

# Portable alpha strategies offer greater scope

*Transporting the alpha from an active strategy to an index-tracking fund is gaining global acceptance. It is a concept that promises index enhancement and challenges the notion that portfolio returns come primarily from asset allocation.*

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One of the latest trends in funds management involves “transporting” the “alpha” of a fund or strategy to an index-tracking fund to generate an enhanced index strategy. A number of major fund managers in the United States and the United Kingdom have recently launched funds incorporating this so-called “portable alpha” or “alpha transport” strategy.

The concept of transporting alpha is also gaining acceptance among corporate sponsors of superannuation funds, with money managers being awarded mandates based on portable alpha strategies.

Unlike indexing strategies that seek to mimic market indices, this new generation of products promises index enhancement with significantly altered investment characteristics.

Portable alpha strategies are differentiated from conventional indexing strategies as they seek to isolate proven excess returns that can be systematically transported into a receiving fund tracking an asset class.

Portable alpha strategies are intended to deliver incremental portfolio outperformance, regardless of market direction but within a constrained process. Portable alpha strategies,

by focusing on consistent alpha generation, are challenging the conventional notion that the bulk of the portfolio return comes from asset allocation decisions.

## CONVERGENCE OF MARKET PORTFOLIOS AND COMPETITIVE PRESSURES

Convergence of investment portfolios has occurred with most Australian institutional fund managers benchmarking the ASX indices published by Standard & Poor's.

In accordance with current industry practice, these indices are capitalisation-weighted to reflect the performance of the largest companies according to market value.

Therefore, the portfolio holdings of the largest equity funds have become closely correlated with the indices against which they are benchmarked.

Because of this convergence, funds behave similarly and the propensity for index out-performance has diminished.

The unrelenting performance gains of the market indices from the mid-1990s onward adversely impacted upon the portfolio

performance – and businesses – of fund managers who ignored the index-following trends and took significant active positions. Investment advisers and their fiduciary clients have also become more concerned with relative underperformance than absolute return.

Many institutional fund managers have therefore become highly restricted in terms of active position-taking in response to industry demand.

In this environment, significant interest has been enjoyed by skill-based “absolute return”, “hedge” or “alternative” strategies. These strategies do not look or perform like index-benchmarked funds.

Single Responsible Entities (SREs) and superannuation trustees have also been encouraged by the promise of strong returns (or at least positive returns), performance-based manager remuneration, and portfolio diversification benefit offered.

**WHAT IS ALPHA?**

“Alpha” measures the difference between a fund’s actual return and its performance taking into account its risk profile.

A positive alpha indicates that the fund has performed better than its risk exposure (or sensitivity to the underlying market as measured by “beta”) would indicate, while a negative alpha indicates underperformance against the risk taken. In the context of investment funds, alpha shows the value added by the fund manager.

Portable alpha strategies thus involve identifying an investment strategy that has consistently generated alpha, and combining this alpha with the performance of an index-tracking fund.

If the designated strategy continues to generate alpha, the end-result should be an index-tracking fund that outperforms the relevant benchmark index.

There is no limit to the number or type of indices with which a source of alpha can be combined. Nor does there need to be close correlation between the source of the alpha and the index being tracked.

**ENHANCED INDEXING BY TRANSPORTING ALPHA**

Portable alpha strategies seek to generate incremental returns above a benchmark by using futures or other derivatives to create economic exposure to the main asset class.

The balance of the portfolio (usually 90-95%) is then allocated to an external fund that has consistently generated alpha. The alpha is therefore transported into the portfolio from the external fund.

Portable alpha strategies represent a radical shift away from both conventional and enhanced index-tracking strategies.

