tell us what combination of those 10 contracts, long and short, most accurately explains how this portfolio of hedge funds was either making money or losing money over the past 20 days. In fact, that model turns out to provide us with a very, very accurate read. It's not perfect, but it's the best thing we've ever found.

And that 20-day moving average, in essense, is sensitive enough to catch the hedge funds' portfolio acrobatics without too much performance slippage?
Andrew: Yes. Let's go back to the example I was just using, when the underlying hedge funds were up roughly 12% in 2021, before fees and expenses, and we were also up about 12% last year. But after you deducted all their trading costs, fees and expenses, the underlying hedge funds returned only about 6.4% to investors in 2021, while we returned like 11.4%. That's the power of our fee disintermediation, giving us, in effect, a 300 basis point head start in each year's performance derby. Again, I'm going to compare what we are doing to when Vanguard was pushing the Index Fund revolution. Early on, many mutual funds were charging fees of almost 1%, but Vanguard could offer an index fund for 30 basis points or so, meaning investors could save roughly 60 basis points a year. But with our Dynamic Beta Engine, you can save 400-500 basis points of fees a year.

That's real money. And this is with your managed futures ETF, right?
Andrew: It is. Sorry if I haven't been clear on the timeline of the strategy. We launched the first version of the managed futures strategy in Europe in November 2015, as the SEI Liquid Alternative Fund, which is a UCITS, obviously. We launched the U.S. version in July of 2016 as a family office strategy. Then, after my co-founder in Dynamic Beta Investments — Mathias Mamou-Mani — and I sold a 45% stake in our shop to the Paris-based fund management company, iM Global Partner Fund Management, in late 2018, we were able to roll out our existing U.S. managed futures strategy, in May of 2019, as DBMF, the iMGP DBi Managed Futures Strategy ETF — which now has been awarded five stars by Morningstar, I'm happy to add. Without getting too far into the weeds, we also were able to roll it into iMGP Funds in a way that preserved the managed futures strategy's continuous

track record from July 2016 to the present, so that any analyst or RIA can look at it.

We've also been very lucky— in the first three years after the DBMF strategy was launched as an ETF — that managed futures as an investment category has put up incredible numbers. It was up 10% per annum, with zero correlation to the S&P 500. With 0 beta to the S&P 500. And on top of that, we hit the three-year mark in terms of its track record as an ETF, back in May. Our asset inflow this year is a pretty good indicator, happily for us, that the "crisis alpha" attributes of managed futures in times of market volatility have been rediscovered this year. Even something of an understatement.

I'll say, your timing looks exquisite, with DBMF up, what? 33% this year, and investor money flooding in.

Andrew: I admit it's gratifying, after hearing from allocators and mutual funds for 15 years that good hedge fund strategies simply *can't* be run in an ETF. But I'd rather focus on the category's 10% per annum return over three years than our (granted, eye-catching) outperformance just this year — to help folks evaluate this. Think about it. Managed futures as a category have no beta, no correlation to the equities markets. So their 10% per annum over three years represents 1000 basis points a year of alpha.

And guess what, our managed futures ETF has generated 15% per annum over that span, with the same statistical characteristics. So instead of adding 1000 basis points of alpha, we added 1500 basis points — and we did it in an ETF with daily liquidity and no annoying K-1s to file with the IRS. So, yes, from an economic perspective, if you care about liquidity and you care about fees and you're not trying to hide your investment performance behind a non-transparent wrapper, like in a private equity deal — some people actually *want* to be shielded from interim volatility in the underlying value of their investments and don't mind sitting in illiquid investments — well, our ETF's 1500 basis points of alpha beats even the very good returns on the underlying managed futures hedge funds we replicate over the last three years. It's just a much better way to get exposure to the space.

With your DBMF ETF now having gathered over $1.1 billion in assets, are you at all concerned about capacity in the strategy?

