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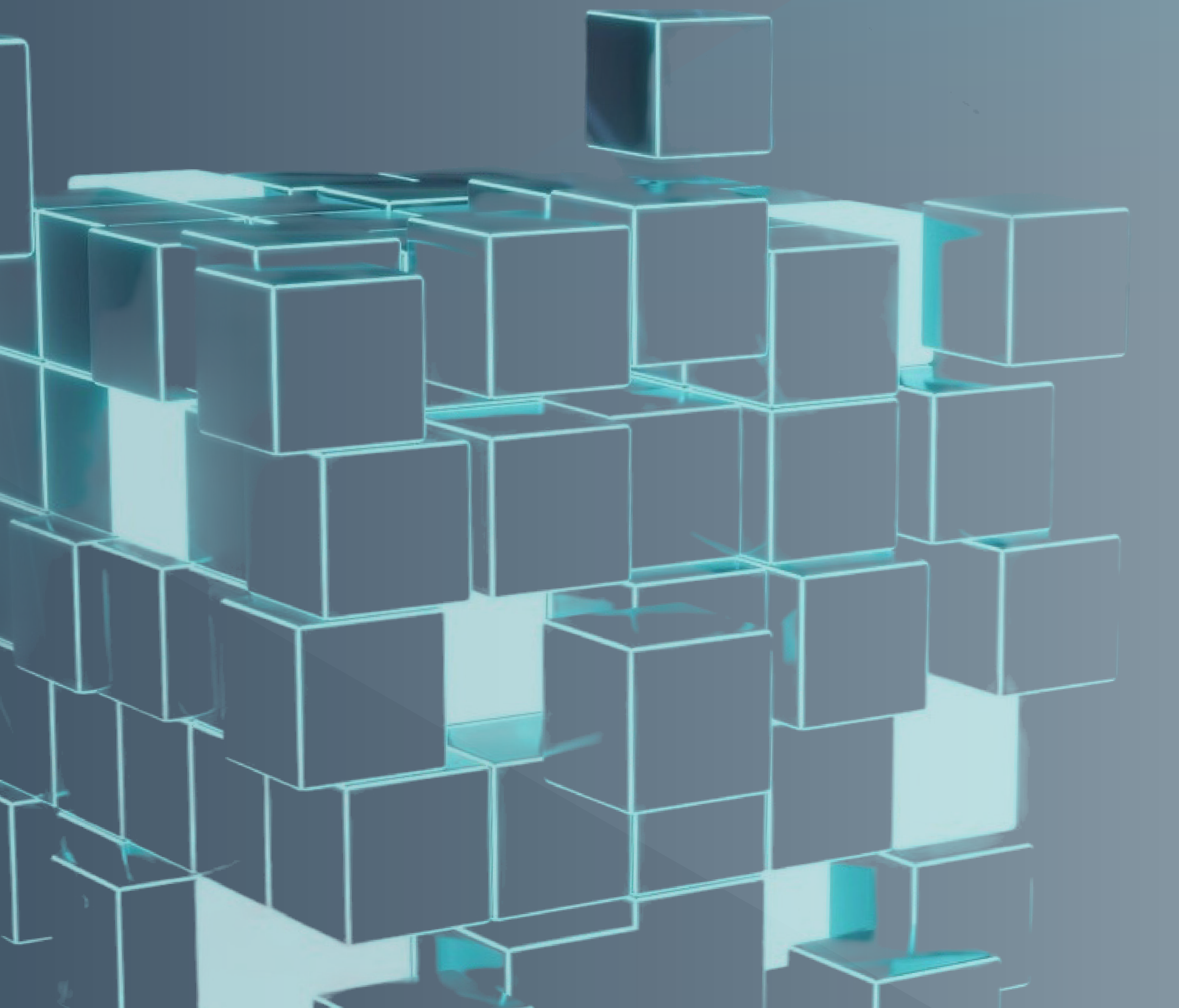
Resource

Sector in Brief:

Portable Alpha



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What's new?

The post-Covid era is bringing no shortage of investment industry surprises. One of the most quietly intriguing is the resurgence of interest in 'portable alpha' approaches.

