



# Financial Newsletter

## Portable Alpha

# Portable Alpha

**Endowments and other Institutions are always a few years ahead of individual investors. It took a number of years for individual investors to embrace traditional asset allocation. Then, after the market crash of 2000-2002, smart institutions realized there had to be a better way. While the individuals are still invested in traditional asset allocated portfolios, the institutions are creating portfolios that separate alpha from beta.**

## Alpha/Beta Separation

Beta is the performance you get from just being in the market and alpha is outperformance. For example, if the market was up 10% and a money manager who took the same risk as the market was up 12%, then 10% of his performance would be from beta (just being in the market) and 2% would come from alpha (outperforming the market on a risk adjusted basis). Beta is easy and cheap to get since you can just buy an index fund. Alpha is harder to find, you need to find money managers that consistently outperform the market or their benchmark. The traditional approach most investors use is to come up with an asset allocation and hire style pure money managers. These money managers would generate beta just by being invested in the market. The hope is that they can make bets around their benchmarks, underweighting some sectors and overweighting others, so they can generate some alpha as well. In the traditional approach, alpha and beta are tied together and come from the same manager. So for example, let's you had an endowment that had come up with their asset allocation and hired XYZ Large Cap Blend money manager to manager their large cap growth allocation. XYZ uses the S&P 500 as its benchmark and won't deviate much from benchmark sector weights.



Because of that, a lot, or most, of their performance would come from beta, just holding many of the allocations and stocks in the index. The endowment would also expect XYZ to slightly overweight or underweight stocks or sectors to try to outperform the index and generate some alpha. However, XYZ can't overweight or underweight too much because they would risk making a bad bet, underperforming the index (tracking error), and getting fired. So it is very difficult for XYZ to generate alpha. There are a number of reasons why traditional, style pure, money managers have trouble outperforming their benchmark:

1. They must have minimum allocations to certain sectors to stay in line with their index even if they don't like the sector.

2. They cannot exceed certain percentages in any one security or sector. This makes it difficult to monetize positive viewpoints on securities and/or sectors.
3. Minimal or no ability to sell securities or sectors short.
4. Requirement to deliver performance within a certain minimum tracking error (deviation from the index).
5. Limitations on the types of securities in which they can invest.

Also under the traditional approach, the endowment might have come across ABC Money

Management. ABC doesn't have a benchmark, they seek to generate absolute returns (some spread above inflation), they invest in whatever they want, wherever they want, to try to generate alpha. Since ABC doesn't fit nicely into any style box, the endowment cannot use them, even if their performance is great. They need to hope that XYZ and their other style pure money managers can figure out some way to generate alpha, a very tall order.

Twenty years ago, some smart institutions started to realize that their might be a better way. If they could separate alpha from beta, they could design more efficient portfolios and increase returns. At that point in history, a monkey throwing darts at a board could have earned 20%/ year in the market, so the idea never really gained traction. Now that we are in a period of mediocre returns, more and more endowments and other institutional investors are converting to a portable alpha approach.

Portable alpha sounds complicated, but it's really not. The key is to separate money manager skill from market risk and return and to use leverage. Beta is easy to replicate, you can invest in an index fund, an index ETF, index futures, or swaps and you will get market returns.



Alpha is not as easy to find, but it does exist if you look hard enough. There are many money managers who have consistently generated alpha over the years. In the portable alpha approach, instead of having money managers who generate beta and hopefully some alpha, the alpha and beta are split off into separate allocations. In our example from above, if the endowment went to a portable alpha approach, they would fire XYZ and replace them with a passive exposure to the S&P 500 (this would usually be through futures, swaps, or other derivatives). Using products such as futures, which only require a small margin to control a large market exposure, frees up cash that can be invested elsewhere to generate alpha. They would also fire their other style box based managers and replace them with passive exposure to whatever index they wanted to replicate returns for---MCSI EAFE, Lehman Aggregate, etc. This would become their beta portfolio. They would then hire ABC and other skill based money managers with their free cash, who would then hopefully generate alpha. This would be their alpha portfolio. They would then combine their beta and alpha portfolios together to create one big efficient portfolio. So instead of the old approach of trying to get alpha and beta from the same place, they split them into different portfolios---a passive beta portfolio and an alpha portfolio--- and then combine them together. The alpha they are creating gets ported to their beta portfolio, hence the term portable alpha.

