Roundtable discussion

swissHEDGE regularly invites reputed professionals to join a roundtable discussion in which to share their views on a particular topic. This time, we have invited a consultant; an investment bank; as well as an investment and advisory firm to share their current views on the concept of portable alpha.

Barclays Capital
Representative: Antti Suhonen | Head of Fund-Linked Derivatives Structuring

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Mercer Investment Consulting
Representative: Ralph Frank | Senior Investment Consultant

Blackstone Alternative Asset Management
Representative: Gideon L. Berger | Managing Director

Q: Is portable alpha a truly novel investment concept; or a fad?

BARCLAYS: The concept of portable alpha is in itself not new, but it has been gathering significant interest over the last year or so. Portable alpha does address genuine issues that investors face. For example, liability matching combined with targeted additional returns to close a liability gap, or requirement for enhanced indexing. Furthermore, portable alpha structures are helping institutions to overcome some of the problems they may have with hedge fund investing, which in part explains the recent high profile of the concept. In short, portable alpha is serving a useful purpose and is definitely more than just a fad.
BLACKSTONE: Probably both. The separation of alpha from beta represents an important evolution in asset management and portfolio construction. Its utility is based on the assumption that one can identify alpha sources whose returns can reliably exceed the cost of leverage in the overlay program. The recent success of portable alpha programs was, in part, a result of low interest rates and cheap leverage. In a higher interest rate environment, overlay programs run a higher risk of underperformance.
MERCER: Portable alpha is neither a novel concept (having been around since at least the mid 90) nor a fad. Rather, it is a concept gaining in profile and acceptance as more market participants become aware of its benefits, as well as the fact that implementation is increasingly straightforward and cost-efficient.

Q: To which extent does the portable alpha concept depend on the ability of managers to generate «pure» alpha?

BARCLAYS: This is an interesting question which goes much beyond the concept of portable alpha – that is to say how much of a manager's alpha is purely skill-based and uncorrelated with any market factors, and how much of it is essentially risk premia from other asset classes or, for example, non-linear exposures to markets. Ultimately, the question is: what is the risk/reward objective of the investor, and the nature of the alpha targeted?
BLACKSTONE: The success of a portable alpha program is entirely dependent on the ability of managers to generate consistent alpha in excess of the cost of leverage. There is a debate, however, as to what constitutes «pure alpha» versus exotic forms of beta (e.g. to hedge fund strategies such as risk arbitrage and other more commoditized strategies).
MERCER: The concept depends on the ability of managers to generate alpha as part of a total return, where the market exposure inherent in the total return can then be hedged out and the desired market exposure overlaid. There is, in our opinion, no return profile that is «pure» alpha – there will always be a degree of market exposure as the underlying capital is invested in some market. For example, market neutral strategies, which seek to have no directional market exposure, have a return profile of «cash alpha», as hedging out market exposure leaves a base return of cash.

Q: What are acceptable risk levels for the alpha generating portfolio?

BARCLAYS: The risk exposures in any actively managed portfolio are multi-dimensional and their relevance will vary from one investor to another. Acceptable risk levels for the alpha generating portfolio therefore depend primarily on the risk tolerance of the investors. Having said that, it is important to note that the inherent risk of the alpha gener-

ating portfolio may have an impact on the flexibility available in structuring the portable alpha product. This is because of the risk parameters, limits and restrictions that the derivative counterparties to the portable alpha vehicle may need to impose to allow the dealing of the derivatives required for the «beta» trade.
BLACKSTONE: The most significant market risk (i.e. as opposed to credit or operational risk) that must be managed in a portable alpha program is the stability of the beta in the alpha generating component. Significant volatility of the alpha manager's beta will result in insufficient or excessive beta exposure. Uncorrelated risk in the alpha manager is no more relevant in an overlay program than it would be on a stand alone investment basis.
MERCER: The acceptable level of risk depends on the investor's risk tolerance. We have seen ex-ante tracking errors of as much as 35% p.a. in some Global Tactical Asset Allocation (GTAA) strategies. Investors tend not to invest all their assets in a single strategy such as this, but ultimately it is a case of the investors consciously deciding how much risk they wish to take on.

Q: Isn't portable alpha just another form of leverage; and if so, does this make it more «risky»?

