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PORTABLE ALPHA CHALLENGES

Is it a good investment strategy? Depends on which data you look at.

Portable alpha is relatively simple in concept: find a high alpha source and overlay it with a futures contract in order to obtain the desired exposure to market beta. However, the real challenge with this approach is finding reliable and persistent sources of alpha.

The use of hedge funds and other non-traditional investment strategies in portable alpha mandates is growing in popularity with institutional investors. Some hedge fund strategies have the potential to generate much higher alphas than traditional, constrained, long-only approaches. In many cases, the alpha potential of the hedge fund strategy is high enough to justify the higher associated management fees.

Much attention has been focused on the fact that the absolute returns in hedge funds have declined relative to the returns the industry was producing in the late 1990s. An examination of the composition of the hedge fund industry provides a partial explanation for the decline in absolute returns. Directional hedge fund strategies dominate the hedge fund universe. They derive a significant portion of their returns from market exposure, or beta. As recent equity market returns are much lower than they were in the late 1990s, the returns of the directional hedge funds have declined as well. In addition, the percentage of the hedge fund industry comprised of non-directional hedge funds has grown significantly over the past 10 years. Non-directional hedge funds derive a majority of their returns from security selection and attempt to eliminate most or all of the exposure to the market in which they invest. The growth in non-directional funds is being driven by institutional demand for higher alpha strategies in portable alpha mandates. The growth of these lower-volatility, non-directional strategies has also impacted the level of absolute returns generated by the hedge fund industry.

It is important to remember that returns to active management are zero, and negative after adjusting for

management fees. Further, hedge funds compete for alpha against traditional “long-only” investors. As the hedge fund industry has grown, anecdotal evidence suggests that the rapid trading activity of these funds is causing some markets to become more efficiently priced, reducing the alpha potential for all market participants.

As a result of the increased competition for returns, historic sources of alpha may diminish over time. Hedge funds and other non-constrained managers maintain the flexibility to move into new markets and strategies in search of investment opportunities. A review of industry statistics suggests that hedge funds continue to be very opportunistic in their pursuit of alpha. The ability to employ flexible investment approaches may at times introduce unwanted risk exposures for hedge fund investors. These investors may need to have their own hedging capabilities in order to control or eliminate unwanted beta risks introduced by the hedge funds.

As some markets become more efficiently priced, alpha-seeking investors will need to look for new opportunities across multiple asset classes and geographic regions. These investors will also need to seek out new and emerging investment strategies. For example, activist hedge funds as well as financing strategies such as asset-based lending are newer strategies that are attracting investor interest. These emerging strategies also come with new and unfamiliar risks. Investors will need to have the expertise to analyze and evaluate the investment and operational risks associated with these new strategies. Diversification of investment risks and managers will be of utmost importance.

The competition for alpha is heating up. Identifying and capturing future sources of alpha is a daunting task that requires sufficient resources and expertise. Alpha-seeking investors must have a willingness to be opportunistic and invest early. They will also need the ability to evaluate and manage new types of risks. The benefits to the successful investor will be higher and more consistent sources of alpha. ■