Modern portfolio theory divides the return on an investment portfolio into a market-related component multiplied by beta, a measure of volatility, and alpha, the specific return associated with a portfolio that is independent of the market. In effect, alpha measures a money manager’s skill in creating excess return over the market benchmark.

Traditionally, pension plans and other institutional investors search for active money managers who can deliver excess returns over the benchmark for their asset class on a consistent basis year after year. That is a tall order, however, for the most efficient asset classes, like large capitalization stocks or Treasury securities. There are so many investors tracking these assets that prices immediately adjust to new information. It’s hard to get an edge.

Now some institutions are looking for other ways to beat their benchmarks, and in many cases this involves the use of derivatives. One of these methods is the so-called portable alpha strategy.

Portable alpha assumes that active managers cannot beat the benchmark for an efficient asset class. The investor therefore takes a passive approach—obtain the market returns, or beta, by using futures or swaps based on an index, such as the Standard & Poor’s 500 or the Dow Jones Eurostoxx 50. The target alpha from this part of the strategy thus becomes zero. Second, the investor allocates the cash freed up by the use of derivatives to an investment manager who can offer greater potential to generate alpha on a consistent basis.

In other words, portable alpha is a way to separately optimize two parts of the investment process—the strategic allocation among asset classes and the search for skillful investment managers. In contrast to hedging applications, the derivatives are not used to offset market risk. Instead they are used as a mechanism to replace active managers in one asset class and shift assets to active managers in another asset class.

People in the investment management business have been discussing portable alpha strategies for at least 10 years, but the concept did not really begin to catch fire in the pension fund community until the equities bear market of 2000 to 2002, according to pension fund consultants. Throughout the 1990s, pension funds could rely on relatively simple long-only strategies because the bull market was generating such handsome returns. As stock prices sank, pension plan asset values declined, driving them to seek alternative ways to improve their returns. At the same time, declining interest rates made their long-term obligations look much larger.

For some institutional investors, the answer was to invest in hedge funds and other alternative investments. One advantage of the portable alpha approach is that it allows these investors to allocate money to
these alternative investments without giving up their traditional exposure to the equity markets, which they view as an important part of their long-term asset allocation strategy. For this reason, portable alpha programs are often described as an “overlay” on the equity allocation.

Portable alpha does involve leverage, but the risk can be minimized if the cash freed up by the use of derivatives is invested in assets that have no correlation with the passive part of the portable alpha program. A market neutral hedge fund, for example, should offer a pure alpha return with no correlation to the stock market.

Experts warn, however, that the degree of correlation has to be closely monitored. Hedge funds that appear to be market neutral in one type of environment may turn out to have beta exposure under a different set of conditions. For this reason, many institutional investors rely on fund of funds to select and track the active managers.

**Case Study: International Paper**

One example of an institution using this method is International Paper. The Stamford, Conn.-based company is the largest paper and forest products company in the world, and the largest private landowner in the U.S. The company’s defined benefit pension plan currently has $6.8 billion in assets and 175,000 participants and beneficiaries. It started looking seriously at portable alpha for large cap U.S. equities, its biggest asset class, in 1999, just as the long bull market was coming to an end.

Robert Hunkeler, vice president of investments at International Paper, explained that the pension fund had had “some success” with large cap stocks, but felt that this would be difficult to repeat going forward. The fund therefore began exploring several alternative approaches to equity investing with its investment consultant, Rocaton Investment Advisors.

“We worked with our investment consultant to analyze four different strategies: pure passive, enhanced indexing, core concentrated and portable alpha.” After looking at various combinations, International Paper settled on 60% enhanced indexing, 20% core concentrated and 20% portable alpha for its U.S. large cap portfolio.

Joe Nankof, a founding partner of Rocaton, worked with International Paper on its portable alpha program. He estimates that 10 of Rocaton’s 50-plus clients have implemented portable alpha programs since the beginning of 2002, encompassing “very significant” dollars. Nankof notes that although hedge funds are the vehicle of choice for most portable alpha programs, any type of strategy or fund that offers absolute returns will do. “If we find a manager who can outperform cash on a risk-adjusted basis to our satisfaction, that’s what we are looking for.”

Robert Hunkeler, vice president of investments at International Paper, is using a portable alpha overlay to boost returns on the pension fund's U.S. large cap equity portfolio.
To generate the alpha for its program, International Paper picked hedge funds. Hunkeler already knew something about hedge funds from a stand-alone investment run by Blackstone. “We thought that marrying hedge funds to an S&P-type derivative product made a lot of sense,” he says.

It took several years, however, before the company actually implemented the program. The first step was education. International Paper started studying hedge funds for the portable alpha mandate in early 2001. “We realized that we didn’t even know what questions to ask,” says Hunkeler. “We spent about three to four months visiting hedge fund managers, fund of funds managers, prime brokers and other experts in the field just to educate ourselves so that when we went to the RFP process we would be a little more knowledgeable.”