The early-2000s saw portable alpha investment strategies becoming increasingly popular, before the 2008 Global Financial Crisis rendered them deeply unfashionable. Now, however, institutional and other clients are once again turning towards this concept in a bid to answer the question: can we make public market portfolios work harder?

Investor conversations globally suggest that one of the key drivers of this revival is the need to make liquid portfolios **work harder**. In an environment where private markets have become a larger share of most investors' portfolios, there is pressure on liquid assets to justify their role. The prospect of adding high quality, diversifying returns without having to sell out of core beta exposures to fund such alpha allocations, is unsurprisingly proving attractive.

Beyond the portfolio efficiency case, there are also performance-led push and pull factors from active managers. The average equity market neutral hedge fund, a good proxy for true alpha returns, returned 10.1% net in 2024 (as per the With Intelligence Equity Market Neutral Hedge Fund Index). In contrast, approximately 66% of global active equity managers fell short of their benchmarks on a gross basis in 2024, according to eVestment data. While this reflects a particularly difficult year for long-only active management, it has prompted some investors to reflect on how and where they take active risk in their portfolios. By porting alpha from hedge fund strategies where there is greater potential for edge and skill to be reflected in returns, investors have an alternative way to add meaningful active returns to their core exposures.

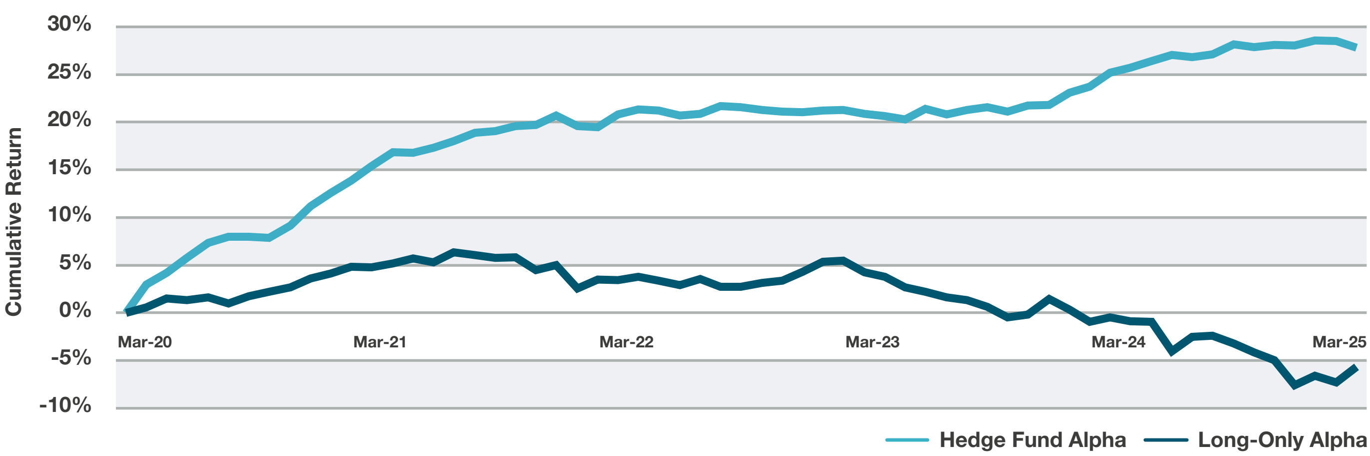
The appeal has perhaps been reinforced by **developments in the sector** itself. The 2008 crisis highlighted the risks of getting portable alpha wrong: correlated losses in both alpha and beta exposures, liquidity mismatches and leverage combined to unseat many funds. Yet the lessons do appear to have been learned. The current landscape is characterised by liquid strategies with tight risk management philosophies. Moreover, accessibility has improved: fund managers have sought to draw smaller institutional investors and wealth management clients to the sector with portable alpha share classes of flagship hedge funds or dedicated commingled funds that offer 'single-line-item' implementation.

Facts & figures

> **73%** of managers responding to recent 'Portable Alpha' RFPs do not currently have an appropriate commingled vehicle or share class, but are either **in the process of launching** one or are **willing to launch** one for a seed client. As such, the true manager universe is much larger than investors might suspect.

