



Returns Get A New Lift

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1717 words

28 August 2006

Barron's

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English

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Hedge funds' go-anywhere investment strategies have reshaped the investing world, and now their opportunistic money managers are preparing to go mainstream.

The catalyst? Hunger for returns is propelling pension funds, endowments and other institutions toward "portable-alpha" investment strategies at a faster pace with every month.

While it may sound exotic, the portable-alpha concept is straightforward. It simply hinges on the difference between the two basic investment-return flavors: "alpha" and "beta." Someone who buys an index fund, such as a Standard & Poor's 500 stock fund, gets pure beta exposure -- their returns will mirror the broad market's, as measured by the S&P 500. But a manager who posts a 10% gain while the S&P 500 is flat is delivering pure alpha -- a return that depends on the manager's skill rather than the broad market's performance.

Portable alpha simply takes the concept a step further, "porting," or carrying, alpha to be wed to the beta and offering pension-fund trustees and other institutional investors the chance to have their cake and eat it, too.

As of late last year, at least \$300 billion had been allocated to portable-alpha vehicles, according to investment consultant Casey Quirk & Associates. That figure may understate the actual amount significantly, adds Jeb Doggett, a partner at the Darien, Conn.-based firm, since it includes only investments in portable-alpha products offered by traditional money managers, not those of funds of hedge funds.

And as this new approach to asset allocation and investment management gathers momentum, it is those hedge funds that stand to reap the biggest gains, thanks to their expertise in generating coveted "alpha" returns. "This is a boon to hedge funds," Doggett says. "Suddenly, they have another way to sell their capabilities beyond battling for a part of the 5% or 10% that an institution might allocate to 'alternative' investments."

The advent of derivative securities has made it possible for an institution to put the same \$100 million to work simultaneously in both large-cap stocks and alpha strategies. Thanks to leverage, the cost of buying \$100 million of exposure to the S&P 500 index through swaps is a fraction of that principal amount, enabling their portable-alpha manager to give \$95 million or more to a group of investment managers to deploy in alpha strategies.

In a perfect world, both the S&P 500 and the alpha portfolio will do well, meaning that the institutional investor will profit from both bets. But if stocks flag, the pension fund will have a source of returns that won't be dragged down by the S&P.

The allure of alpha and portable alpha alike has grown with each year of lackluster returns from conventional stock and bond investments. "The style box that long-only framework people have been working within has many constraints which leave money on the table," says John Minahan, director of research at New England Pension Consultants.

For decades, alpha returns were the icing on the cake: a few extra percentage points that could turn a 12% market return into something even better.

Nowadays, alpha has become vital, and portable alpha offers investors a way to get more of it without forcing them to yank too much cash out of stocks or bonds to invest outright in alternatives.

Minahan introduces the concept to pension-fund clients by discussing the constraints placed on traditional money managers. "One of the things that hedge funds have taught us is that removal of those shackles allows for higher returns to be earned by skillful managers," he says. "Portable alpha is one way of packaging the benefits of relaxing those constraints."

The more receptive ears Minahan finds among his client base, the greater the opportunity for hedge-fund managers. A September 2005 report from Russell Investment Group on alternative asset classes showed that nearly a quarter of the pension funds it surveyed are already using portable alpha, with many more studying the concept.

"If you think about the amount of assets now invested in traditional strategies, that is the opportunity set," says Roger Fenningdorf, global manager of research for Rocaton Advisors, a Norwalk, Conn.-based consulting firm, who expects multi-strategy hedge funds and funds of funds to be among the biggest winners.

Not surprisingly, these players are already hard at work pitching their prowess at generating alpha and structuring portable-alpha strategies to pension funds, seeking ways to capture pieces of core stock or bond allocations that the funds might previously have handed over to traditional investment firms.

For Prisma Capital, a fund of hedge funds, portable-alpha strategies are the key to hedge funds' move from the sidelines to the mainstream, says Girish Reddy, the New Jersey-based firm's founder and a former partner and co-head of equity derivatives at Goldman Sachs. At any given time, the \$3 billion in assets that Prisma oversees is scattered among 30 to 35 managers who specialize in trading in relatively straightforward assets, like securities whose performance is tied to energy prices, as well as more esoteric strategies, like profiting from merger trends, events in the reinsurance market and trade-finance receivables.