Then came 9/11, which sidetracked the project for a year while other priorities took precedence. Due diligence resumed in 2002 and the portable alpha program went live in June 2003 using funds of funds run by Blackstone and UBS Global Asset Management as well as an investment in Ramius Capital, a multistrategy manager pursuing various absolute return strategies. All three have near-zero beta.

Two years after the initial investment, Hunkeler is generally pleased even though the alpha managers have delivered lower returns than he expected. “Our going-in design was for hedge funds to deliver 4% to 6% net returns above Treasuries,” he says. “They have not achieved that goal over the last two years, but they have achieved an alpha that would be hard to get in the large cap market.” He won’t disclose the specific results, but he says the program has beaten the annualized total return on the S&P 500 by more than 200 basis points.

He adds that the decision to use portable alpha was driven by the search for excess returns, rather than pension plan demographics. “If the hedge funds we run are designed to be generally market neutral—pure alpha generators—the issue of matching assets and liabilities is best done somewhere else,” he explains.

Futures vs. Swaps

Portable alpha programs try to generate beta returns as cheaply as possible, which usually means synthetic exposure through futures or swaps. To handle this part of the program, International Paper hired NISA Investment Advisers. The St. Louis-based company manages $28 billion for 68 clients, and specializes in providing customized investment solutions for pension funds and other tax-exempt institutional investors, including American Airlines, the Missouri State Employees’ Retirement System and the Pennsylvania State Employees’ Retirement System.

Practical considerations drive the choice toward swaps in most cases, according to NISA chairman and chief executive officer Jess Yawitz, who spent 14 years teaching at Washington University’s Graduate School of Business and five years with Goldman Sachs before joining NISA’s predecessor in 1990. “Swaps give us lower tracking error against the underlying S&P 500 than using futures. No slippage. No difference as to when the market closed as there is with futures. No basis. We use futures for overlap programs, however. “We don’t have a firm-wide view that swaps always dominate futures in these overlay assignments,” Yawitz says, “To state it very simply, if you were to hire us to put this trade on for two days, we’d use futures. If instead you wanted to put it on for two years, we’d use swaps.” In asset rebalancing programs, for example, the firm almost always uses futures. “You can see why,” he says, “There’s no longevity to it. You
Portfolios are of course diversified to provide risk management. Calpers also favors futures. The California-based money management firm, which currently has more than $229 billion in assets under management, has traded exchange-based futures and options since 1988, and has authority to use derivatives in over 75% of its client portfolios. In addition, its portfolio management team includes a futures expert with over 10 years of experience trading S&P 500 futures.

Because hedge funds are a relatively new investment for International Paper, Hunkeler says he monitors them more closely than traditional asset classes, a task made easier by transparency so extensive his team struggles to keep up. “We get more details on these portfolios than we get on any of our traditional asset classes. We’re almost at the point where we can’t digest everything we get from them,” he says. For both traditional and hedge fund managers, Hunkeler worries most about style drift, i.e., a tendency for investment managers to drift away from their original mandate and pursue other types of investment opportunities.

International Paper’s program includes a generous 25% cash cushion to meet potential demands for additional collateral if the beta portfolio declines in value. “If the markets were to tank, we could draw on that margin without having to access any of the other investments in our pension fund,” Hunkeler says, “We could have 1987 and we wouldn’t have to tap anything else.” The rest of the fund includes investments in markets with enough liquidity to rebuild the cushion in an orderly fashion if necessary.

The cushion size is under review at the moment. “We could generate a little more alpha by lowering that cushion a bit and putting more money in the hedge funds,” says Hunkeler. If the portable alpha commitment grows, he will either increase the commitment to his existing hedge funds or look at other strategies. “We might have a core-satellite approach. We’ve got the core now so we might go out a little on the risk spectrum targeted to a particular area,” he says.

Hunkeler also is thinking about applying portable alpha to his core fixed income portfolio, which he sees as a prime candidate. “If you think the U.S. large cap equity market is efficient, the bond market is even more so,” he says. Finding a cost-effective instrument for achieving market exposure will be a challenge, however. There are no futures based on the Lehman Aggregate Bond Index, the benchmark for that part of his portfolio, and swaps based on that index are expensive.

Although portable alpha has served International Paper well so far, Hunkeler is not willing to bet the farm on the strategy. “A portable alpha program that represents 10% of your assets is probably about as much as you want to have right now,” he says. He worries that fund flows into hedge funds may curb returns or encourage style drift. Peer pressure plays a part, too: how far out on a limb is International Paper willing to go? But Hunkeler has no qualms about the portable alpha concept, even if the returns have fallen short. “I’ll take 200 basis points over the S&P any time,” he says. “If you could guarantee I could get that for the rest of my career I’m going home. I can’t beat that.”

Neil O’Hara is a freelance writer whose 29 years in the financial services industry in London and New York included 17 years as an international hedge fund portfolio manager. He contributes regularly to FTSE Global Markets, On Wall Street and Compliance Week magazines. His articles have appeared in Financial Planning, U.S. Banker, Complinet and Working Money.
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