Portable Alpha: Traditional Technique, Modern Perspective

March 2021

Executive Summary

- High equity valuations and ultra-low interest rates may make it difficult for today's investors to meet their return targets with the traditional 60/40 portfolio.
- Portable Alpha targets enhanced returns with flexibility, cash efficiency, and greater cost transparency.
- Effective Portable Alpha requires an alpha strategy that targets returns that are uncorrelated with the specified beta portfolio.
- We believe that a carefully designed Portable Alpha strategy can remedy the problems of the past and provide an innovative solution for the present.

It is hard to imagine a more favorable environment for passive investment than the recent historic bull market. For nearly a decade, global equities shrugged off negative risk shocks, regularly achieving new highs. The stunning market crash in Q1 2020 was a painful reminder, however, that concentrated equity exposure carries significant downside risk. Moreover, the path toward diversification is less clear, with potential reduced opportunity in bonds, private equity, and credit.

We propose a traditional technique, implemented with a modern perspective: Portable Alpha. Once a popular approach, Portable Alpha fell from grace in the aftermath of the 2008/2009 financial crash, when many purported alpha strategies collapsed alongside the beta they claimed to diversify. These results, however, were attributable to execution, rather than the underlying philosophy. We believe that a carefully designed Portable Alpha strategy can remedy the problems of the past and provide an innovative solution for the present.

The Opportunity Landscape

The investment landscape may have changed, but the lofty expectations on plan sponsors have not. Regardless of the market environment, most are required to meet consistent risk and return mandates or objectives that are often legally specified. When equities are reasonably priced and interest rates attractive, the traditional 60/40 capital allocation provides a viable path forward. Today's investors may not have that luxury. With stock valuations high and bond yields depressed, the expected rate of return for the traditional portfolio is fairly modest over the long term.

Past or hypothetical performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

As a result, many plan sponsors have to look outside of conventional asset classes to meet their target characteristics. In recent years, many investors have assumed substantial credit risk and/or tried to capture the illiquidity premium through private equity and private loans. These solutions, by and large, worked when equity markets were climbing steadily higher. Unfortunately, these types of investment also share common downside risk when economies and markets turn negative. Some investors have chosen a different path, increasing exposure to hedge funds and alternatives, but many funds still have not met their objectives.

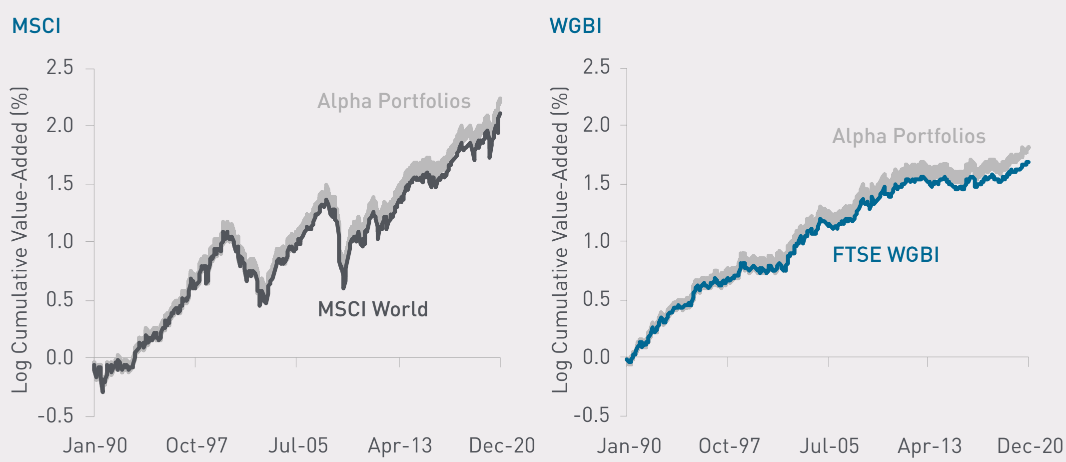
Portable Alpha in Concept

For investors who require enhanced returns with a cost-effective implementation, we believe the right solution is Portable Alpha (PA), and we are indeed seeing a resurgence of interest in this type of strategy. The intuition behind PA is simple. By definition, true alpha is uncorrelated return to market exposures, or beta. If a manager offers "true alpha" with no beta exposure, then such a product can be implemented either as a stand-alone strategy or "ported" as an overlay as the alpha component of PA. Since sponsors can achieve passive beta exposure cheaply through derivatives or index funds, a PA manager is hired (and paid) for the amount of alpha they aim to provide.

