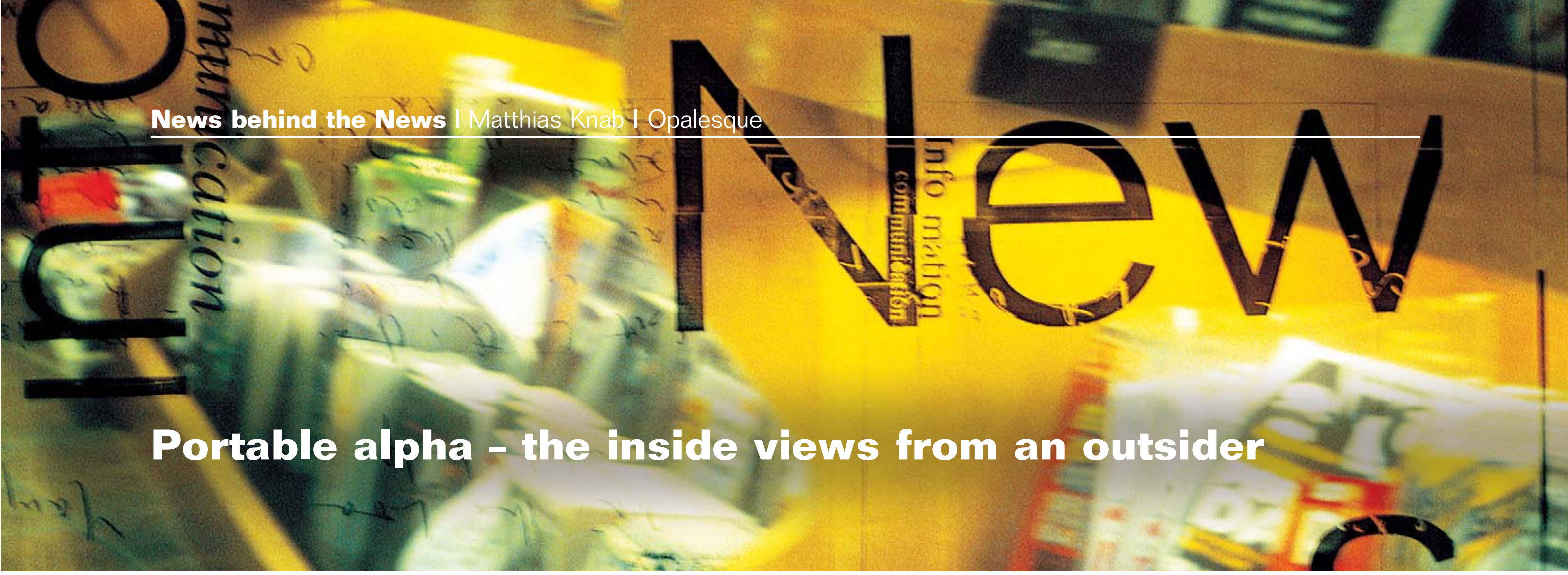

Portable alpha – the inside views from an outsider

«News behind the news» I Author Matthias Knab edits Alternative Market Briefing (published by Opalesque Ltd), a daily premium news service on hedge funds and alternatives. In this column, exclusively available to swissHEDGE readers, he reflects and analyses what is behind current topics that dominate the industry and the media.

Since I cover our industry in-depth and every day for Opalesque, many would perceive me to be an «insider» within the hedge fund industry. Regardless, I see myself more as an outsider, just because I neither run money (as a manager) nor am I an asset allocator. However, this position lets me at times recognize interesting patterns or news that an «insider» may miss, simply because of the high pressures prevalent in the asset management business.
For example, a promotional email about a portable alpha conference hit my «in-box» recently, claiming that a formerly lofty financial concept is now turning into a tangible business: «What's in it for you?» was one of the headlines, and these the promises:

Institutional and private investors will:
- Hear about innovative ways of structuring alpha generation.
- Learn about the risks of using portable alpha and the most effective techniques to reduce them.
- Determine the best criteria for effective manager selection.

And investment managers will:
- Find out what the end-users' perspective is from investor case studies and panel discussions.
- Discover who is looking to adopt portable alpha strategies.
- Benchmark your performance against that of your competitors.