> **83%** The average 'alpha participation rate' of portable alpha solutions, based on the latest manager research. 38% of portable alpha solutions are able to offer 100% alpha participation (see Jargon Buster, page 4).

FIGURE 1: FIVE-YEAR PERFORMANCE: EQUITY HEDGE FUND ALPHA VS. LONG-ONLY EQUITY ALPHA



Hedge Fund Alpha: Cumulative Return of With Intelligence Equity Market Neutral Hedge Fund Index over FTSE 1-Month T-Bill Index
Long-Only Alpha: Cumulative Return of eVestment All Global Equity - Mean over MSCI AC World ND Index

Source: bfinance, With Intelligence, and eVestment

What is portable alpha?

Portable alpha (sometimes known as 'return stacking') is an investment approach designed to separate alpha generation from market exposures, in contrast to traditional active long-only management where these two aspects are inseparable.

At its core, the strategy involves obtaining exposure to market beta in a non-traditional manner, involving a reduced capital requirement, thus freeing up cash to invest in an alpha source. As long as the alpha return stream can beat the financing cost of the beta exposure and any other implementation costs, this will be additive to the portfolio over time.

For example, market beta exposure could be obtained via derivatives (e.g. futures or swaps on an index) – a process referred to as '**beta replication**'. Alternatively, a passive investment strategy could be used, but **leverage** could be applied against that portfolio in order to invest in an alpha source. A third approach, '**equity extension**' (not strictly portable alpha but often conceptually linked to it by investors) involves introducing a fixed percentage of equity long/short alpha —30%, in the case of 130/30 strategies— effectively using the capital obtained from the shorts to fund additional long equity exposure, thereby extending the long portion of the portfolio to 130% of the original investment capital.

The concept has been applied in various ways over the decades. PIMCO is often credited with the first iterations during the 1980s, with futures to used providing S&P 500 exposure, leaving capital free to invest in an actively managed bond portfolio. With the growth of the hedge fund industry in the 1990s-2000s, institutional investors began to implement the concept in a variety of ways: hedge funds (fund of hedge funds or multiple underlying managers) were often used as the alpha source. Today, we have seen a strong focus on using single Equity Market Neutral or Market-Independent Multi-Strategy hedge funds as the 'alpha source,' given their broad market independence and consistency of return generation.

Jargon buster

Beta replication:
Refers to the process of using derivatives, such as futures or total return swaps, to replicate the performance of a specific traditional market exposure or index without directly holding the underlying assets. As these derivative-based exposures require only a portion of capital as margin to deliver the index return, this creates unencumbered cash that is available for an investment into an alpha source.

Alpha source:
An active strategy into which unencumbered cash from the beta replication can be deployed. Theoretically this could be almost anything, from low-duration credit to sophisticated multi-strategy hedge funds, as long as the alpha source can provide net returns ahead of the beta replication cost. The investor should, however, consider the possibility of negative returns in both the beta and alpha components in any given period of time, thereby magnifying potential losses compared to holding a fully funded beta exposure.

Alpha Participation Rate:
The degree to which a portable alpha strategy offers participation in the 'alpha source' returns (e.g. the returns of the hedge fund being used as the alpha source in the construct). Implementation approaches are explored on page 6.

What is portable alpha? continued

Implementation example: Portable Alpha using beta replication with a fully-funded alpha source

Today, there are many different ways of implementing portable alpha (as discussed on the following page). This section, however, provides a relatively classic example of the construct:

Scenario: An investor has $500 million of passive S&P 500 exposure. The asset class is a core part of their strategic allocation which must be maintained. However, the investor is willing and able to access the diversifying return stream of a market neutral hedge fund. Rather than selling S&P exposure to fund the allocation (breaching SAA requirements and potentially introducing a performance drag in strongly risk-on markets), a portable alpha structure is used.

Step 1: Identify target beta exposure. Passive equity exposures are preferred, as these can be directly replicated synthetically (e.g., S&P 500 in this example).