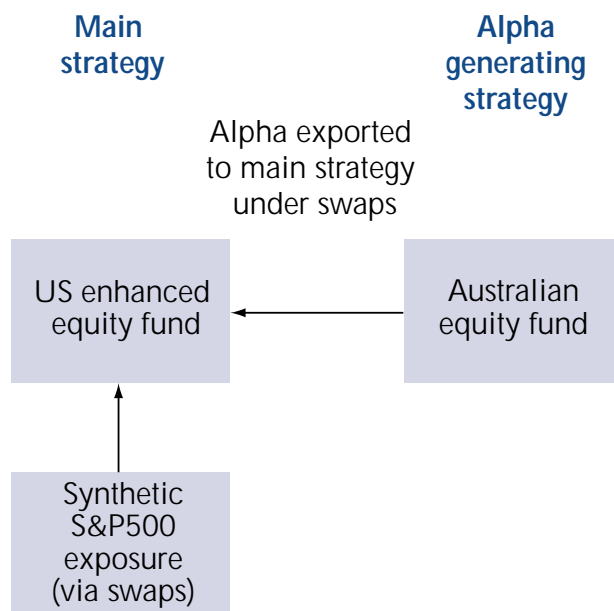
Unlike conventional index funds that hold physical index securities, market (or sector) exposure under the portable alpha strategy is created synthetically through exchange-traded index futures or over-the-counter index swaps.

In the case of an equity index swap, synthetic exposure to the relevant index, such as the S&P/ASX 200 Index, is obtained by making payments pegged to an interest rate (eg BBSW/BBSY plus a margin) over a notional principal amount, in exchange for payments pegged to the performance of the benchmark index.

Accordingly, a fund using a portable alpha strategy can use a small proportion of the portfolio’s liquid assets to create a cash-backed derivatives position that provides the effective market exposure of a conventional index-tracking fund investing in physical securities.

Where alpha is sourced from a discrete fund, a Fund of Funds is established for investing in the alpha-generating fund, and that investment is then combined with exposure to an index created via derivatives.

**FIGURE 1 Building a portable alpha portfolio using swaps**



**TABLE 1 Swap transactions for portable alpha strategy**

Swap out Australian index return	Pay: S&P/ASX 200 Receive: BBSW
Swap differentials on short term interest rates	Pay: BBSW Receive: LIBOR
Swap in US index return	Pay: LIBOR Receive: S&P 500

Alternatively, where the portfolio manager generates the source of alpha via an investment strategy, the fund will invest according to that strategy, and the main investment will be created with index-linked derivatives.

Figure 1 illustrates the construction of a portable alpha strategy that is designed to provide consistent outperformance of the US equity benchmark (S&P500 index).

The source of alpha for our example is an Australian share fund that has consistently generated alpha in excess of the S&P/ASX 200 Index.

This alpha is combined with a synthetic exposure linked to the S&P500 (created by a S&P 500 Index swap).

The total return to the portfolio from the portable alpha strategy will be the total return on the source of alpha plus the gain/loss on the swap.

In our example, we have illustrated the use of index and cross-currency interest rate swaps to create economic exposure.

There is no restriction on the types of asset classes that can be used, or the nature of the investment process employed.

The success of the portable alpha strategy rests on identifying a reliable alpha-generating strategy.

Where an active management process is employed, it is critically important that there is no deviation from that process as that can undermine the ability to reliably create alpha.

Where the process is reliant on quantitative techniques, it must be a "glass box", since reasonable judgements must be made about the repeatability of the process and the consistency of the returns over the long run (that is, the quantitative process needs to be intuitively understandable with a certain degree of transparency).

Another crucial factor for a successful portable alpha strategy is the existence of a liquid futures market or OTC swaps market for the relevant performance benchmarks.

Thus, both the benchmark for the main asset class that is synthetically created, and the benchmark against which the source of alpha is measured, must be recognised indices.

The important element is that there must be a futures or swaps market in the benchmarks for the main strategy and the alpha-generating strategy, in order to separate the alpha from its benchmark and combine it with main benchmark.

The traditional formulation of the prudent investor rule, which was established in the 19th Century, places an absolute bar on trustees and other investment fiduciaries purchasing speculative investments.

In determining whether or not an investment is speculative, the fiduciary must consider the characteristics of an investment in isolation from the other investments of the trust fund.