In either of the above design options, the investor typically has the prerogative to choose specific beta exposures and can, in theory, mix and match beta and alpha sources. For instance, an investor may have a policy that requires an allocation to US Large Cap equities, which can be obtained cheaply and efficiently in the S&P 500 futures market. Yet consistent alpha is difficult to find in the long-only large cap space. In this scenario, a fund could simply couple an S&P 500 futures position with a more reliable alpha source through a multi-asset or single-asset alternative investment, such as a global macro or currency alpha strategy – or both! As long as the alpha sources are also uncorrelated with one another, a fund can use any combination of strategies, creating a potentially limitless opportunity landscape.

Figure 01 below offers an illustrative example of how an independent alpha source can potentially enhance the return stream for global equities and global bonds. We randomly generated 100 hypothetical alpha portfolios, each with an IR of 0.5 and annualized volatility of 15%. Since these were constructed entirely independently of the beta sources, we would expect realized correlation to be lowly positive

FIGURE 01 - GROWTH OF A DOLLAR FOR HYPOTHETICAL PORTABLE ALPHA PORTFOLIOS (JANUARY 1990 - DECEMBER 2020)



For the hypothetical alpha portfolios, we randomly generated 100 return streams with 7.5% annualized return and 15% annualized volatility. To illustrate portable alpha, we blended the MSCI World, USD Unhedged (left) or FTSE WGBI, USD Unhedged (right) and a 5% allocation to each randomly generated hypothetical alpha portfolio, assuming monthly rebalancing and no transactions costs.

Sources: First Quadrant, L.P., and Datastream or lowly negative, and that is indeed the case. The graphs demonstrate the cumulative value added for a 5% alpha overlay over the MSCI World and the FTSE World Government Bond Index, contrasted against each as a standalone.

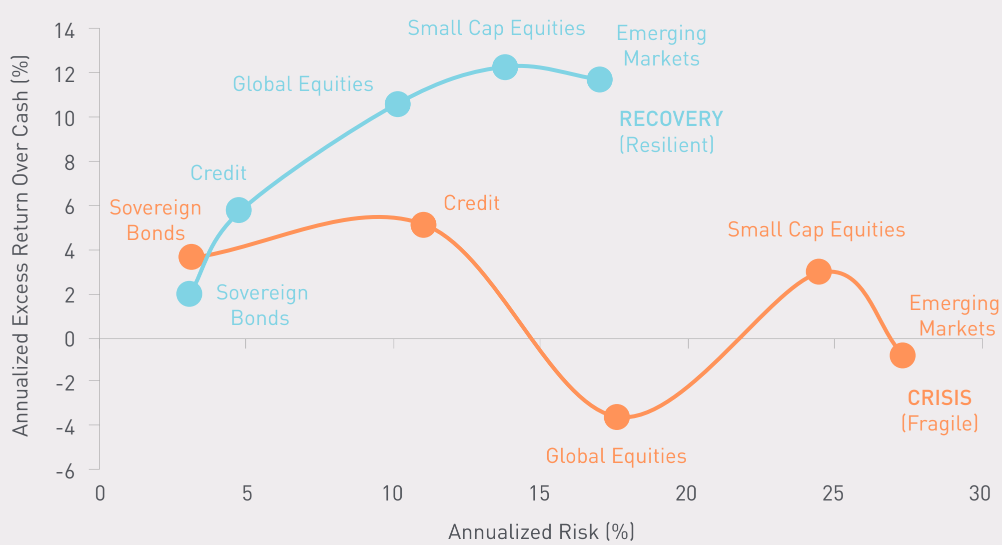
This intuitive approach offers a number of attractive design features. First, PA is typically extremely flexible, accommodating a wide range of passive beta vehicles. It also tends to be a relatively affordable diversifier, limiting the costs to the alpha component rather than the program as a whole. In other words, investors can continue to achieve low-cost passive beta exposure through their existing allocations, only paying a premium for the diversifying element of an alternative. Finally, many alpha strategies use highly liquid instruments, so unlike most private equity and credit alternatives, they can quickly be converted to cash if sponsors are pressed to meet margin requirements.