Step 2: Identify an appropriate alpha source. For example, an equity market neutral hedge fund targeting returns of cash + 4% p.a. net (8% absolute at the time of writing, for convenience).

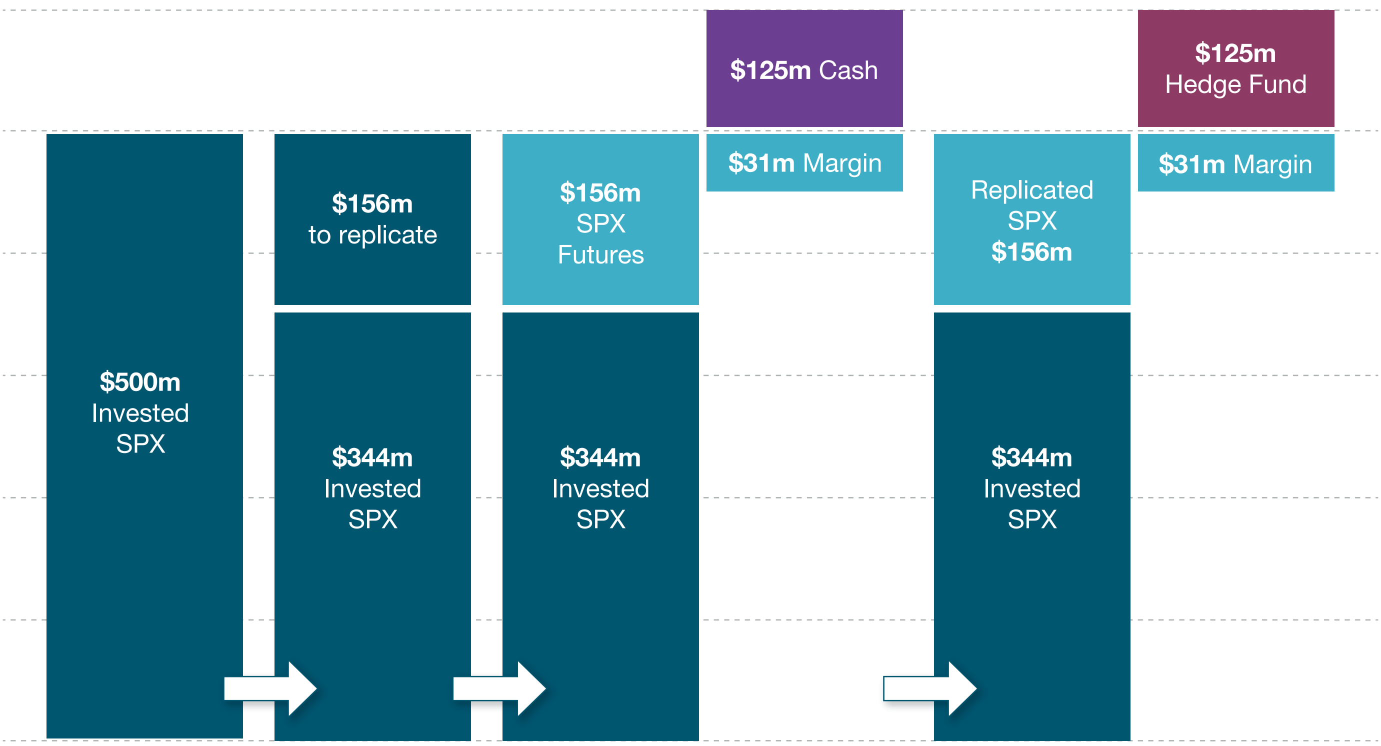
Step 3: Define the level of notional alpha required. For example, a 2% alpha target on $500m of equities implies a $125m alpha allocation is required.

Step 4: Calculate funding requirements. This will vary depending on operational and implementation specifics, but solutions may typically offer 80% alpha participation, with 20% used to support synthetic beta replication.

Step 5: Structure the portable alpha solution: replicate the required beta synthetically and invest in the alpha source. In this example $125m of alpha would require approximately $156m of free cash (excluding any implementation costs for the futures or other operational costs).

