Hooked on Alpha: The Failure of Portable Alpha & Absolute Return Mandates

Rene Levesque
Founder, Mountjoy Capital
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The term "Portable Alpha" is a misnomer, or at least a source of confusion between the intentions and the means. As this article shall demonstrate, the attributes leading to the failure of Portable Alpha mandates are strangely found in its nomenclature alone.

A Portable Alpha program simply consists in overlaying a passive equity or fixed income allocation with a portfolio of hedge funds with the intention of adding a stream of reliable and stable source of returns to supplement the index returns. This is simply accomplished by buying the futures contracts on the reference market, or Beta, and allocating part of the unencumbered cash to hedge funds; hence, port a leveraged "Alpha" on a Beta. The key words are "reliable and stable" whatever the market environment, direction, and volatility regime. The all-weather and absolute return investment solution is a pivotal element to a successful Portable Alpha mandate. Obviously, the intention is not overlaying the overall portfolio with a return profile that is similar to the traditional asset management allocation. In most situations, this new allocation is replacing what was previously mandated to active managers who were evaluated vis-a-vis a benchmark, a Beta. This reliable and stable stream of returns is meant to provide a superior alternative in the quest to outperforming the referenced benchmark; hence the word "Apha".

The concept, although sound and well-intended, unfortunately failed miserably because of ineffective and ill-qualified execution. There seems to be some confusion between the intention and the means; the intention being adding a constant Alpha to a reference benchmark, and the means being the generation of absolute returns.

The paradox is that a successful Portable Alpha mandate dwells on an overlaid reliable source of absolute returns and protection of capital, but not of Alpha. What good is a leveraged negative 14% when the market is down 22%? The key to the construct of a successful Portable Alpha mandate is an effective understanding and identification of absolute return strategies.

Recent research from a consulting group shows that even top performing Alpha-seeking managers eventually underperform, and that most have done so already. They claim that the industry should revisit the idea of treating alpha as if it were a regularly observable phenomenon, when in reality, alpha is not stable. They also observe that alpha is not necessarily "earned" in the period in which it is measured. True skill might be demonstrated in the period of idea generation and research before purchasing a security, rather than in that security's subsequent outperformance. Simply, a manager's ability to add alpha may be dependent on forces beyond his control, such as the emotions of other investors. After all, the market, not the manager, ultimately determines prices. Dwelling on Alpha as a reliable and stable source of absolute returns

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ultimately leads to disappointment, and particularly when absolute return is needed it the most.

The concept about skill being demonstrated in the period of idea generation and research, or prior to portfolio implementation, is interesting. Once implemented, a portfolio of expressed ideas is subjected to the emotions of other investors rather than the manager's skill. This concept holds true unless the manager's activities and involvement extend beyond the portfolio implementation process such as dynamically calibrating portfolio capital to the ideas currently rewarded by the market, i.e. in favor to the collective emotions of other investors; and conversely, reducing/avoiding the allocation of portfolio capital to ideas that are indifferent or in negative-favor to the collective emotions of other investors. Absolute return is an active undertaking. It is at this juncture that the absolute return framework can significantly be distinguished from traditional Alpha-seeking asset management.

Absolute return strategies are only a subset of the hedge fund universe; albeit scarce, they perhaps represent about less than 3% of hedge funds offered.

The hedge fund universe is highly contaminated; essentially fee and legal structures, but what we find within these structures is widely diverse in nature. Their generous and overlaid fees attracted attention and talent. Although most managers had good intentions and the skills to provide superior returns, offering access to unique risk factors not available within the traditional asset management arena, and embedded within a downside risk mitigation framework; but they are not necessarily absolute return focused. The universe also attracted the star analysts now able to express their hard-earned research and conviction in an unconstrained investment policy, the academics with brilliant ideas and models that performed well in benign market environments, the managers that undertook significant and leveraged liquidity risk to generate returns, as well as the many others that explicitly and/or implicitly sold volatility and gap-risk in exchange for a premium to generate returns.