Andrew: No. There are all of five managed futures ETFs extant. The one that is closest in size to ours is at about $300 million in assets. The entire space has only about $1.7 billion to $1.8 billion in assets.

Tiny, in ETF land.

Andrew: Right, that is out of $6 or $7 *trillion* of ETF assets in the U.S.

A mind-blowing number, but okay.

Andrew: Think about it, there are literally *trillions* of dollars in ETF-based model portfolios, and in multi-asset portfolios that have virtually zero exposure to managed futures. Yet managed futures, I think, are unequivocally the best diversifier on planet Earth, if you are starting off with a portfolio of stocks and bonds. Quite simply because it has zero correlation to both over time. As a diversifier, managed futures hit the trifecta of making money in the dotcom crisis, in the GFC *and this year*.

Albeit, they've been inaccessible to ordinary investors until quite recently —

Andrew: No doubt. It has long been that 98% of managed futures strategies were built for institutional investors who can, in a sense, assemble their own cars — or hire guys to tell them what parts to buy and how to put them together. And that created a lot of jobs and businesses to make and assemble all those parts in the "Wall Street aftermarket." But with our managed futures fund ETF we are disrupting that whole ecosystem by being that guy who 3D prints an entire car.

I get that, Andrew, very cool. Still, not to be a spoilsport, but that "crisis alpha" you've been capturing for the last several years generally doesn't feature in bull markets — which, despite recent experience — are much more common than bears.

Andrew: True, and in equity bulls managed futures — suck. They diversify returns — down.

Right. The alpha isn't with them then.

Andrew: Managed futures last went through what I call "a long winter" in the back half of the 2010s. Granted, that was exactly the time when we launched our managed futures strategy. But that long winter was *not* as bad as it appeared for the guys running managed futures hedge funds. Basically, it was a period in which those guys didn't make any returns and the category saw 10%-plus drawdowns. Individually, some managed funds suffered through 20% drawdowns.

That sounds fairly dismal.

Andrew: But remember, whenever you hear about hedge fund performance, it's always stated *after* fees and expenses. So, while performing poorly is never fun, it actually isn't terrible for the guys running the money. They did fine during that span. The reality is that, for the people in the business, its structure — their fee and expense revenue — was good enough to carry them through that long winter

Ah, yes, the hedge fund as a perpetual cash machine.

Andrew: But if you were an investor in a managed futures fund in that zero-interest rate environment, when the Fed kept tamping down the market every time it got a bit frothy — you were paying 500 basis points every year for useless protection against downside volatility — and not doing so well. Unless, of course, you were a huge institution or pension fund and you could use your negotiating leverage to put assets to work in the space at nowhere close to the sticker price.

One saving grace the managed futures hedge funds do possess, though, is that they tend to be very quick to pivot out of positions when they start to move against them. Those guys are completely dispassionate. Their investment decisions don't spring from some sort of quasi-religious fervor. So if something stops working, they are out of it in a flash.

Which, happily for their investors, means that portfolio drawdowns tend to be pretty contained in managed futures funds. You don't see ARKK-like drawdowns in the space. All drawdowns are annoying, sure, but it's more of a series of paper cuts than it is anything fatal. In fact, in the entire history of the managed futures space, I'm not aware of a single large fund that has gated investors. Just think about that. Not in the dotcom crisis, not in the GFC. Not amid crazy rotations. The maximum drawdown I've seen in the category is in the low double digits. In any event, when we got into the managed fund space, we set out to solve the biggest mistake people tended to make in it, through the design of our ETF.

Which is?

Andrew: Even though there is no shortage of good-sized hedge funds in the space, the biggest mistake people tend to make is giving their allocation to just one fund.

That's the "single-manager risk" you mentioned wanting to avoid.

Andrew: It is always tempting to allocate to "the best" in any category, however it is measured. But there is no persistence of returns. If anyone could figure out how to make any of the managed futures models of today better than any of the others, they'd be named "Renaissance Technologies" — and they wouldn't want our money anyway.