BARCLAYS: It is potentially riskier in an absolute sense than either of the component parts may be individually, but not necessarily in a relative sense. That is, when the transaction is seen in the context of the client's overall assets and liabilities. Depending on how the portable alpha vehicle is constructed, there may be varying levels of embedded leverage arising both from pure borrowing and from derivative positions. The risk of the structure primarily boils down to the risk of the «beta» engine (which should be relatively well defined); the stability and size of the alpha that may be generated; and finally the costs associated with the structure (including the cost of the implicit leverage). Probably the one risk that is the most difficult to pin down is that associated with the alpha component – which is why an investor would be strongly encouraged to conduct their independent due diligence and risk assessment on the fund managers involved.
BLACKSTONE: Portable alpha programs certainly involve the use of leverage which does introduce a source of risk. The inability of the alpha manager to outperform the cost of leverage and/or unexpectedly high correlation between the alpha manager and the beta source, particularly in times of market decline, will result in losses in excess to what would have happened had one simply owned the index.
MERCER: Leverage is likely to be involved in the porting process. However, we would expect an aggregate investment strategy incorporating portable alpha to be less risky, per unit of return than a «traditional» directional strategy as the investor is able to select his sources of risk exposure as opposed to being constrained (either by the desired source of market exposure or desired source of expected alpha). Operational risk and counter-party risk may well be greater than under a traditional approach though.

Q: What are the alternatives for alpha and beta transfer (eg using futures or swaps; swaps on traditional indices or on alpha portfolios)?

BARCLAYS: The question is whether one is transferring the beta or the alpha component into a structure. The transfer of beta can be done by using futures in the most liquid markets, or via swaps in which case a wider universe of beta engines can be accessed. In fact, some of the more interesting markets from the perspective of liability matching, such as inflation, can only be accessed via swaps in the absence of a liquid future contract. Alternatively, the assets of the portable alpha vehicle may be held in the beta asset and the alpha returns are then transferred to the vehicle via a swap. A third alternative would be to hold the assets of the portable alpha vehicle in cash or cash substitutes and gain both the alpha and beta exposures via derivatives, whilst using the cash to collateralize the derivative transactions. Finally, it is possible to construct «synthetic» portable alpha transactions – essentially securities or derivatives whose payoff is formulaically derived from the performance of a chosen alpha and beta source.
BLACKSTONE: There are a wide variety of options to consider in selecting both the alpha and beta portions of an overlay program. The primary considerations in selecting an alpha manager are maximizing alpha and credit worthiness, given that these assets will typically be used as collateral for the beta investment. The two most popular beta alternatives are futures and swaps, with futures benefiting from their lack of credit risk while swaps benefit from their flexibility.
MERCER: Given the desire to invest as much capital as possible in the alpha generating element of the portfolio, leveraged derivatives are the instruments of choice in generating the desired beta exposure. The decision whether to use swaps, futures or a combination thereof rests on the

betas being removed and added, operational complexity, counterparty exposure issues and costs. There is no hard and fast rule for which instruments are «best», except for the fact that if non-standard market exposures are involved, a tailored swap is likely to be most effective in changing the market exposure. However, this precision needs to be weighed up against the expected higher costs of a tailored swap against the risk resulting from using a more «vanilla» instrument. It really is a case of «horses for courses». Also, we do not rule out the development of new instruments that may be useful in this regard.

Q: What are the critical elements while implementing a portable alpha concept?

BARCLAYS: The choice of a consistent, reliable source of alpha – in other words a skilled investment manager – is without doubt the most critical element of the implementation process. The extraction of alpha from the total return of an asset manager is not necessarily a straightforward exercise, and will in any event require some level of dynamic rebalancing over time. This goes back to the earlier discussion about the «purity» of alpha and the acceptable risk levels in a structure. Furthermore, the fees and expenses inherent in the different alpha/beta transfer mechanisms do vary and should be considered carefully, including the costs associated with leverage and/or possible negative carry in the structure. Finally, transparency of the structure and the ability to de-compose the returns to the alpha and beta components is important so that accurate performance attribution and reporting can be carried out by the investor.
BLACKSTONE: The critical issues that must be confronted when implementing a portable alpha program are the alpha source, the beta source, the counterparty, the rebalancing mechanism and frequency, execution costs and risks, and tax consequences.

