

BRIDGING THE ASSET RETURN GAP

Capitalizing on alpha strategies to reach a new frontier.



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Most conventional methods of calculating future expected returns point to a great challenge ahead in meeting future pension plan obligations. Reasonable expectations for total portfolio returns over the next 10 years fall considerably short of the required median return for a typical Canadian balanced portfolio. It is important, given these set of circumstances, to revisit the structure of the policy portfolio to determine what action, if any, needs to be taken to eliminate this potential return gap.

We know that the total return of a pension plan is a function of the risk-free rate plus the beta (or market exposure) plus the alpha (or active management exposure). Finding solutions to fill the return gap can be found by examining how the beta and alpha exposures can be combined to create a more optimal solution for Canadian pensions in light of the new capital market regime we are likely to face with the repeal of the Foreign Property Rule. This article focuses on how the alpha component can be restructured to help contribute in raising the total expected return of a portfolio.

During the 1980s and 1990s, the median Canadian balanced fund returned approximately 11% on an annualized basis. The typical managed plan also had a targeted contribution from active managers of approximately 1.2%, which meant that the contribution of alpha towards total return was a relatively small 11% (or 1.2% of 11%). If it's reasonable to assume that for the next 10 years annualized returns will only reach 6% or so, holding the existing active managers' structure intact, the alpha contribution to the overall return will almost double in importance as a percentage of total return. In itself, this is reason enough to review how alpha is structured within one's portfolio, but there's more.

ALPHA ATTRIBUTION

Since in a low-return world the contribution of alpha is increased as a share of total return, the sources of alpha should be more diversified to reduce the aggregate

volatility of this component. Yet, when we decompose the various sources of alpha of a typical pension plan, we observe that the reverse is true: a predominant portion (often more than 80%) comes from the activity of active stock selection, while the activity of active bond selection make up the remainder of the alpha pursued. Alternative sources of alpha, such as various arbitrage strategies, global macro and overlay strategies or currency management, have typically been neglected in these structures.

A review of the historical variability of alpha generated by the stock selection activity (whether on the Canadian, U.S. or international markets) also reveals that this source of excess return can be volatile even over rolling periods of three years. This is consistent

"EXPECTATIONS FOR TOTAL PORTFOLIO RETURNS OVER THE NEXT 10 YEARS FALL CONSIDERABLY SHORT."

with other findings which show alpha is "lumpy" since it is influenced by changes in economic environments.

Finally, it has been demonstrated that traditional methods of generating alpha are sub-optimal. A number of policy constraints hinder the ability of managers to maximize the use of their talent; limitations pertaining to short-selling and the use of leverage are prominent among them. Short-selling allows managers to effectively double their opportunity set, while the ability to employ leverage allows managers to focus their capital on their best ideas, and not necessarily at the expense of diversification. The removal of these constraints could improve the quality of a plan's excess return.

In short, important benefits can be gained from restructuring the way excess return originates and is generated in their portfolio. Plan sponsors can fill part of the return gap by looking to diversify their sources of alpha with alternative strategies in order to enhance the return per unit of risk generated by this activity. ■