What I'm really saying is that outperformance in the managed futures space is usually luck, not skill, and it doesn't repeat.

So by replicating the portfolios of a group of managed futures funds, you're inceasing your odds?

Andrew: That's the idea. Now, the way this has played through for us is that in Europe, we've been able to solve the conundrum of managed futures, which has been described as, "I want the space, not the manager," and "I want the strategy without the fees." In Europe, where we manage that multi-strat UCITS fund, 40% of our allocation is to managed futures replication — because if you can work around those two big issues, you can have that big allocation to managed futures — and do very well.

I'm sorry, which is the fund?

Andrew: It is the SEI Liquid Alternative UCITS-Fund, which we manage for SEI Investments' clients in the U.K. It has been, by a wide margin, the top-performing multi-strategy UCITS hedge fund vehicle since we launched it seven years ago. And it won *The Hedge Fund Journal's* UCITS Hedge Fund award for Best-Performing Fund in 2020 and over 2-, 3- and 5-year periods, in the hedge fund index replication strategy category. In fact, the fund and its predecessor strategies going back to 2007 have outperformed the broad asset-weighted hedge fund indices — despite multiple return objectives and risk constraints.

Am I correct that the SEI fund combines managed futures replication with hedge fund replication?

Andrew: That's right. It has AUM of about $700 million, and is up around 8% year to date, with its assets allocated 60% to our multi-strategy hedge fund replication product and 40% to our managed futures hedge fund replicator.

Why that split? In a very different context 60/40 splits have earned a tarnished reputation this year.

Andrew: Well, sizing the managed futures side of a multi-strategy allocation is always the big question. The idea, of course, is that managed futures are expected to have zero correlation with equities over time and provide "crisis protection" for periods like 2008 —

And earlier this year —

Andrew: You noticed! So by combining portfolios of managed futures and hedge fund replications we should make the strategy's correlation to equities low enough, over the full cycle, to boost its beta meaningfully. A very common problem in institutional investing is that everyone is afraid that if they allocate too much to managed futures and the category goes into another long winter (in a bull market for equities), they will have a big chunk of their portfolio earning nothing but costing about 5% a year for its first five or six years. In which case, "our fund won't be around seven or eight years out — when that crisis protection will probably be needed."

But the low cost of our managed futures replication strategy eliminates that issue, allowing us to size the managed futures position to be an effective offset to downside in our hedge fund replication sleeve when equities go into a bear cycle. Essentially, combining our replications strategies allows us to accomplish what we've always talked about in the industry — creating a golden age of hedge funds. One in which we could deliver to investors what they really want from hedge fund investments — a portfolio that can generate mid- to high-single digit returns annually during normal periods — and not go down during a crisis.

Downside protection is so elusive.

Andrew: It's really rare. Hedge funds did it in the early 2000s, during the dotcom crisis because they had on the world's greatest factor trade — they were long small-cap value and short large-cap growth. So by 2007, if you had polled investors, you probably would have found them pretty sanguine about how hedge funds would do in a future bear market.

Oops.

Andrew: Exactly. Then came catastrophe. Not only did hedge funds go down far more than they were supposed to, we had Madoff. And exposure to his fraud in a lot of funds of funds. So basically, overnight, hedge funds went from the GOAT of asset classes to —

Complete dogs. To be fair, though, by that time the hedge fund universe — and the corps of fund jockeys — had expanded so dramatically that the talent pool was — quite diluted, to put it politely.

Andrew: Completely. That stuff happens as the business grows, but what else is new?

Not to be rude, but your SEI fund and managed futures ETF are now "overnight successes" after 15 years of work. And your smaller hedge fund replicator ETF, while not unexpectedly posting negative numbers in this market, is handily outperforming its benchmark. How much growth can they absorb before hitting walls reminiscent of 2007?

Andrew: Well, as I've been saying, our approach is very different than the typical hedge fund's. We try to avoid the kind of factors I've mentioned that our research tells us contribute to reversals in hedge fund investors' fortunes.

