

2nd Annual Portable Alpha Summit

October 11, 2006

Eric M. Teal

Chief Investment Officer- First Citizens Bank



Topics

- **Setting appropriate benchmarks for performance**
- **Demonstrating the difference between non-skill based actions and true alpha**
- **Evaluating the total cost of an investment strategy**
- **Realizing the value of consistent returns over time**

Overview

Portable Alpha and Portable Beta

- **Various levels of Portable Alpha strategies exists based on the framework of the policy portfolio or the degree of obsolescence of the policy portfolio. Typical programs have an index tracking component plus an absolute return engine.**
- **Hedge Funds are vehicle of choice for most programs.**
 - **Market Neutral strategies are most commonly utilized since alpha is “theoretically pure.”**
- **Today, Portable Alpha has morphed into equitizing Market Neutral strategies but can apply to other alpha sources.**
- **Effectiveness of Portable Alpha is contingent on the ability to short betas. However, markets are not complete on the beta side. A wider set of instruments are required for broader adoption.**

Overview

Is it Alpha or Beta?

- **Using the Hedge Fund Research (HFR) Composite Index, Asness, Krail, and Liew [2001] demonstrate that from 1994 through 2000 hedge funds in aggregate had a beta of .37 and a correlation of .52 with the S&P 500.**
- **Fung and Hsien [2002] reached a similar conclusion:**

“The evidence indicates that hedge-fund benchmarks have much greater exposure to traditional asset categories than the typical hedge fund has – which leaves us with a puzzle: *By diversifying among hedge funds, an investor may be exchanging idiosyncratic hedge-fund risk for systematic exposure to traditional risk factors.* The implication is most uncomfortable for investors looking to hedge-fund investments as a means of diversifying a portfolio of traditional asset classes.”

Overview

Is it Alpha or Beta?

- **Alpha cannot always be separated from beta and is often entangled. Hedge fund managers are not organized in this manner (e.g. long-short strategies have residual beta exposures).**
- **Asness, Krail, and Liew [2001] studies indicate that hedge funds have only exhibited statistically significant alpha for two of the nine strategies tested.**
- **Recall the fundamental law of active management from Grinold and Kahn. Increases in breadth and skill are required for increasing the Information Ratio.**
- **Alpha selections are magnified in the post-porting framework versus the classical long only structure.**

Benchmarks

Is This an Asset-Only Exercise?

- **Despite research to the contrary, market-neutral should have no beta and benchmark cash.**
- **Should alpha management include the following:**
 - **Liability relative investment policies (e.g. spending policies, pension discount rate, inflation, etc...)**
 - **Comparison to relative return products**
 - **Style benchmarks based on alpha sources and correlations to index return series. Fung and Hsien [2000]**

Cost

Implementation Challenges

- **Derivatives are most liquid and cost effective in more efficient markets, but alpha is often sourced from many markets including those less efficient.**
- **ERISA accounts and committees are wary of derivative laden portfolios and require addressing the policy portfolio debate.**
- **Portable alpha costs are opaque and require study by advisors and fiduciaries at sub-levels.**

Cost

Implementation Challenges

The following are costs worth monitoring although not isolated to Portable Alpha Strategies:

- **Hidden Cost of Beta** – Futures roll can vary between 10-20 basis points. The futures market is transparent and reduces any counterparty risk but increases leverage. Swaps or notes may be expensive with lower tracking error, but are often volatile and counterparty credit risk must be monitored. Overall a synthetic exposure, like the Lehman RBI baskets, are best for optimal execution.
- **Opportunity Cost** – By indexing beta policy, market timing is not utilized and alpha is theoretically isolated, even if beta management may have been a favorable policy prior to porting.

Cost

Implementation Challenges

The following are administrative costs worth monitoring:

- **Transaction and Market Impact Costs** – Rebalancing and hiring/firing costs. Cash drag can be material if liquidity is needed from illiquid alpha sources.
- **Operational Costs** – Margin flows and daily cash settlements require infrastructure to support, and require some level of custody cost.

Cost

Implementation Challenges

Other significant costs requiring inspection include:

- **Monitor all hedge fund costs and the additional layer of fees at the Hedge Fund of Funds level including incentive payments.**
- **Monitor all leverage costs and financing rates.**
- **A Master Manager can facilitate the overlay but presents an additional layer of fees for the program if not internalized.**
- **Turn-key solutions are available but likely include all of the above bundled costs but are optimal for smaller programs.**

Conclusion

- **Long-only constraint requires relaxation and the Policy Portfolio requires recasting.**
- **Portable alpha is real and relevant and brings traditional policies under review but one must not forget the zero-sum game of alpha. Negative alpha is easier to find than positive alpha.**
- **All program cost should be incorporated in the hurdle rate and opportunity cost monitored.**