GTAA: PROCESS AND PHILOSOPHY

Flexible overlay strategies can exploit market hot spots globally.

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With market returns in the coming years likely to be lower than average, funds need managers who deliver "true alpha." A manager who delivers true alpha adds value, regardless of market direction. In fact, a true alpha portfolio not only outperforms the benchmark in both up and down markets, but also does so at the same level of absolute risk as the benchmark itself. This does not mean that the manager does not take active risk (or "tracking error"), but that the active return does not contribute significantly to total risk because it has low correlation with the benchmark return.

Unfortunately, the asset classes which have the largest strategic allocations are also the ones where it is the most difficult to find managers who can actually deliver true alpha. Beta exposure to these large markets—such as large cap equities and Treasury bonds—should be cheap, since there are so many vehicles such as index funds with low management fees that offer such returns. "Portable alpha" strategies could deliver added value while maintaining the same benchmark.

For example, since the large cap U.S. equity market is mostly efficient, it is difficult to find a large cap manager who can deliver true alpha. However, small cap markets are less efficient: a fund could port small cap alpha to the large cap space by shorting Russell 2000 index futures against a small cap portfolio and going long the asset class of choice (such as the TSX 300 or the S&P 500). This operation is easy and cheap to implement.

However, there are capacity issues to porting alpha in this way. Sadly, true alpha is easier to find in asset classes with low liquidity, and no fund could ever find enough small cap managers with skill to replace their large cap allocation through portable alpha strategies. An alternative is to use futures markets (which are highly liquid) as the source of alpha rather than as a hedging vehicle. Global tactical asset allocation (GTAA) is one such strategy: GTAA generates returns by shifting between global stock, bond and currency markets, overweighting markets and countries that are expected to outperform a benchmark.

GTAA has been successfully used as an overlay strategy for many years, but implementation restrictions have kept the strategy from delivering upon its potential—however, those limitations are being lifted. Overlay strategies were typically implemented as if the manager were overlaying a cap-weighted index; because most countries have small cap weights, managers were not able to add significant value on the short side. Now funds are allowing symmetric bets and so increasing the opportunity set available to managers.

A GTAA overlay strategy would be run as a fund of funds; that is, it would consist of a global equity long/short, global bond long/short, currency, and a stock/bond component. Each component has a low correlation with the others so a GTAA overlay can deliver positive alpha at a low residual risk level—a return/risk ratio of 1.0 should be achievable to a manager of skill. Also the level of return and risk can be customized for the individual fund, with characteristics potentially ranging from a portable alpha risk level of 2% to a global macro fund level of 10% easily. And, since exchange-traded futures are used, capacity can be billions of dollars.

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In the current market environment, buy-and-hold is likely to result in funding shortfalls unless funds can find enough managers with the skill to deliver "true alpha." Portable alpha strategies are one way to ensure that a fund can achieve its goals. GTAA is one form of portable alpha that can deliver without the capacity issues inherent in other portable alpha strategies. ■