In this illustrative example, the resulting portfolio would require $344m remaining invested in cash equities, $156m of synthetically replicated equity exposure, and $125m allocated to the alpha source (an implied portfolio level leverage of 1.25x) to produce an expected return profile of **S&P 500 + 2% p.a.**

FIGURE 2: ILLUSTRATIVE EXAMPLE COMBINING ALPHA AND BETA EXPOSURES WITHIN A PORTABLE ALPHA CONSTRUCT USING SYNTHETIC EQUITY REPLICATION.



Source: bfinance

Gaining portable alpha exposure

Traditionally, portable alpha was accessible only to large institutions able to deal with segregated accounts, derivatives, the management of margin, and so forth. However, recent developments have simplified and broadened access through commingled funds and share classes, reducing or removing the need for clients to manage complex structures.

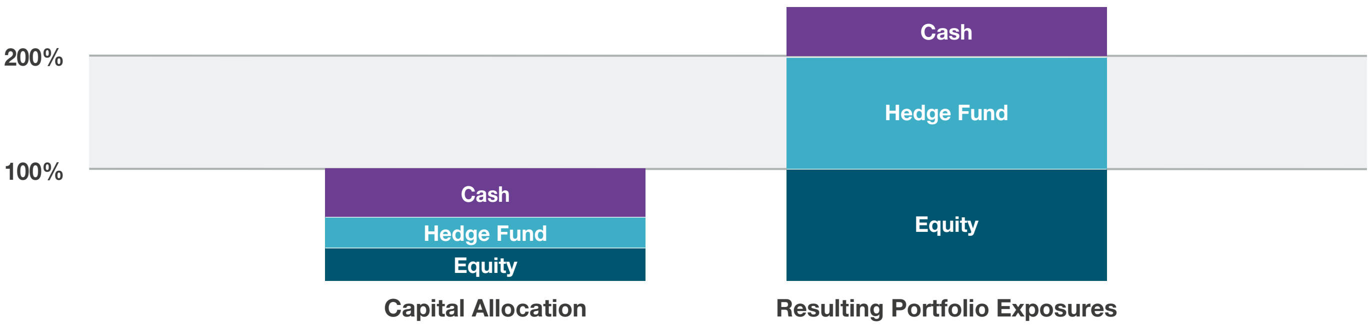
In a recent portable alpha implementation project for a bfinance client, **around a quarter** of managers could offer existing portable alpha share classes or had dedicated portable alpha funds already in place. The **other three-quarters** were either in the process of setting up such a structure, or were willing to do so for the investor, suggesting asset managers are proactively responding to current demand.

New structures

In the example shown in Figure 2, cash had to be held back specifically as margin to support the beta replication. Yet new portable alpha funds or share classes may take alternative approaches.

Some are designed to enable a **fuller investment in the alpha source**. In these integrated, **single line-item** solutions, the whole programme runs off one balance sheet, so that margin requirements of the alpha and beta components can be managed more efficiently. As such, rather than providing only an 80% alpha exposure (as in Figure 2), a $100 million investment in a portable alpha share class could provide $100 million of exposure to the S&P 500 as well as $100 million exposure to the alpha source, as shown in Figure 3. The equity exposure could even be higher than 100% (still with 100% alpha participation) in cases where the alpha is expected to show consistent and reliable negative correlation with the beta source, such as a tail protection alpha solution.

FIGURE 3: IMPLEMENTATION EXAMPLE: PORTABLE ALPHA USING BETA REPLICATION WITH A CAPITAL EFFICIENT, MARGIN FUNDED ALPHA SOURCE.



In other examples, we see portable alpha funds that hold the beta asset and margin, and then simply buy units of the hedge fund with the remaining unencumbered cash. Whilst this is in many ways a more traditional setup, these still offer benefit of being a '**single line-item**' implementation for the investor.

In a recent portable alpha search, the degree to which portable alpha strategies were able to participate in the alpha source (hedge fund) returns ('alpha participation') was 83%, on average. Results also showed that alpha participation depended on several factors relating to the alpha strategy, including the **liquidity of the alpha source**, the degree of **leverage** implicit in the alpha strategy's investment process, and also the manager's approach to **risk management**.