Crowded trades, illiquid investments, asset/liability mismatch —

Andrew: The whole laundry list, including single-manager risk, frauds and counterparty risks — all the stuff that leads to funds gating their investors' withdrawals, or suspending them, and swing pricing. And the primary way we do that is by only trading in liquid exchange-traded futures. To be clear, we aren't investing in hedge funds. We invest in futures contracts that our Dynamic Beta Engine tell us replicate a significant portion of the positions held by the groups of large funds we are tracking.

We believe that when you replicate a whole bunch of funds — yes, you will miss the guy who goes on a ten-year run and you'll wish you had every penny with him. But you'll also miss the guys who hit the windshield.

I get the feeling that as much as you like seeing the retail funds you're guiding gaining traction, you're still trying to get the institutional world to pay attention.

Andrew: You are right. It's the world I've always inhabited and I started down this research path trying to solve some dilemmas for asset allocators. If I'm at a pension plan, and or I'm a consultant to a pension plan and I want exposure to, for instance, managed futures, is the best way for me to do that to go pick one managed futures hedge fund? The clear answer is no. Should I take the time to assemble a collection of four to six of these guys and invest in them as a package? That's what most people do, though it's scarcely perfect or the diversifier they think it is. Or should I hire a fund manager and have them do the whole thing for me? You can do that, but it's expensive.

But, just perhaps, do you instead buy a managed futures ETF that does better than the hedge funds, on average, with a fraction of the fees and expenses? Just allocate to that and redeploy your people who would otherwise be spending countless hours on this decision — have them instead work on that great private credit deal you'd like to add or whatever else you'd like to add to your portfolio.

You're describing your mission.

Andrew: That's why I'll make a pilgrimage to Boston next week to start meeting again with some consultants. The economic answer is very obvious, but the question still is whether the investment industry structure will accommodate that kind of institutional portfolio position.

Should be an interesting trip. I'd like to be a fly on the wall in your meetings.
Andrew: I'm going to call you afterwards.

Good. Can you help me a bit on the differences in your methodologies for applying your Dynamic Beta Engine in managed futures versus multi-strategy hedge funds – Your managed futures ETF replicates 20 hedge funds, you said. But your multi-strat ETF uses a group twice that size?
Andrew: Yes, it's usually 40 or 50 – because our aim is to be representative of large pension fund portfolios. So our multi-strategy hedge fund replicator tracks the 50 largest funds that report performance to the available databases — and that ranking is done fairly mechanically.

How often do the constituents change?
Andrew: We revisit the constituents once a year in January. But they're pretty stable. The thing we always tell people is it's not a perfect list. There are some large, long-established funds where we don't have access to their data. But many of those are closed to new investors anyway, and their best performance is probably historical. Besides, there are a lot of others whose data *is* available. And the ranking is done pretty mechanically. We don't want discretion in the ranking as part of our focus on avoiding single-manager risk — even if *we* are that single manager.

With funds claiming all sorts of esoteric specialites these days, how do you make sure the funds you're replicating really reflect "multi-strategy' hedge funds?
Andrew: Again, we don't want to be making those decisions, so the categories we use, like long/short equities, are so broad that they can pretty much encompass anything that's attracting assets. Fundamental, quant, discretionary, mechanical, global specialist, etc., etc.

On the managed futures side, we simply try to replicate the performance of the 20 constituents of the SG CTA index, which is the industry-standard performance benchmark of major commodity trading advisors — and by design, it is split pretty evenly between trend following and non-trend managers and includes representative samplings of the major approaches to commodity trading.

