



Economic Insights

Ask the Economist

with Milton Ezrati

Portable Alpha Threatens the Established Investment Order

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Hedge funds often make traditional investment managers feel as though they are fighting a fifth column movement that is set to siphon off assets and undermine established investment conventions. Their fears, however, are misplaced because the hedge funds themselves are not much of a threat. The unreasonable enthusiasm surrounding them today most likely will only lead to future public disenchantment. Concern instead should lie with the portable alpha investment approach that stands behind many hedge funds. Radically different and highly flexible, portable alpha will outlast the coming disappointment with hedge funds and, in time, irrevocably alter the business of investing in America, Europe, and Asia.

The Appeal

Portable alpha's distinction and appeal lie in its ability to separate the two basic parts of portfolio management: the effort to generate superior returns (what the trade calls alpha) and the desire to maintain exposure to a particular asset class (what the trade calls beta). Conventional investing bundles these two objectives together. The portfolio manager tries to give the investor general exposure to an asset class or market index, mostly by diversifying holdings, while simultaneously trying to generate superior returns, usually by emphasizing particular holdings within that particular asset class. The portable alpha approach, however, relies on one manager to achieve general asset exposure, usually through purchases of index futures, while relying on a completely different manager to seek superior returns. Typically, this second, or alpha, manager uses what are called market-neutral techniques, which have no link to a particular asset class, and might, for instance, match purchases of favored securities with short sales of less attractive securities. Because this alpha effort is separate from any beta exposure, it is said to be "portable."

With its separated structure, portable alpha can offer solutions to many long-standing investment problems, one of which is fees. Because the traditional approach bundles the index management with the alpha management, it obscures which fees are applied to which function. Portable alpha, however, is much more transparent. The beta manager gets a modest fee, leaving it much clearer as to whether the alpha manager is worth his or her price. Portable alpha also offers a new flexibility in selecting talented portfolio managers. In the conventional approach, no matter how talented a particular manager is, investors can partake of that skill only to the extent that they want exposure to the particular asset class in which that manager works. But because portable alpha makes its basic asset allocation separately, and then asks the alpha manager to generate excess return from a market-neutral approach, the investor can concentrate assets on the most talented manager without distorting the overall portfolio's strategic asset allocation.

Positive Funds Flows

Furthermore, evidence suggests that investors are already responding to these attractions. The U.S. Securities and Exchange Commission estimates that American investors have increased their exposure to portable alpha by 15 percent a year for the past five years and presently have more than \$1.0 trillion committed to the approach. The American consultancy Greenwich Associates reports that during this time U.S.-based pension funds have quintupled their allocation to portable alpha and intend to bring their allocation up to one quarter of all their assets. (Endowments and universities already have more than one-fifth of their assets so invested.) Evidence from Britain, Europe, and Asia is as yet more anecdotal than statistical, but it seems reasonable to expect that these investors will be just as responsive to the benefits of portable alpha as are American investors.

The Threat

Even though hedge funds dominate portable alpha today (and will likely, inevitably, suffer a setback in the not too distant future), the approach will nonetheless survive. Indeed, the use of portable alpha might well accelerate, since any losses in hedge funds should prompt other sorts of investment managers to offer their own variations on the approach. In short

order, this broadened base of managers should add to the public acceptance of the approach. While sophisticated institutions should take the first steps, individual investors will quickly follow their lead. It will not take long, then, for mutual funds, unit trusts, and the like to find ways to offer the approach to individual investors and, accordingly, increase the assets involved.

All this growth in portable alpha will almost certainly occur at the expense of more traditional approaches to investment management. Conservative investment managers in particular will suffer as this trend gains momentum. In a world where investors make explicit distinctions between general index exposure and the quest for superior returns, conservative managers should face increasing difficulties in their attempts to distinguish themselves from index managers and, consequently, in justifying anything greater than minimal fees.

Portable alpha, of course, is not for all investors. It will never entirely displace the more conventional approaches. As investor assets grow, all sorts of managers should gain. The lead, however, will move away from the more familiar approaches, especially from the more conservative managers.

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