THE ALPHA GENERATOR

Finding the right approach to portable alpha implementation.

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In a portable alpha investment structure based on an index for which there exists a liquid futures or swap market (i.e. the S&P500), the effective cost of investing in the alpha source is approximately equal to the London Interbank Offered Rate (LIBOR). It follows that the portable alpha investor benefits whenever the alpha source returns more than LIBOR, and loses money when the alpha source under-performs LIBOR. Thus, four simple measures allow a comprehensive comparison of the benefits provided by different portable alpha-sources. The return-related measures are the frequency and the amount with which the alpha source out-performs LIBOR while the risk-related measures are the magnitude and duration of any under-performance of LIBOR.

The following tables compare these four measures over all 12-month periods between July 1994 and December 2005, for a low-beta, multi-strategy hedge fund of funds (FOF) and the HFRI Relative Value Arbitrage Index (RVA). RVA includes a broad selection of market-neutral strategies such as equity market-neutral, fixed income arbitrage and convertible arbitrage. It is used here as a proxy for market-neutral hedge funds.

Table 1: **Frequency of Out-Performance of $US LIBOR**

	LIBOR+0%	LIBOR +5%
FOF	91.3%	72.4%
RVA	92.1%	57.5%

Table 2: **Average Magnitude of Out-Performance of $US LIBOR (Excess Return)**

FOF	9.23%
RVA	5.95%

Table 3: **Maximum Magnitude of Under-Performance of $US LIBOR**

FOF	-2.54%
RVA	-4.26%

Table 4: **Maximum Duration of Under-Performance of $US LIBOR**

FOF	11 months (late '02 – early '03)
RVA	10 months (late '98 – early '99)

FOF and RVA are comparable with respect to their frequency of out-performance of LIBOR (both have out-performed more than 90% of the time) and the duration of their under-performance of LIBOR (both have had a dry spell of a little less than a year). However, FOF achieves the real-world target of LIBOR+5% much more often than RVA (72% of the time for FOF versus 57% of the time for RVA).

FOF has also significantly out-performed the market neutral strategies represented by RVA, in two key respects: first, the FOF's average 12-month out-performance of LIBOR is 55% higher than RVA's; second, FOF's maximum 12-month under-performance of LIBOR is 40% lower than RVA's.

In conclusion, the low-beta, multi-strategy FOF has out-performed LIBOR by significantly larger amounts on average than has RVA, and with a similar degree of reliability. Currently, FOF's trailing 12-month LIBOR out-performance is approximately double that of RVA.

As a rule of thumb, assuming 5 to 10% portfolio exposure to a portable alpha strategy, the alpha source should out-perform LIBOR by 300-500 basis points (bps) annually, with a good degree of reliability, for the benefits of a portable alpha investment to be meaningful. In this respect, the lower returns typically associated with market-neutral funds become problematic: FOF has achieved a LIBOR + 5 return target 72% of the time while market-neutral strategies, as represented by RVA, have achieved this target only a little more than half of the time over the same period.

Looking forward, the return opportunity for market-neutral funds is currently constrained by flat yield curves, tight credit spreads and overcrowding in convertible arbitrage markets. In this environment, maintaining a high likelihood of out-performing LIBOR by 300 to 500 bps represents a significant challenge to most market-neutral managers. A low-beta, diversified fund of funds with better return prospects and comparable downside risk is, therefore, preferable to a market-neutral fund in portable alpha structures. ▮