You mentioned that you run the commodity pool's performance for the past 20 days through your replication process. That would seem way too short a tracking period for a lot of the hedge funds in your multi-strat pool.
Andrew: Correct. Managed futures has always been a world where there's more frequent reporting of data. They are farther along in that curve. So on the broader hedge fund replication side, we only rebalance the portfolios once a month, after using a 14-month look-back period (with a higher weighting to recent returns) to infer the sources of those managers' returns. Remember, we're not relying on the hedge funds' reported positions to determine their exposures — which we could only do long after the fact in too many cases. We're trying to use that Sharpe/Lo statistical analysis to infer what their positioning is from recent performance. And we're only trying to pick up the very, very big things. Are they increasing or decreasing equity risk? Are they shifting from U.S. to international stocks, from developed to emerging markets? From small cap to large cap? The very big underlying changes.

And when you look at a large pool of funds like we do, there are always going to be managers who won't change their stripes. Back when I was growing up in the business, clients loved it if hedge funds would do something completely different from one year to the next.

They wanted managers who were "with it."
Andrew: Exactly, but with the institutionalization of the hedge fund business, today's managers are generally more constrained. Nonetheless, what we're really doing in trying to track those portfolios is looking for the swing voters. We're looking for the guys who — within portfolios where they have flexibility to shift exposures — actually do that. Because that's where most of the alpha in equity long/short comes from. It's less about did they pick this stock or that stock, but rather, did their stock picking accumen lead them to conclude that Apple and a bunch of oligopolistic tech companies had these fortress business plans back in the 2010s — so that they were able to ride that as a play on tech? Were they in emerging markets at the right time during the BRIC wave? We're trying to pick up on those kinds of major portfolio rotations — and it turns out we can do that pretty well and replicate them using just those 10 futures contracts I mentioned.

And the reason we use futures contracts is because you can go long and short. Your trading costs are close to zero. There's no counterparty risk. What's more, when the world goes to hell, their trading volume goes up. You don't have any of the illiquidity risk that you almost everythere else. And by the way, the great Jedi mind trick of quantitative finance guys is to pretend that they have evidence that something has worked for seven years.

You're referring to backtesting boondoggles?

Andrew: You've got it. In reality, what they're basically saying is this is our pretend back-tested track record, and they layer it up with a ton of statistics. This fools some people into believing that whatever they are being sold is some permanent feature of the markets. But the real trick is that if they walked into a client meeting and said, "We have a great, opaque, black box, leveraged long/short derivatives-based strategy, what do you think, guys?" There's no allocator on planet Earth who would buy that. But if they instead take another tack and say, "All we are doing is harvesting these risk premia that have been around for seven years," that gives the person they are selling to a *very* simple metaphor to tell their investment committees.

As many an investment committee has learned to their rue.

Andrew: One of the things I've realized over this whole crazy 15-year odyssey is that when allocators want to believe something, they don't ask hard questions because they don't want to know those answers. In something like a lot of the risk premia products that have cratered — very, very smart people knew that they weren't asking the right questions. They were too sensitive to what their businesses needed, at that moment, and to what their investment committee clients were demanding: "Why are we investing in all these hedge funds? We're paying you 4% a year and we're not making any money. Give us something liquid and low cost — preferably with a big brand name behind it."

So they gave the clients what they wanted, of course.

Andrew: If it didn't work, it didn't work. It wasn't really their fault. There are no permanent ways of making money, but it is a very compelling marketing pitch.

So, what is going to be the next big challenge, investment-wise, to your funds? And all the rest of us?

Andrew: My own personal views is we're in the midst of a huge regime shift. Eventually, I think, people are going to look back on the last decade-plus in the markets and they're going to say, "Our grandkids are not going to believe this." I'm really looking forward to — and I hope you or some of your peers will write them — lots of tell-all books about what has gone on, like Andrew Ross Sorkin's *"Too Big To Fail,"* about the GFC.

