SMART THINKING IN A POST-BUBBLE WORLD

Alpha and beta strategies in challenging times.

JEFF KNIGHT
Chief investment officer, Putnam PanAgora, Integra Canada

In the current, post-bubble investment environment, investors must face the challenge of generating sufficient returns to meet ever-mounting liabilities even as stock and bond market averages deliver below-average results. In response, plan sponsors have introduced a modest, incremental allocation to hedge funds or other alternative investments. However, to get the most out of an investment portfolio, investors ought to revisit every aspect of their traditional investment strategies, looking for return enhancement opportunities throughout each portfolio component. Liability-matching returns are possible even in this low-return environment, but achieving these returns will require a modern approach to both asset allocation (beta) and active management (alpha).

In a bull market like the 1990s, a smart beta strategy involved high and fixed allocations to equity. Faced with a more modest return environment, this approach may not succeed. World stock and bond markets are expected to deliver below-average but positive returns to passive investors in the decade ahead. This means that at least some of the necessary return levels can be achieved by taking advantage of the fact that markets do go up over time. Yet, because the risk premium for equities is likely to be below average, the traditional golden rule of the beta strategy—that adding more equities equals more return—may be flawed in the decade ahead. In a low-return environment, being smart about beta means three things: reducing reliance upon equities and incorporating greater diversity of asset class exposure; embracing a strategy of flexible diversification, where asset allocations change in response to changing opportunities; and relaxing traditional constraints to enable prudent use of financial leverage, allowing more flexibility in the risk-reward trade-off.

In addition, standard practice links the alpha strategy directly to the beta strategy by allocating active risk to a portfolio in proportion to the size of the asset classes. In other words, if 40% of a portfolio is invested in government bonds, then 40% of the dollars pursuing active returns are likely to be allocated to government bond strategies through manager selection choices within that asset class. This approach has led to a concentration of active risk in low alpha asset classes such as bonds or large-cap equities, which tend to represent a large portion of a traditional plan. Modern portfolio management techniques and derivatives now enable investors to separate the alpha decision from the asset allocation decision, allowing a more sophisticated approach to active management across a portfolio.

Specifically, we suggest that being smarter about alpha means decoupling allocations to alpha from those of the beta strategy through portable alpha approaches; utilizing the power of diversification across active strategies; and relaxing traditional constraints like long-only to expand the frontier of active returns.

Clearly, innovative portfolio solutions encompass a plan's entire asset mix, not just the small proportion allocated to alternative investments. Therefore, traditional managers can and should be part of the solution as well. Indeed, many traditional managers are directing their experience and capabilities towards offering portfolio strategies that are smarter about beta, and smarter about alpha. Diversified, flexible, absolute return-oriented multi-asset portfolio strategies represent the new frontier of beta-oriented investment strategies, while portable alpha strategies, particularly those that incorporate diverse alpha drivers, represent the new frontier of alpha-oriented investment strategies. Multi-asset absolute return strategies may represent an alternative to "alternatives" as a plan considers new strategies to incorporate into their asset mix. Portable alpha strategies should be considered as potential substitutes for traditional, long-only single asset class strategies.[1] ■

Endnote

1. The opinions expressed are those of Jeffrey Knight, Managing Director and Chief Investment Officer of the Global Asset Allocations Team, Putnam Investments, at the time of publication. They are subject to change with market conditions. Prepared for use in Canada by Putnam Investments Inc. [Investissements Putnam Inc.] (Operating as Putnam Management in Manitoba.)