On the demand side, many hedge fund analysts applied and continue to apply traditional asset management principles in the evaluation of hedge funds with the objective of sourcing absolute returns, or non-traditional asset management returns. As well, they deploy and rely heavily on quantitative screens that fail to filter out managers that dwell on the contaminants mentioned above to generate returns. On the supply side, most hedge fund managers (albeit talented and skilled) applied and continue to apply traditional asset management principles in the deployment of their strategy, but within a hedge fund format. This has resulted in a "meeting of the minds" between the analysts and managers who apply and dwell on traditional asset management principles in the deployment of their hedge fund strategies.

Effective absolute return managers are actually and surprisingly not-at-all focused on "beating the market" or generating Alpha. They effectively navigate in the markets' ever-evolving perception of reality, or the collective emotions mentioned earlier. They respect the overwhelming forces of these perceptions and understand that these forces can alienate market price well away from intrinsic valuation; and that the identified valuation gaps can remain intact a very long time. The traditional asset manager may be "right" or "correct" in expressing his research skills through identified high-conviction value gap opportunities in a portfolio of positions sized and scaled to the underlying conviction level. However, in a leveraged portfolio, he may be right longer than he may remain solvent.

In sharp contrast to the traditional asset manager, the absolute return manager's objective is not being "right" per se; it is about making money, generating returns, and applying a discipline of "stepping aside" when the market is not receptive to the identified opportunity set and valuation gaps. They are free of, or constantly seek to suppress, the destructive behavioral biases such as overconfidence and the disposition effect. They tend to bias a long explicit or implicit volatility (Vega) and gap risk (Gamma) posture in the expression of ideas and themes in a portfolio. The elaboration of the above-mentioned elements shall constitute the subject

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matter of a subsequent article.

The hedge fund framework provides the manager with the required toolbox to generate returns and protect capital in market dislocations, reversals, downward trends and unexpected changes in volatility regime. These tools include, among others: unconstrained investment policy, net and gross exposure calibration, positions sizing, directional short exposures, and the use of derivatives to hedge unwanted risk and generate returns.

As indicated above, an effective Absolute Return strategy is an active undertaking, i.e. actively managing risk allocated among an array of ideas. One should not confuse the concepts of Risk Management with Risk Mitigation. Absolute return is not the result of hedging/mitigating risks, and much less the result of Risk Monitoring. Exposures must be actively managed to ensure that at least most of the capital is allocated to ideas currently being rewarded by the market. As well, exposures must be actively managed to reduce as much as possible the exposures to ideas not being rewarded by the market and/or contrary to the prevailing market sentiment. The "buy & hold" framework applied in the traditional asset management arena is ineffective in generating absolute return and protecting the capital.

It is well documented that the genesis of hedge fund strategies dates back to Mr. Alfred Winslow Jones' investment framework, i.e. The Jones Model, where he added the concept of leverage to buy more shares and short-selling to mitigate/reduce market risk. However, this does not coincide with the concept of absolute return. As a matter of fact, none of the basic hedge fund tools offer a guarantee of absolute return; hedging, market neutrality, diversification, and pairing of positions, only serve as a means to reduce the volatility of returns, not generating absolute returns. Contrary to popular belief, absolute return is possible without the use of any of the above-mentioned basic tools.

Investors allocate capital to alternative investments to derive alternative returns. In the case of hedge funds, much of the intention is aimed at deriving absolute returns and the protection of capital, including in market dislocations. Clearly, not all hedge funds are managed to derive absolute returns as their focus is "hooked" on the generation of Alpha. Consequently, the investor that fails to distinguish between absolute return strategies from hedge fund strategies ends up effectively subsidizing and providing a decent living to a manager that will ultimately fail him when an absolute return profile is needed most.

Editor's note: To contact Rene, call him at +001 438 402 2022 or email him at rene@mountjoycapital.com and visit the site www.mountjoycapital.com

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