FIGURE 4: ALPHA PARTICIPATION ACROSS DIFFERENT STRATEGIES, CATEGORISED BY THE TYPE OF STRATEGY BEING USED AS THE 'ALPHA SOURCE'.

	Equity Market Neutral	Market Independent Multistrategy	Volatility Trading	All Proposals
Average Alpha Participation	89%	74%	90%	83%
Range	65 – 100%	50 – 100%	75 – 100%	–

Source: bfinance

Manager selection considerations

Implementing a portable alpha strategy effectively depends heavily on selecting the right manager and strategy. A successful portable alpha strategy will have an alpha source(s) that exhibits the following three key characteristics:

Market Independence: The alpha source should perform independently of the beta exposure. Low correlation is particularly important in the left tail of the beta's return distribution to ensure that market exposure can be maintained.

Reliability: Consistent performance over time is essential to minimise drawdowns and to maintain investor conviction in the alpha source.

Liquidity: The alpha source should be at the more liquid end of the hedge fund spectrum, to ensure that margin can be posted to maintain beta exposures in a market drawdown if needed.

Typical alpha sources that fit these characteristics include equity market neutral strategies, market independent multi-strategy, and some CTA / macro approaches. Long volatility and tail hedging strategies are also highly relevant to this construct, in theory, but we observe fewer examples available in the market at present.

Managing liquidity and leverage risks

Managing portable alpha effectively means finding the right balance between seeking outperformance and managing the risks that come with leveraging capital and handling potential margin calls from the use of derivatives. While the prospect of boosting returns through return stacking is undoubtedly appealing, it's important to recognise that maintaining both alpha and beta components simultaneously introduces a higher risk profile in terms of potential losses. Employing robust risk management practices – including stress testing and dynamic rebalancing – can also help reduce the likelihood of significant drawdowns.

A key advantage of current portable alpha implementation is their relative liquidity compared to earlier versions. Liquidity of the alpha source is key, as it dictates the frequency with which the solution can rebalance, thereby preserving the expected behaviour of the overall solution. Although we observed a variety of liquidity profiles in recent research, all proposals offer quarterly dealing or better (with no, or very limited, investor gating provisions).

Fee scrutiny is essential

Fees for portable alpha strategies are naturally concentrated on the alpha element. Even if offered as an integrated solution, management and performance fees are in line with the fees for accessing the hedge fund directly. Given the use of passive instruments, most managers choose not to charge additional fees for the beta component, although investors should expect to bear the small trading and operational costs relating to the beta replication.

While there are many alpha sources whose fees lie within longstanding hedge fund industry norms (management fees of between 1-2% p.a., and performance fees of up to 20%), we see increased use of alpha sources with pass-through cost structures – in particular for multi-strategy hedge funds. Total costs under pass-through structures **can materially exceed** these '2&20' norms and investors should seek **full transparency** on the gross-to-net performance calculations as part of their due diligence. Excluding pass-through fee structures will limit the range of alpha sources available to investors. In a recent, broadly unconstrained portable alpha search, almost a quarter of proposed alpha sources operated under pass-through fee structures.

Key takeaways

Portable alpha is primarily a portfolio construction tool, not an investment strategy. A portable alpha approach can enhance returns and improve portfolio efficiency, as long as implementation involves robust risk management and careful manager selection.

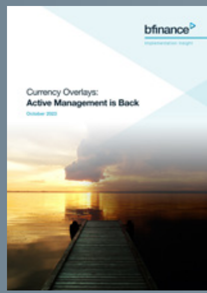
Although very well established as a concept, recent innovation in the space has allowed to portable alpha solutions to be offered on a 'single line-item' basis, via commingled funds or portable alpha share classes of flagship hedge funds. As such, these tools are now accessible to a wider range of asset owners.

Lessons have been learnt from the pre-GFC incarnations and there has been substantial innovation across the hedge fund space to allow more straightforward implementation.

Related reading:

Sector in Brief – Hedge Funds and Tail Protection
(August 2024)

Sector in Brief – Equity Market Neutral
(July 2024)



Currency Overlays: Active Management is Back
(October 2023)

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