Keeping market exposure while adding other sources of return

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The idea

An investor does not have to choose between owning the stock market and pursuing other sources of return. The two can be held at once, and the approach that does this is usually called portable alpha.

Most portfolios treat the choice as either/or. Every dollar moved into an alternative strategy (a hedge fund, private equity or real estate, for example) is a dollar taken out of stocks. The investor gains a new return stream but gives up market exposure to pay for it, and in a rising market that trade can cost more than the new strategy earns.

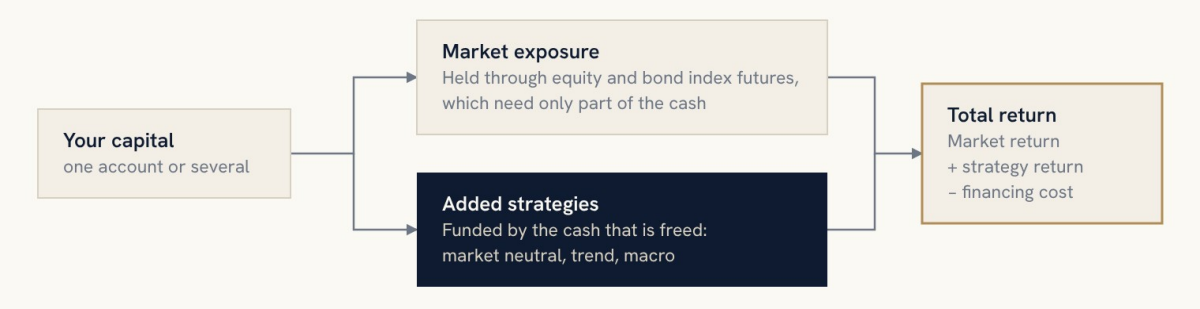
Portable alpha separates the two decisions. How much market exposure to hold is one question. Which additional strategies to run is another. Answering them separately lets a portfolio keep its market exposure and add to it, instead of swapping one for the other.

Large institutional investors have worked this way for decades. It has been less common in private wealth, mainly because it needs instruments, risk controls and attention that most advisory firms are not set up to provide.

How it works

The approach has two parts. They can sit in the same account or in separate ones.

1. **Market exposure, held efficiently.** Exposure to stocks or bonds is obtained through instruments that need only part of their value in cash, such as equity and bond index futures. The portfolio moves with the market much as it would if the whole amount were invested directly.
2. **A second set of strategies, funded by the cash that is freed.** That capital goes into strategies chosen because their returns do not depend on the direction of the market. Examples are market-neutral equity, trend-following and macro strategies.



A portfolio keeps its market exposure and adds a second source of return.

The total return is then the market's return, plus whatever the second set of strategies earns, minus the cost of financing the market exposure. That cost is the interest charge built into the price of the futures, which runs close to short-term rates on the full amount of exposure. Put simply, the capital moved into the second set of strategies has been borrowed at that rate. Those strategies have to earn more than that rate over time for the approach to be worth doing.

There is a second route to the same result. An investor who already holds stocks, often with large unrealized gains, can keep them and borrow against them, for example through box spreads, and place the borrowed capital in the added strategies. The financing cost can be slightly higher, but nothing has to be sold, which for a taxable investor can matter more.

This same structure explains why a tax-aware long/short portfolio can sit on top of an existing stock holding. The market exposure stays in place while the long and short positions around it do separate work.

Why diversification does the work

Any added strategy that earns more than the financing cost adds return, even one that moves with the market. What diversification changes is the risk taken to earn it. Combining return streams that do not move together gives a steadier result, and one that does not depend on any single strategy being exceptional.

A familiar example is a portfolio of 60% stocks and 40% bonds. It has historically been less volatile than stocks alone, by more than the reduction in its expected return. Diversification is the reason: the two assets often do well at different times, so their swings partly offset.

The table below works through that example with assumed figures. It is arithmetic, not a forecast.