There are going to be lots of crazy stories about how insane things were. Someone is going to talk about being in some war room at some central bank that was taking interest rates negative for the first time. Worrying about whether the financial system can handle it, and whether it even works that way. There are going to be stories about tech guys who knew that they are paying absolutely utterly absurd valuations but didn't want the music to stop. Or what they felt like when they knew that six months earlier they had thought people were overpaying for their company at a tenth of its current valuation. But now they had a $70 billion market cap — and still hadn't sold public equity. Asking their partners, "Don't you think we should sell?" And hearing them ask, "Where do we put the money? The company that we passed on six months ago now has a $50 billion valuation — and they don't even know how to make cars or software or..." There's almost no end to those stories. But the ones that will probably plumb the true depth of the crazy will likely come out of court proceedings involving all the crypto guys.

You can probably put *real money* on that. So you are bullish on authors, but not so much on the economy and markets?

Andrew: I just don't think it's an easy fix. The markets basically are very, very focused on the precise moment at which the Fed starts to dial tightening back, or when it looks like the worst is going to be over. Right now it's a very U.S.-centric view. Everyone's focused on Jay Powell, the people around him and their body language. That's going to drag the markets up and down. But meanwhile we have really scary things going on — with food supplies, with emerging markets, a war in Ukraine, with China. We're seeming to escalate tensions with China in a very unpleasant way. New Covid strains are proliferating, it seems. Everybody seems to be focusing on known problems —

While too often the "unknown unknowns" are what kill you —

Andrew: Suppose something more deadly and transmissible than Covid emerges from somewhere and the new vaccine technologies don't work on it? How crazy would that be? When guys like Stan Druckenmiller and Paul Tudor Jones say, "This is the most difficult investment environment we've seen," that gets my attention.

Ditto.

Andrew: There's just going to be a lot of ups and downs and chaos and confusion in the markets, I suspect, for quite some time. And it's a lot more fun when everything's going up. We haven't had our Enron moment yet in this go-round. We haven't had our Lehman moment.

Gosh, you're really cheerful.

Andrew: It's going to be very challenging. It is going to be really interesting to see what happens in 2023 — especially if we have a relatively calm or positive fourth quarter. Will people come to the conclusion that the bear market is over? How are they even processing what has happened this year? I just don't see the market quickly returning to the relatively smooth upward trajectory that dominated the last decade.

Nor do I. But my big heuristic bias comes from starting work at Dow Jones in March of 1974, right out of college.

Andrew: Beautiful timing.

You think? Small wonder you're beating the drum for your strategies in this hostile market environment.

Andrew: The big bet that I am making — and really have been making for the past 16 years — is that we have the best answer to the question — at least for certain strategies — of how to provide investors with diversification's benefits, but with low fees, with liquidity, and without blowup risk, all in a user-friendly package. So now that the world seems to be moving in our direction, I think we have a great decade ahead of us.

I certainly hope so for your sake. I'll look into it further for mine. Thanks, Andrew.

Welling on Wall St. Interviewee disclosure: Andrew Beer is the Founder and a Managing Member of Dynamic Beta Investments, a pioneer in hedge fund replication that offers full transparency and daily liquidity. Additionally, he is also Co-Portfolio Manager of the firm's investment strategies along with co-founder and co-managing member Mathias Mamou-Mani. Andrew has more than 25 years of experience in the alternative investment business. For more than 15 years, his focus has been identifying strategies to match or outperform portfolios of leading hedge funds with low fees, daily liquidity and less downside risk. Prior to founding DBi, he was the founding partner of three hedge fund firms in areas ranging from derivatives arbitrage to fundamental commodity investing to cross-border trading in Asia. They were Pinnacle Asset Management, a leading commodity-focused fund of hedge funds based in New York, Apex Capital Management one of the first institutional long/short hedge funds focused on the Greater China Region and Belenos Capital Management, a predecessor firm to Dynamic Asset Management. Andrew started in the hedge fund industry straight out of the Harvard Business School in 1994, when he joined the Baupost Group as one of six generalist portfolio managers working for Seth Klarman. In Andrew's spare time, he's on the board of directors of UNICEF, USA and also Lead Trustee of the Pierrepont School, in Westport, CT.

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