Along with the conference firms, asset managers now too advertise being «open for business» and capable of delivering the purest and most potent alpha. Citing a hedge fund manager, the FT concluded that the traditional asset allocation model is broken, and that the cure is portable alpha: «Thanks to globalisation, almost everything you know about the old way of doing things no longer applies. Of course, many investors are painfully aware of this but they don't know what exactly is broken, let alone how to fix it».
Michael Litt, portfolio strategist at FrontPoint Partners in Greenwich, also believes that the traditional asset allocation model becomes obsolete, and that the cure is portable alpha. «This is a seismic shift,» he tells FT Wealth, «and the early institutional adapters will be the ones who succeed.»
I believe Roger Urwin, global head of investment consulting at Watson Wyatt, may concur with this judgment. He reportedly told the attendants of a packed «portable alpha» conference in London that «we are in an environment of low-expected returns with big pension expectations to fill – we need alpha. In 10 years, we will use portable alpha as easily as we use the term asset allocation now.»
Urwin was further cited in the financial press (IPE.com) as saying that, while portable alpha is still in infancy, it will be big with pension funds: «Pension funds have become buyers of innovation. The new solutions they are considering - increasingly derivatives-based, frequently absolute rather than relative return in character – are more aligned to meet pension liabilities.» Further, «sophisticated (pension) funds have departed from traditional divisions and constraints in strategies by separating market-based from skill-based returns – in the jargon of the day, they are «porting» alpha and beta.»

And what does research say?

You may now think that «well, that's fine, but what does real research say about all of this portable alpha stuff?» Research work carried out by the Edhec Risk and Asset Management Research Centre in 2004 demonstrated that active portfolio managers, who attempt to generate abnormal

profits through bets on well-identified risks, can benefit from using suitably packaged derivatives satellite portfolios as portable alpha and beta vehicles.
These portfolios, based on active asset or sector allocation decisions, can be used either as standalone absolute return alpha providers, or as overlay portfolios customized to help managers modify the exposure of their portfolios with respect to a variety of sources of risks on which they have no desire to bet.
Focusing on the Eurozone, the Edhec Risk and Asset Management Research Centre's studies report statistically significant evidence of predictability at the 2.5% level in Dow Jones EURO STOXX 50 excess return for the period from July 2000 to June 2003. These econometric forecasts can be turned into active portfolio decisions and implemented via Eurex index futures to generate absolute return portable alpha benefits based on active asset allocation decisions equal to more than 7% annual return over the period with a low volatility. This performance can be further improved by using an option overlay portfolio as a portable beta vehicle. In particular, the Edhec Risk and Asset Management Research Centre's work demonstrates that suitably designed option strategies would have added more than 120 basis points of performance for the period without any increase in the portfolio risk.

Lessons from real life

But then again, «seeing is believing» so let's take a look at how portable alpha is faring in the «real» world.
In a special feature, RiskCenter.com portrayed Joe Nankof, a founding partner of Rocaton, who worked with International Paper (a large US pension fund) on its portable alpha program. Nankof estimates that 10 of Rocaton's 50-plus clients have implemented portable alpha programs since the beginning of 2002, encompassing «very significant» dollars. He notes that although hedge funds are the vehicle of choice for most portable alpha programs, any type of strategy or fund that offers absolute returns will do. «If we find a manager who can outperform cash on a risk-adjusted basis to our satisfaction, that's what we are looking for.»
To generate the alpha for its program, International Paper picked hedge funds. The client already knew something about hedge funds from a stand-alone investment International Paper had in a fund of funds run by Blackstone. «We thought that marrying hedge funds to an S&P-type derivative product made a lot of sense,» he says. It took several years, however, before the company actually implemented the program.

Several years? Why is this? Ah, I recall hearing Robert Howie, head of European hedge fund research at Mercer Investment Consulting, saying at a conference called «Generating Absolute Returns for Pension Funds» that it is vital to be able to identify the minority of managers that have true skill and are likely to deliver real alpha. However, stumbling blocks are not so much the complexity of portable alpha constructs. Often, difficulties start out simply with people not believing in the concept, i.e. that alpha is «out there» and identifiable.
This is in line with an Edhec study that in early 2006 shocked the industry, affirming that «European institutional investors do not know how to benefit from hedge fund investments.» The results of this «EDHEC European Alternative Diversification Practices Survey» are based on the answers of 151 major European institutional investors representing a total volume of over EUR1 trillion.
The main conclusion of the survey is that institutional investors «do not know how to take advantage of the diversification possibilities of hedge funds because they have both insufficient knowledge of the risks to which their assets are exposed as well as an ineffective asset allocation policy».

