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India Mutual Fund

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2021 BEST IDEAS - PART 5

Enhancing Returns: A Portable Alpha Overlay

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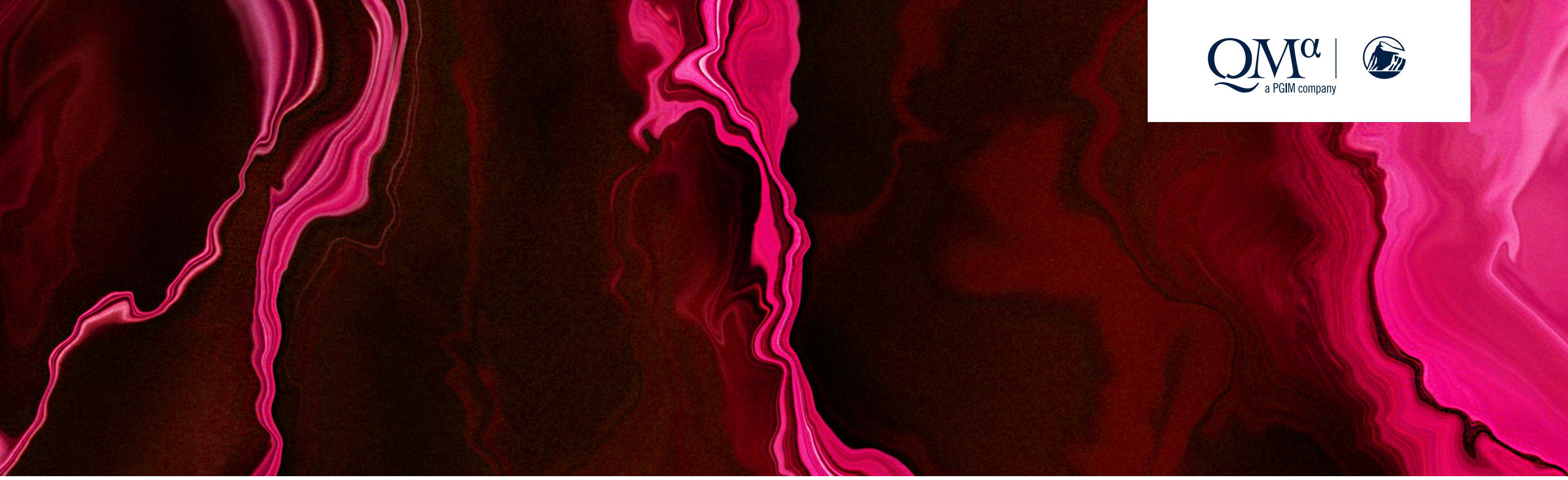

ENHANCING RETURNS: A PORTABLE ALPHA OVERLAY

The 2010s provided generous returns to traditional asset class exposures in equities and bonds, coinciding with the longest post-war U.S. economic expansion on record. But the backdrop over the next 10 years may be less hospitable for investors, and traditional approaches are unlikely to produce the long-term returns that asset owners need to achieve their goals.

Enter the portable alpha overlay.

A portable alpha[1] overlay is an uncorrelated and unfunded separate source of excess returns generated by active management. Alpha strategies that use liquid derivative instruments do not have to be fully funded. The strategy provides a flexible and scalable way for investors to enhance the expected returns of their allocations. With flexible implementation options, portable alpha overlays can be added in a total portfolio context, as a means to enhance the return of individual beta allocations or available liquid reserves.

Portable alpha overlays can be implemented with high capital efficiency, without reducing exposure to longer-term strategic investments, making them an effective way to meaningfully enhance returns on a strategic portfolio allocation. Moreover, a well-designed overlay strategy may enhance diversification[2] by offering a low correlation to traditional asset class exposures and consistently add value in both up and down equity and bond markets.

DESIRABLE CHARACTERISTICS

Many strategies can be implemented as portable alpha overlays, but there are universal characteristics to look for that are particularly desirable:

- **Cash Efficiency:** A portable alpha strategy should be financed with a cash allocation from the underlying strategic portfolio in order to add meaningful excess return. The more cash-efficient the strategy, the less exposure needs to be implemented synthetically in the strategic portfolio to finance the portable alpha overlay.
- **Liquidity:** The more liquid the instruments in a portable alpha strategy, the lower the cost of implementation, and the more flexible the strategy will be to offer better terms to investors who need to invest and redeem. Limiting the opportunity set to the most liquid public market instruments also avoids potential supply/demand imbalances that may arise in less-liquid asset classes.
- **Scalability and Capacity:** Depending on desired risk tolerances and return objectives, a well- designed portable alpha strategy can be customized to deliver a target excess return scalable by the level of risk the asset owner is willing to take. Only a strategy with reasonable capacity can deliver this in size.
- **Diversification:** Additional desirable properties in a portable alpha strategy are excess returns that are diversifying to primary asset class exposures in a strategic portfolio, as well as style exposures that might be present in actively managed

strategies as part of the strategic allocation. Ideally, you want to look for a strategy that is beta-neutral to stocks and bonds over a full market cycle.

- **Risk Management:**[3] As the strategy is not fully funded, risk and drawdown management become critical elements of the investment process. The funding requirements should be congruent with possible drawdowns and associated increased capital calls.

A STRATEGY FOR THE NEXT DECADE

At QMA, our 10-year forecast for a 60/40 portfolio of global equities and bonds sits at 4.1% as of the 2020 fourth quarter. For context, the latest available median corporate pension expected rate of return is 6.3%, while the equivalent public expected rate of return remains over 7%, which if achieved leaves plans with a return shortfall of 2.2% to 2.9%, even before allowing for costs.

We believe a well-designed portable alpha overlay strategy with a low correlation to traditional asset class exposures can provide diversifying, additive returns when asset owners need it most, in particular during drawdowns in risky assets that typically occur at the end of economic expansions. Further, in contrast to other alternative allocations, portable alpha overlays can be implemented in existing portfolios without changing underlying portfolio allocations and/or existing active managers. In our view, on any realistic perspective, they represent the best hope of achieving the returns in coming years that plans and their participants need.

There is no guarantee that this forecast will be achieved.

[1] Alpha indicates the performance, positive or negative, of an investment when compared against an appropriate standard, typically a group of investments known as a market index.
[2] Diversification does not protect against a loss in a particular market; however, it allows you to spread that risk across various asset classes.
[3] No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

IMPORTANT INFORMATION