Portfolio	Assumed return	Volatility	Return per unit of risk
100% stocks	10.0%	16.0%	0.63
60% stocks, 40% bonds	8.0%	10.2%	0.78
60/40 leveraged to stock-level risk, before accounting for the cost of financing	12.6%	16.0%	0.78
60/40 leveraged to stock-level risk, after a yearly financing cost of 3%	10.9%	16.0%	0.68

Assumptions: stocks return 10% a year with 16% volatility, bonds return 5% with 5% volatility, and the correlation between them is 0.2. Leverage of about 1.57 times brings the 60/40 portfolio to 16% volatility (a similar level of risk to stocks). The last row shows how much of the benefit a 3% financing rate removes, which is why the cost of financing matters so much. The 3% rate is an illustrative long-run assumption for short-term interest rates, not today's rate. The actual cost moves with short-term rates: at 4%, the last row would fall to about 10.3%.

The same arithmetic applies to strategies. Several strategies with modest individual results and low correlation to one another can combine into a steadier whole than any one of them. The more independent they are, the larger the effect.

Two cautions belong here. First, low correlation is an observation about the past, not a property that can be fully relied on. Second, diversification lowers risk but does not add return by itself. A diversified portfolio earns the average of its parts, and when the parts include lower-returning assets such as bonds, that means a lower expected return. Portable alpha uses leverage to bring the risk back up to the level the investor wants. Diversification and leverage therefore go together, and the leverage is where most of the danger lies.

Where it goes wrong

Portable alpha has had difficult periods, most visibly in 2008, and the reasons are well understood.

- **Leverage magnifies losses as well as gains.** The portfolio holds more exposure than the cash invested. If the market and the added strategies fall together, the loss is larger than in an ordinary portfolio.
- **Correlations rise in a crisis.** Strategies that looked independent in calm markets can lose money at the same moment. This is when diversification is most needed and least reliable.
- **Liquidity can run out.** Futures require margin that rises when markets fall. An investor whose added strategies cannot be sold quickly may be forced to cut market exposure at the worst prices. This was the central failure in 2008.
- **Financing has a cost.** When short-term interest rates are high, the hurdle the added strategies must clear is high too.
- **It can trail the market for years.** If the added strategies earn less than the financing cost, the investor would have done better simply holding an index fund. A stretch like that can last long enough to test anyone's patience.
- **Models can be wrong.** Systematic strategies are built on historical relationships that may not persist, and errors in data or code can produce unintended positions.

What it takes to run well

The lesson of past failures is that the structure matters as much as the strategies inside it. Five disciplines do most of the work.

1. **Keep enough of the added strategies liquid.** Some can be illiquid, but enough should be able to be reduced within days, so that a margin call is met by trimming them and not by being forced into selling market exposure.
2. **Set the level of risk in advance.** The total risk of the portfolio is agreed with the investor and written down, and leverage is sized to that level and no higher.

3. **Hold a cash reserve against margin.** Enough to withstand a severe market fall without forced selling.
4. **Measure risk across the whole portfolio.** The market exposure and the added strategies are assessed together, including how they behaved in past periods of stress.
5. **Watch cost and tax.** Financing, trading and fees are counted against the return, and for a taxable investor the result that matters is the one after tax. Index futures used for the market exposure are generally taxed 60% as long-term and 40% as short-term gains, whatever the holding period, and gains are recognized each year. Many active strategies produce mostly short-term gains, so where an investor has both taxable and tax-deferred accounts, the higher-turnover strategies are often better placed in the tax-deferred ones.

None of this removes the risks described above. It reduces the chance that a bad period becomes a permanent loss.

Who it suits

The approach suits an investor with a long horizon who wants to stay invested in the market, can tolerate leverage, and will not need to withdraw during a downturn.

It does not suit an investor who needs the capital within a few years, who would be forced to sell after a large fall, or who is uncomfortable with a portfolio that will sometimes lag a simple index fund. For those investors a conventional allocation is the better choice.

For a family, the decision is rarely about this approach alone. It depends on what else the family owns, what it owes, its tax position and what the money is for. That is why at Tulan it is considered as one part of the whole balance sheet, and used only where it fits.

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Strategies of this kind use leverage, futures, options and short selling. Leverage magnifies both gains and losses, and losses can exceed the margin posted and, in some cases, the amount invested. Diversification does not guarantee a profit or protect against loss. Investing involves risk of loss that investors should be prepared to bear.

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