"Our goal is to one day be seen as a logical candidate for consultants to include when they are looking for an active equity manager on a client's behalf," says Reddy. "We believe that eventually we'll be routinely included in those searches, even though we don't manage equities at all, because portable alpha will reshape the way investors perceive us."

"Traditional active management won't die, but the days of allocating 45% of your portfolio to large-cap, bottom-up stock-pickers are gone," argues Rob Blackwell, managing director of research and strategy at Tacoma, Wash.-based Russell.

Institutions that began by dipping their toes into portable alpha are venturing further into the water, often pulling money away from traditional long-only managers to give to funds of funds.

For example, Massachusetts Pension Reserves Investment Management, Allstate Corp. and Pennsylvania State Employees' Retirement System recently began increasing their exposure to the strategy. Earlier this summer, the Pennsylvania fund's trustees approved a proposal to boost the plan's \$6.7 billion allocation to portable alpha by investing another \$2 billion or so in a range of funds of hedge funds.

Still, hedge funds are likely to face competition for portable-alpha allocations. Giant money-management firms with decades of experience using derivatives are already structuring their own portable-alpha products, while boutique firms specializing in quantitative investing or tactical asset allocation are also finding that their own expertise gives them a toehold in the portable-alpha universe.

"Hedge funds won't automatically dominate this world; there are a whole series of competitors out there looking for and offering solutions," says Doggett. "Still, hedge funds do have the most experience of delivering the alpha part of the solution."

For State Street Global Advisors, a giant asset-management firm, part of the answer may be "co-opetition," says Alistair Lowe, global head of asset allocation. State Street already oversees \$4 billion invested in absolute-return strategies that generate alpha for investors, and the firm has developed a variety of ways to combine these with the necessary beta strategies to offer portable-alpha products.

"At the same time, we're in discussions with some of the largest funds of hedge funds," says Lowe. "They are coming to us for help structuring the beta part of a portable-alpha product, so that they can break into the competition for the mainstream allocations" by institutional investors.

No deals have been struck yet, but Lowe says that it may be just a matter of time and negotiation. Meanwhile, State Street is also responding to direct requests for help with the beta portion of portable-alpha strategies. "We just worked with a client who had hired two funds of funds to generate alpha, and needed someone to structure the beta," he says.

For investors, the biggest risk may lie in making sure that they are indeed getting the alpha returns they are paying hedge-fund-level fees to acquire. "Finding alpha is more important than ever, but it hasn't become any easier," cautions Russell's Blackwell. "And the cost is rising."

But managing the beta exposure isn't without risks, either. "You need to make sure you don't have all your swaps with one counterparty, or that they don't all roll over on the same date," says Joe Gieger, managing director of GAM USA, a division of Julius Baer Group. And when it comes to putting the two together, the recipe becomes even more complex.

"Many alpha strategies end up generating some beta return for investors," explains Gieger, whose firm has put together different funds-of-hedge-fund-based portable-alpha strategies for institutional clients. "You need to have coordination between the beta and alpha so that you don't spend money getting more beta exposure than you need."

GAM recently launched a next-generation portable-alpha strategy that it figures will address just that issue, as well as introduce a way to limit the cost of establishing derivative positions, a consideration that has risen in importance as higher interest rates have driven swaps costs higher. "We have built in a lending and liquidity feature that eliminates the need to keep money set to one side as collateral for our swaps positions," Gieger says.

The next steps forward may be the most dramatic of all: a complete reshaping of the way institutions think about asset allocation and their portfolios. Rather than pondering how much to allocate to what asset class, institutional investors -- and ultimately individual investors, as well -- will concentrate instead on what kinds of returns they need to generate.

Yoshi Ohmura, who works with GAM Investment Management in Zurich as lead manager of the beta portfolios of GAM Portable Alpha Strategies, is already thinking ahead to that day. "Eventually, portable alpha will be portfolio-wide, and based on customized benchmarks," he predicts. "This is more than just another investment strategy; it's a paradigm shift." And, if he's right, a big shift in the way investors think.

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