## Leverage

Many investors look at the word leverage and ultimately think of high risk. Leverage doesn't have to be risky; it just depends on how you use it. Homeowners use leverage to buy their homes, car buyers use leverage to buy cars, etc. Using leverage wisely can enhance your portfolio, using it unwisely to make large speculative bets can wipe you out.

Individuals can do pretty much the same thing. Let's say your benchmark is the S&P 500, you want to beat the index and you are willing to take some risk that your returns will not be quite in line with the index. Here's how portable alpha would work:

Step 1: With some part of your portfolio, you need to replicate the returns of the S&P 500. This can be done with futures, swaps, leveraged index funds, or leveraged ETFs.

Step 2: Since you didn't need of your entire portfolio to replicate the index return (because of leverage), you now have excess money that can be invested. You would then identify money managers or different strategies that consistently generate alpha and are not that well correlated with the S&P 500 (have as little beta risk as possible).

The alpha portfolio has the potential to increase returns but it this can go the other way as well. If your alpha portfolio cannot return at least as much as the cost of the leverage then portable alpha is a losing bet.



At first, this might seem overly complex, but it really isn't. You use portable alpha in your daily life. Let's say you have \$5,000,000 in cash and you want to buy a house for \$5,000,000. You have two choices, you can put all of your money down or you can put \$1,000,000 down and take the other \$4,000,000 and invest it. If you pay cash for the house and its value goes up you do well, and if its value goes down you do poorly. If you only put \$1,000,000 down, you still experience the appreciation and depreciation of your property but you also have the extra \$4,000,000 to invest. If you invest it wisely, your total return will be better than it would be if you had put all of your money into the house (assuming of course that your returns on your \$4,000,000 beat the mortgage interest rate).

There are two key concepts to portable alpha. The first is that leverage can increase returns (also potentially increasing risk). Secondly, diversification has the ability to increase returns and potentially reduce risk. Portable alpha uses borrowing to improve a portfolio on two fronts---diversification (a portable alpha portfolio will be much more diversified than a traditional portfolio) and alpha generation.

## Alpha Generating Vehicles

Successful investment vehicles for a portable alpha strategy should have the following characteristics:

1. Consistently outperform their benchmark
2. Low volatility
3. Low correlation to the markets (your sources of beta)

In short, you are looking for smart money managers who consistently outperform their benchmark but invest in such a way that they have little or no correlation with your sources of beta.

## Portable Alpha

Some examples of alpha and beta sources are below. Portfolios can easily be customized based on how much risk you want to take vs. how much you want to beat your benchmark by.

## Beta Sources

S&P 500  
Dow Jones Industrial Average  
Mid Cap Stocks  
Small Cap Stocks  
International Stocks  
Emerging Market Stocks  
Lehman Aggregate



**Alpha Sources**

Hedge fund of funds that have low correlation with beta sources

Hedge funds that have low correlation with beta sources

Short term bonds

**Risk**

Because of the use of leverage in portable alpha, investors need to proceed cautiously and carefully monitor the risk of their portfolio. Investors in a portable alpha strategy run the risk that in any given year their alpha generating vehicle(s) will not outperform the cost of leverage (internal fund expenses).

There are also a lot of permutations to this. Since you can find proxies for just about any index you want, you have flexibility with your beta choices—50% stocks/50% bonds, combine international stocks, emerging market stocks, and the S&P 500, etc. You can also decide how much risk you want to take that your portfolio will not move in line with the index. The possibilities with portable alpha are almost endless.

Portable alpha can also be used at an asset class level. Some asset classes like large cap U.S. stocks and government bonds are very hard to generate alpha in. Large stocks are fairly efficient since there is not much that an analyst can learn about a large company that everyone else doesn't already know. Government bonds are pretty plain vanilla investments so it is hard for the best of investors to generate much excess return. Let's say an endowment has \$1 million allocated to large cap blend U.S. stocks and wants to add some alpha. The endowment would use a futures contract on the S&P 500 which would give them the same \$1 million exposure as they had before but with less than \$1 million down (this is because futures contracts only need a margin deposit that is a small percent of the amount of assets the contract controls). The endowment will then take the extra money and invest it in one or more alpha generating investments.

Many endowments and other institutional investors believe that portable alpha is the future of money management. They foresee a time when money management firms will either structure beta or be providers of alpha. I could definitely see this happening, it will take a while to catch on with individual investors, but once it does there is no real reason to go back to the traditional way of thinking.

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