SEPARATING ALPHA FROM BETA

The challenges of portable alpha strategies.

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Interest and growth in portable alpha strategies have prompted many investors to review their beta management in more detail. Although the investment principles of beta management are relatively straightforward, an integrated program can quickly become complex. What are the mechanics, variations and challenges involved in beta management? And, specifically, how do they apply to portable alpha strategies?

Let's start by looking at the mechanics. Exposure to a market premium can be achieved efficiently in several different ways, some of which leave the underlying physical assets unencumbered. The most basic application of synthetic beta management is a cash equitization scheme, where a combination of cash and a future or swap position synthetically replicates the physical exposure to an asset class. A common application of portable alpha is not very different. An alpha source that has no inherent market exposure (i.e. non-directional hedge funds, active currency, etc.) is designed to return cash + alpha. Combined with a synthetic position you now have cash + alpha + beta.

There are also variations. A more complex application involves physical assets with an alpha source that has inherent market exposure combined with a long/short synthetic position. The synthetic position is long on the desired beta exposure and short on the undesired beta exposure inherent in the alpha source. For example, physical assets could be given to an EAFE equity manager. The EAFE index could be sold short synthetically and another asset class such as large-cap U.S. equity could be bought long. The return pattern now becomes cash + alpha + beta_{eafe} $-\text{beta}_{eafe}$ + $\text{beta}_{uslgcap}$. Clearly, managing the beta exposure in these cases is critical.

Finding alpha

It's important to keep in mind the challenges as well. The lynchpin of such strategies is finding alpha in the first place, which is a difficult and uncertain undertaking. As with traditional structures, there is a strong case for diversifying alpha sources at both the asset class and manager level. But increasing the complexity of the alpha structure necessarily increases that of the beta management requirement. For one alpha source in a single asset class, a turnkey portable alpha solution is often most efficient, whereby one manager (or manager of managers) does both the alpha and beta management. As funds expand and diversify their alpha sources, a few things become obvious. First, it becomes clear that the alpha managers' core competence is not in beta management. Second, that beta management is more efficient when done at the total fund level rather than the individual account level. This allows for netting of trades, economies of scale, and increased flexibility.

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Finally, beta management is not just for portable alpha. Synthetically investing frictional cash, synthetic rebalancing, duration management, currency hedging and many other strategies require beta management.

Not surprisingly, mandates are taking advantage of specialization. A beta manager not only improves return (ensuring the fund is fully invested and trades efficiently), but also reduces risk (through rebalancing, currency hedging, etc.) and eases overall administration. Beta managers can provide enhanced reporting, cash flow management, and total fund analytics. Both the challenges and potential rewards of a portable alpha structure are large, but the marketplace is embracing them and good beta management is the foundation. ■