Portable alpha strategies
Building resilience by separating return sources

Defining portable alpha
The objective of a portable alpha strategy is to generate returns in excess of a specific market index such as the S&P 500 Index or MSCI ACWI Index.

A typical portable alpha strategy is composed of:
1. A target index exposure, or “beta” component
2. A separate source of excess returns, or “alpha” component

Portable alpha strategies effectively separate the returns of a target index, or beta, and the returns of an alpha-seeking manager, or alpha. This separation allows the returns of the alpha component to be “ported” on top of whatever market index exposure is desired by an investor.

Portfolio construction benefits
A portable alpha approach can help overcome some of the historical challenges of portfolio construction. Traditionally, institutions invest in specific markets based on their target asset allocation plan. Within each asset class they select investment managers who primarily invest in securities from within their target asset class. Effectively, the asset allocation decision and the source of alpha are linked together. Linking these decisions is constraining for both the investor and the investment manager.

Tom's Take
In the past few years, there has been a renewed interest in portable alpha strategies. Many institutional investors, such as public pensions, foundations and endowments, have been exploring ways to improve returns as the broader markets have become more challenging.

Today, as many see a potential regime change to higher market volatility, we believe these portable alpha strategies have become the next logical step in building resilience into portfolios while still adhering to a target asset allocation.

In the following pages, we will define and explain the mechanics of portable alpha strategies, review the potential portfolio construction benefits, and share key considerations when beginning to implement a solution.

Portable alpha strategies can potentially help generate returns above a market index while maintaining a target asset allocation.

Portable alpha strategies separate the beta and alpha return sources of an investment, giving investors greater flexibility to build portfolios.

We believe that robust liquidity management of the beta exposure and selecting an uncorrelated alpha source are key in portable alpha implementations.

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For the investor, it constrains the universe of managers that they can select from to help generate alpha, and for the investment manager, it constrains their investible universe and limits their potential alpha sources.

A portable alpha strategy can allow investors to separate asset allocation from alpha generation. Investors choose the optimal manager who can generate their target beta exposure efficiently. Separately, high quality alpha-seeking managers can be selected from a far wider universe of managers in an effort to generate excess returns.

To illustrate this, consider an investor seeking an investment with an excess return over the U.S. stock market. A portable alpha strategy can allow the investor to get exposure to the U.S. stock market (e.g. S&P 500 Index) through a beta investment, and then to separately choose an investment manager that they believe has the best active return potential (e.g. a global multi-asset long/short strategy). This can give the investor the flexibility to find an alpha-seeking manager without being limited to choosing from managers focused on U.S. stocks.

Mechanics of portable alpha strategies

There are three key steps to implementing a portable alpha strategy (Figure 1). First, the investor chooses a target index for their beta exposure. Second, the target index is replicated using market-linked instruments which typically only require a small amount of cash in the form of a margin requirement to achieve the desired exposure. As a result, there is excess cash to allocate to the target alpha-seeking manager. Finally, the third step of the process is to invest the remaining funds in an alpha-seeking manager and a cash reserve.

The return generated by the overall strategy is a function of how much capital is allocated to the alpha-seeking manager, how much alpha they generate, and the return of the index exposure. The use of market-linked instruments to create the target index exposure comes with a financing cost, typically a cash rate (e.g. LIBOR) plus a spread.

It is important to note that in a portable alpha framework, the alpha-seeking manager is additive to the portfolio as long as they produce positive returns greater than the cost to finance the target index exposure.

The key implication for investors is that if they seek above market returns they don’t necessarily have to choose a manager with an aggressive risk and return profile. A manager with a more defensive profile may maximize the probability of consistently outperforming the financing rate overtime, and thus be additive to the portfolio.

Understanding returns

Using the example in Figure 1, let’s assume that the target index is created at a financing cost equal to LIBOR. The 50% of the portfolio that is invested in cash (which includes the 25% cash to replicate the index plus the 25% reserve) should be able to generate a LIBOR return.

The alpha-seeking manager is then looked upon to generate LIBOR plus some level of excess return. As 50% of the overall portfolio is invested with the alpha-seeking manager, the investor would receive 50% of the alpha generated by the manager. If the alpha-seeking manager was targeting LIBOR + 6%, then the overall investment would have an expected return of the target index + 3% to the investor.

Figure 1: Three key steps to implementing a portable alpha framework

Example of portable alpha implementation and expected return

1. Select target market index
2. Replicate index with market-linked instruments
3. Invest cash into alpha source and cash reserve
Key considerations for implementation

Investors may recall that portable alpha strategies had some measure of popularity before the 2008 global financial crisis. There were some important lessons learned during that period which can be applied today to mediate some of the past missteps.

When implementing a portable alpha strategy, investors should identify alpha-seeking managers that limit their beta exposure and have a history of delivering uncorrelated alpha. Additionally, investors constructing portable alpha strategies should apply stress tests to determine the size of the cash reserve required to sufficiently cover both mark-to-market moves of the target index and any potential changes to margin requirements on market-linked instruments used to create the exposure.