Portable Alpha in Practice: When Alpha Isn't Alpha

So, why isn't such a seemingly straightforward idea more widely used? Not so long ago, it was. In the early 2000s, PA rapidly grew in popularity -- then failed miserably during the 2008/2009 Financial Crisis, when diversification was needed most. Many PA managers had supplied what they claimed, and perhaps even believed, to be true alpha, but in reality, contained quite a bit of beta. In effect, this meant that PA strategies had actually doubled down on beta, compounding losses when risk assets collapsed. The flaw was in the execution rather than the philosophy, but unfortunately, the idea of PA became tainted by these failures.

When evaluating candidate alpha strategies, it is important to evaluate their expected characteristics at different points in the market cycle. At First Quadrant, we extensively research the risk landscape and have identified two broad regimes within the market cycle. The first we label "resilient": The global economy is generally growing, and risk appetite is generally robust. Volatility is low and stable, and tail risk is modest. During these periods, most traditional capital market assumptions hold. In addition, the conventional asset classes tend to be lowly correlated, so diversification works well. The other state we label "fragile". Volatility is high and unstable, and tail risk is significant. Conventional asset classes become more correlated, rendering common forms of diversification ineffective. It is during these

FIGURE 02 - STRATEGIC ASSET ALLOCATION BETWEEN TWO MARKET STATES (JANUARY 1990 - DECEMBER 2020)



DEFINITIONS: Global Equities is MSCI World Index, Net (local currency), Small Cap Equities is Wilshire US Small-Cap Index, Emerging Markets is MSCI Emerging Markets Equity Index, Credit is BofA ML US Cash Pay High Yield Index, Sovereign Bonds is FTSE World Government Bond Index (local currency). Cash is Ibbotson US 30-Day T-Bill.

Sources: First Quadrant, L.P., Datastream, StyleAdvisor, Global Financial Data (GFD) periods that alternative types of diversification are needed most – and also when purported alpha strategies have disappointed the most.

In our research, the resilient market state generally holds about 2/3 of the time and goes for very long periods. Many alpha strategies tend to work well in these types of environments, when market conditions are stable. Unfortunately, they may fail during the fragile state, when market returns are on average negative. This failure could be the result of any number of factors: (1) The "alpha" is simply covert beta, an implicit or explicit proxy to growth; (2) The underlying models rely on classic capital market assumptions, which our research has found to hold only during the resilient periods; (3) The underlying models overlook the impact of market participants on asset pricing, and fail to consider the market environment's influence on their behavior.

Portable Alpha in Practice

In contrast, we argue that a viable candidate for PA should display attractive correlations in general, over the full market cycle, and in particular, when markets are under stress. Moreover, the manager should be willing to help sponsors explore whether the alpha candidate is expected to diversify their particular beta exposures, as well as any existing alpha allocations.

From an investing perspective, we advocate for an approach that sidesteps common sources of return or risk premia. Popular trades may, over time, become correlated with broad markets simply because of their popularity; when equities retreat, investors have to pull out of other trades, as well, for funding or collateral needs. Common equity factors, for example, have notoriously experienced return compression and greater synchronicity with equity beta as they gain traction in the marketplace.

First Quadrant has designed its alpha strategies with these specific needs in mind. Through careful research discipline, we aim to avoid persistent correlations to global growth, common risk premia, and broad asset classes, at both the individual model and overall strategy levels. Moreover, our investment philosophy is rooted in a deep understanding of how the market environment impacts market influencers, and in turn asset pricing, and our strategies nimbly and systematically adjust as the environment changes. Finally, we rely on cash-efficient instruments, such as liquid futures and forwards, to implement our insights. Altogether, our differentiated perspective has resulted in differentiated results, and correlations we think are quite compelling, particularly when markets are under siege.

Summary

We believe portable alpha has the potential to help investors achieve their long-term goals. It may be one of the few cost-effective ways to achieve plan objectives in an environment where beta returns are expected to be modest, at best. But even though portable alpha is simple to understand, we should abandon the idea that true portable alpha is also simple to achieve. With dynamic and uncertain markets, we need to be concerned with the source of alpha and its relationship to the market cycle.

In this discussion, we illustrated how an alpha overlay could possibly generate excess returns returns, and how different market regimes can play a role in maximizing potential return. The ideal mix for a given beta instrument would depend on the alpha source's expected correlation and expected performance. We believe investment managers should work with plan sponsors to determine the appropriate construction for their specific mandates and return targets. We welcome any additional conversation about how portable alpha works in practice, and whether our alternative strategies at First Quadrant may be effective solutions.

For index definitions and trademark language used in this publication, please visit **https://www.firstquadrant.com/index-definitions** for further information.

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