The inadequacies of the traditional formulation of the prudent investor rule have been recognised by the United States courts and, more recently, the English courts.

It appears that the Australian courts will follow the lead of the US and English courts and require fiduciaries to assess investments not in isolation, but in the context of their likely impact on the fund's return objectives

and risk profile (with reference to analytical tools such as modern portfolio theory).

Accordingly, investments, which might be considered speculative in isolation, may represent prudent investments when viewed in the context of a fund's entire portfolio.

This process of making alpha portable requires the use of leverage in parts of the portfolio, although as a whole no economic leverage is employed.

Portable alpha strategies therefore require careful management of the effective exposures (from the synthetic positions) and cash management used to meet deposits and margin requirements for the derivatives held.

#### SOURCES OF ALPHA

To date, the principal sources of alpha for portable alpha strategies have been "market-neutral" and "long/short" equity funds or strategies. However, alpha can be sourced from any type of fund or asset class.

Table 2 sets out the annual performance of the relevant CSFB/Tremont and Hedge Fund Research indices for market neutral and long/short funds.

In the case of a "market neutral" strategy, the fund manager maintains balanced long and short equity positions of the same size.

TABLE 2 Annual performance of market neutral and long/short indices

Year	CSFB/ Tremont Equity Market Neutral Index (% change)	HFRI Equity Market Neutral Index (% change)	CSFB/ Tremont Long/Short Equity Index (% change)	HFRI Equity Hedge Index (Long/Short strategies) (% change)
1994	(2.00)	2.65	(8.10)	2.61
1995	11.04	16.33	23.03	31.04
1996	16.60	14.20	17.12	21.75
1997	14.83	13.62	21.46	23.41
1998	13.31	8.30	17.18	15.98
1999	15.33	7.09	47.23	44.22
2000	14.99	14.56	2.08	9.09
2001 (to Sep.)	7.73	7.61	(5.12)	(5.27)

(Sources: CSFB/Tremont Index LLC; Hedge Fund Research LLC)

For a “long/short” strategy, the manager will switch between a net long position and a net short position depending on the manager’s view of the future direction of the market.

#### THE LEGAL DUTIES OF INVESTMENT FIDUCIARIES

The implementation of portable alpha strategies comprises: investing in a discrete source of alpha or implementing an alpha-generating strategy; and overlaying or combining that investment with synthetic exposure to a recognised investment benchmark created by transacting index derivatives.

Therefore, the implementation of portable alpha strategies has legal implications for fiduciaries with regard to the requirement to invest prudently, and to be authorised to invest in index derivatives, OTC swaps, and in the fund sourcing the alpha.

First, it is essential that the investment mandate allows the use of derivatives for creating index exposure, as opposed to hedging.

Secondly, SREs, superannuation trustees and other investment fiduciaries owe a duty of prudence in relation to the investment of the funds of their unitholders and beneficiaries.

This duty – known as the “prudent investor rule” – arises at general law and supplements the statutory duties of care, skill and diligence imposed on SREs and superannuation trustees.

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Accordingly, investments, which might be considered speculative in isolation, may represent prudent investments when viewed in the context of a fund’s entire portfolio.

The key question for fiduciaries therefore, is whether employing derivatives within the portable alpha strategy is consistent with the risk profile and return objectives of the overall portfolio, not merely whether those derivatives used in the strategy are of a speculative nature when viewed in isolation.

Index futures and swaps offer an efficient means of obtaining exposure to a market or sector – a fiduciary can achieve returns pegged to the performance of an index, for a fraction of the cost of investing in the physical constituents of that index.

Using derivatives, rather than purchasing index securities, also minimises tracking error against the benchmark.

Portable alpha strategies attempt to outperform an index by overlaying a source of alpha with index-linked derivatives.

The leveraged nature of derivatives may provide the opportunity for gains and losses that are greater than if the fiduciary had invested directly in the index securities.

Where the designated source of alpha fails to generate the targeted levels of alpha, the combined return will underperform the fund’s benchmark; hence the need for adequate due diligence of the investment process/“glass box”, discussed above.

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