More specifically, among the findings of the survey are the following:

- Only 29% of European institutional investors appear to be capable of carrying out a risk analysis independently of that provided by the fund manager and only 48% of them appear to be capable of integrating these risks in a global analysis of the risks of their assets.
- 73% of European institutional investors manage an optimal mix of asset classes without distinguishing between passive and active products.
- Only 33% of European institutional investors have implemented a core/satellite approach to constructing their portfolio.
- While 67% of European institutional investors claim to take the risk factors to which their hedge fund investments are exposed into account in their allocation, only 30% distinguish hedge funds between strategies or by grouping them into types of risks, which prevents them from taking advantage of the diversity of hedge fund strategies.
- 45% of European institutional investors do not have any allocation policy, and among the 50% following either a pure quantitative approach or a mix of quantitative and qualitative analysis, a majority opts for the mean/variance framework, which is clearly ill-suited to the construction of portfolios of hedge funds.

› In terms of investment vehicles, 74% of European institutional investors invest in hedge funds through diversified funds of hedge funds, but only 37% invest directly in single hedge funds. A mere 2% of European institutional investors invest in single strategy indices.

Following this research, the «Invesco Continental European Institutional Asset Management Survey» took a closer look at the European pension fund industry, finding that in continental Europe, hedge funds are most popular among pension funds in France, with HFs accounting for 2.7% of their total assets. According to the report, French plans allocated more than twice the 1.2% average, while those in Germany and Italy set aside 0.9% and 0.3%, respectively. Seemingly, Belgium's pension plans have not invested a single euro into hedge funds. The survey also found that multi-strategy was the most popular style – the choice of 22% of respondents – followed by long/short equity (11%). In addition, twice as many pension plans as insurance companies invest in multi-strategy funds.

According to the Hedge Fund Daily, investment in alternatives has jumped to 12% today (up from 8% in 2003), though Invesco notes that the growth has come mainly from the so-called «alternative alternatives» – options, futures, exchange- traded funds and structured products – rather than «traditionals» such as hedge funds, private equity and real estate.

Things are different in the US: The Commonfunds survey found that the average allocation to alternatives now represents 35% of total assets, a one percentage point increase over the 2005 report, but steady growth over half a decade since the first such study.

Among alternative investments, there were incremental reductions in hedge funds and venture capital, but slight upticks in private equity, real state, distressed debt, energy and natural resources. While allocations at institutions with assets of more than USD500m AUM remained virtually unchanged, those with under USD500m pumped up alternatives by two to three percentage points.

A free lunch?

So, one might assume, in the due course, (and maybe after a few more portable alpha conferences), Europe may have caught up with the US, closed the knowledge and allocation gaps and everything will be fine again. But hold on! Here comes William Ferrell saying «It ain't that easy!» Ferrell, Chief Executive of funds-of-funds firm Ferrell Capital, explains that, according to the firms research, if an investor «just adds alpha onto beta», this increases risk without necessarily increasing returns proportionally. As beta risk cannot be actively managed it is up to investors to focus on managing alpha. As the most reliable source of absolute returns Ferrell recommends a highly diversified portfolio of hedge fund strategies[1].

What else has happened in the past months?

Bonus mania hits Wall Street and London City, but entry barriers higher than ever

At the time of writing, the final bonus numbers of Wall Street and London City workers just got published. According to PIOnline.com, Wall Street bonuses are expected to reach a record USD21.5b in 2005, topping the previous records of USD19.5b in 2000 and USD18.6b in 2004. The average bonus in 2005 was a record USD125k, up by USD11k from 2004 and USD25k higher than in 2000.

For London, the IHT wrote that the number of financial-services employees in the City of London rose 3 percent to 325,500 last year, exceeding the technology-fueled peak of 324,200 in 2000 that preceded a three-year slump in stock markets. City firms will pay an average bonus of GBP23k, or USD40k, per employee, the Center estimated. About 3,000 people may receive bonuses this year in excess of GBP1m.

No doubt, such news creates a big buzz among graduates and young professionals. However, hardly anyone has an idea that most of them won't be able to get into the game. In 2005, Goldman, for instance, had 94,957 applicants but only hired 327, according to Fortune. Marketwatch commented this is no surprise considering the firm has an average salary of USD127k for analysts and associates. Edward Jones turned away more than half a million applicants for 605 jobs. And then, there's American Century: The company turned away 10,524 applicants last year and didn't hire anyone.

[1] The white paper can be accessed at: http://www.opalesque.com/files/Ferrell.pdf

Matthias Knab is executive editor of Alternative Market Briefing published by Opalesque Ltd. (www.opalesque.com). Alternative Market Briefing is a premier international hedge fund news service reaching more than 44'000 professionals worldwide. Interested readers may use promotion code «swisshedge» for sizable discounts.