MERCER: Some of the critical elements include:
› the ability to identify areas where alpha is richly and persistently available and where the associated beta can be cost-effectively removed;
› the ability to identify investment managers who are open to new business and able to exploit the sources of alpha previously identified;
› the existence of instruments that can be used to cost-effectively eliminate unwanted beta and overlay desired beta;
› the ability to identify investment managers to execute the process of removal and subsequent overlay of beta. This includes the ongoing administration of the arrangement (particularly collateral management); and
› the understanding on the investor's/fiduciary's part of the concept and the willingness to apply it.

Q: Where do you see the main obstacles for the application of the portable alpha concept?

BARCLAYS: Many investors still appear hesitant to commit to portable alpha structures due to their perceived complexity and lack of transparency. As discussed earlier, the manager selection and due diligence process is at least as important in portable alpha structures as it is when one is just investing into an active manager – and that process may be a time-consuming one. Furthermore, there are a number of structural issues to resolve and alternatives to consider when putting portable alpha vehicles in place and the market is still very much in an exploratory mode, trying to identify the most efficient structures. These are areas we have worked on extensively with both investors and investment managers.
BLACKSTONE: The most significant challenge in implementing a successful portable alpha program is identifying legitimate alpha sources. In a rising interest rate environment, where the cost of leverage is high, finding alpha sources that can reliably outperform the leverage expense may be difficult. Further, in overlay programs, alpha sources are constrained to be highly liquid, low beta investments. Recently, many of the arbitrage strategies that fit in portable alpha strategies will have proved challenging.
MERCER: The primary issue is one of understanding the mechanics of how the approach operates. Given its relatively low profile at present, many potential investors are reluctant to consider a portable alpha based approach as there are limited precedents to follow and they do not want to be one of the first to adopt it. Other issues include capacity constraints at a number of active managers who would be candidates as alpha sources as well as the limited number of practitioners able to effectively execute the process of removing and overlaying beta on a cost-effective basis.

Q: What investors will be suited for applying portable alpha concepts, and why?

BARCLAYS: Portable alpha as a concept is suited first of all to investors who are looking to match defined liability

streams – a good example being pension funds whose liabilities grow broadly in line with inflation. Portable alpha vehicles enable such investors to combine the returns of an asset that provides matching exposure to the liability with the returns generated by an investment manager – the alpha. Secondly, portable alpha may be appealing to investors who seek to track (or indeed over-perform) certain benchmarks. An example would be a transaction we have seen in particular in the US market where institutional investors are looking to invest in "enhanced indexing" products that combine the beta of an equity index – say S&P500 – with the alpha from active management.

BLACKSTONE: Portable alpha is a reasonable alternative for any investor who is able to justify the cost and manage the associated operational requirements, e.g. negotiating ISDAs, monitoring, effecting rebalancing trades, etc.

MERCER: There are three categories of investors, who are not mutually exclusive, likely to adopt this approach:

› those who grasp the concept and are comfortable that they can address the critical issues as set out above;
› those whose strategic exposure is to asset classes with limited alpha-generating potential; and
› those who focus on risk management and a desire to take risk in areas where it is «best» rewarded.

Q: How do you believe will portable alpha impact the investment industry in general and the hedge fund industry in particular?

BARCLAYS: Portable alpha is a manifestation of one of the key trends we see in the investment management industry – the polarization of active versus passive management. The search for alpha by investors will encourage traditional managers to better define their core competencies and value proposition to an investor, whether it is efficient delivery of beta or consistent and demonstrable creation of alpha. On the other hand, hedge funds are addressing the requirements for transparency and robust infrastructure from the institutional investment community and thereby making themselves accessible to a wider universe of investors. By enabling investors to better match the returns and exposures of an investment with their individual requirements, portable alpha structures are facilitating this process.

BLACKSTONE: Portable alpha programs represent just one of many investment strategies. The search for alpha both within and outside of hedge funds will always be the most scarce and elusive resource independent of how it is used in a portfolio context.

MERCER: An increase in the use of portable alpha based approaches is likely to increase the demand for strategies generating material quantities of alpha and correspondingly reduce demand for those that generate incremental alpha (at low information ratios). Beta exposure is likely to be more widely sought from overlays than from long passive products in an environment where increased use of portable alpha based approaches is more prevalent although the long passive industry will not disappear. Hedge fund strategies, to the extent that they are alpha generating, will probably benefit from the search for alpha. However, we would expect investors to continue to be more discerning, seeking to identify, and subsequently avoid, strategies/managers where «active» returns are actually generated from passive market exposure. Pay for performance is likely to become increasingly important and as a result there will be more emphasis on performance fees in combination with lower base fees.