Selecting an alpha-seeking manager

Investors should be mindful to select an alpha-seeking manager with limited market beta exposure. Rigorous analysis on the manager’s return profile is required to achieve this. Investors must feel confident that they are not getting a tilt into risky assets, such as credit or equity, as this can result in additional market exposure above and beyond the target index. While periods of underperformance may happen even for uncorrelated managers, the long-term goal of the alpha-seeking manager should be to generate returns that are uncorrelated to the target market index.

A popular option for the alpha component of portable alpha portfolios are unconstrained or absolute return strategies. These types of strategies aim to generate returns above LIBOR, making them a practical investment to combine with beta exposure that requires LIBOR financing costs. Additionally, an unconstrained or absolute return manager typically looks globally for the best opportunities to deliver alpha, and generally avoids exposure to market betas which might correlate with the target market index.

The BlackRock Investment Institute published a research paper on the quality of active manager alpha which found that different asset classes have different expected active manager excess return expectations. The paper ranks the expected information ratios across asset classes. Investors can use this framework to target an optimal strategic asset allocation. They can also separately identify the optimal asset classes and managers with the highest expected information ratios and uncorrelated active returns.

A portable alpha approach can be used to combine the target index and the alpha-seeking manager together in an effort to construct the most optimal portfolio.

Managing liquidity of the index exposure

The successful implementation of a portable alpha strategy also requires the proper management of the target market index exposure. Selection of the target index manager should follow the investors’ normal selection process for a passive manager with increased scrutiny of their expertise implementing synthetic strategies.

Once a manager is selected, a key decision is to determine how much cash reserve needs to be maintained to cover potential changes in the value of target index. Several factors drive the size of this reserve: the amount of leverage being employed in the strategy, the expected potential drawdown of the target market index, and any expected changes to margin amounts on the market-linked instruments being utilized.

The amount of leverage employed and the target index return volatility will drive the vast majority of the sizing of the cash reserve, but margin variations should not be ignored. Appropriately sizing the cash reserve to account for all of these components will likely lead to an adequate cash reserve during periods of market stress, exactly when it is needed most.

Historical data on common target betas can guide the appropriate size of the cash reserve. Using a few popular indices as a guide, the 20-year average annualized returns and max drawdowns are summarized below (Figure 2). These figures include the drawdowns that were observed during the 2008 global financial crisis. The most conservative approach would be to establish a reserve that can ideally weather future drawdowns of these amounts.

Figure 2: Downside risk of target indexes

20-year annualized returns and max drawdowns

<table>
<thead>
<tr>
<th>Index</th>
<th>Annualized Return</th>
<th>Max Drawdown</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500 Index</td>
<td>5.6%</td>
<td>-51.0%</td>
</tr>
<tr>
<td>Russell 2000 Index</td>
<td>7.4%</td>
<td>-52.9%</td>
</tr>
<tr>
<td>MSCI ACWI Index</td>
<td>4.5%</td>
<td>-54.9%</td>
</tr>
<tr>
<td>Bloomberg Barclays Agg</td>
<td>4.6%</td>
<td>-3.8%</td>
</tr>
<tr>
<td>Bond Index</td>
<td></td>
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</tbody>
</table>

The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Source: Bloomberg, as of 12/31/2018. Past performance is not a guarantee of future results. Index returns are shown for illustrative purposes only. It is not possible to invest directly in an index. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.
Finally, it is worth considering changes to margin that can occur during periods of stress. Many times margin requirements will change due to market conditions, requiring a cash reserve that takes this into account will potentially improve overall resiliency when volatility increases.

**Potential risks of portable alpha strategies**

Similar to all investments, there are potential risks involved when employing a portable alpha framework. Primarily, it is possible for the alpha-seeking manager to underperform the LIBOR rate of return it needs to exceed. Additionally, the active-seeking manager may also generate negative absolute returns. Finally, market-linked instruments may not be perfectly correlated with a market index over time, creating tracking error that may differ from initial return expectations.

**Conclusion**

A portable alpha investment framework, or one that effectively separates the alpha and beta components of a portfolio, can help both investors and asset managers pursue better portfolio outcomes. Investors are able to maintain their specific asset allocation mix while gaining more flexibility to choose the optimal alpha-seeking managers to seek excess returns. Asset managers then benefit from not being constrained by a target index and can invest where they may see the best opportunities.

Implementation of these strategies has a few key considerations. Investors should seek an alpha source with a low correlation of returns versus the target index exposure. Additionally, the target index allocation must have a large enough liquidity reserve to handle both moves in the target market index and any changes in the exposure’s margin requirements.

We believe portable alpha strategies have become the next logical step in building more efficient portfolios that seek returns above a market index while maintaining a target asset allocation.
All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed.

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