Portable alpha

Maintaining your SAA while implementing a portable alpha strategy

Client case study

The organization

Recognizing the disparate alpha opportunities by public equity managers in different segments of the world, a large corporate defined benefit plan partnered with Russell Investments' Overlay Services team to implement a portable alpha strategy. Specifically, the strategy focused on perceived alpha opportunities in both Emerging Markets (EM) equity and U.S. Small Cap equity, supplementing those investments in markets with lower perceived alpha opportunities in U.S. Large Cap equity. The Overlay program was used to provide synthetic beta exposures (both long and short), to maintain adherence to its strategic asset allocation (SAA), and to implement the changes in a manner that mitigated costs and risks.

The challenge

Asset allocators around the world are challenged to find money managers that provide the best opportunities for alpha. Estimations of alpha tend to vary considerably by asset class—with less efficient markets tending to provide larger alpha opportunities relative to mature markets. Seeking to exploit the segments of the market with above-average potential for alpha, a large defined benefit plan sought a solution that could simultaneously minimize portfolio fluctuations relative to its SAA.

The solution

A portable alpha strategy can be an effective way for pension funds to pursue managers and asset classes that have a higher expectation of alpha. Asset classes such as U.S. Small Cap and Emerging Markets equity have been popular choices for pursuing alpha while U.S. Large Cap and Core Fixed Income strategies have tended to be areas with lower alpha expectations. An investor can attempt to capture more alpha by funding managers with a higher expectation of outperformance while simultaneously using derivative instruments to short the beta exposure required to maintain close adherence to the desired SAA. With the synthetic cash created by shorting the beta, an Overlay manager can purchase long derivative (beta) exposures in the asset class with lower alpha expectations.

An Overlay program can seamlessly provide the beta exposure (long and short) for a portable alpha strategy in a cost-efficient manner.

Mandate guidelines

In this case, the pension plan already utilized an Overlay manager to equitize its idle cash balances, and to reduce the risk of unintended exposures relative to its SAA. With this platform in place, implementing a portable alpha strategy was rather seamless. As shown in Exhibit 1, the client indicated a desire to maintain its SAA targets for U.S. Large Cap at 20%, U.S. Small Cap at 3%, and Emerging Markets equity at 5%. With these targets in place, along with the existing rules of the Overlay program, the client was assured that any overweight position to EM and Small Cap would be offset, more or less, with a short synthetic beta position within the Overlay program. Similarly, any underweight position to Large Cap would be filled with a long synthetic beta position by the Overlay.

Exhibit 1: Equity allocation

ASSET CLASS	STARTING PHYSICAL EXPOSURE	MANAGER CHANGES	SYNTHETIC OFFSETS	NET POSITION	POLICY TARGET WEIGHTS (SAA)
U.S. Large Cap	20.0%	-4.0%	+4.0%	20.0%	20.0%
U.S. Small Cap	3.0%	+1.5%	-1.5%	3.0%	3.0%
Emerging Markets	**5.0%**	**+2.5%**	**-2.5%**	**5.0%**	**5.0%**

Source: Russell Investments.

Implementation

Over time, the client identified and ultimately hired additional EM and Small Cap managers in which they had a high conviction of outperformance over the benchmark. In several scenarios, Russell Investments' Transition Management team was hired to manage the transaction costs and investment risks associated with liquidating a Large Cap equity portfolio and simultaneously replacing that exposure with S&P 500 futures contracts purchased through the Overlay program. When the circumstances permitted, this was accomplished through an Exchange-for-Physicals (EFP) transaction whereby an S&P 500 Index (or index-like) portfolio was instantaneously exchanged for an equivalent amount of S&P 500 Index futures and cash.[1] On the other side, the transition team purchased the targeted EM and Small Cap portfolios while coordinating with the Overlay exposures to short EM and Small Cap futures contracts. By trading both the target and legacy equity portfolios simultaneously with the long and short futures portfolios, through the same trading desk, the client achieved an outcome that controlled for risk and minimized transactions costs.

Some of the new EM allocations were in the form of commingled fund subscriptions. In several of these cases, a physical equity transition was not advisable due to local market fees and security transfer challenges. Since a cash subscription was the optimal funding method, the Overlay team offset the funding by executing a Block Trade at Index Close (BTIC) transaction on the MSCI Emerging Markets equity future. This is a pre-negotiated, off-exchange block transaction in which an investor can obtain the closing price on the underlying MSCI Emerging Markets Index (MXEF) less a basis. Since commingled fund transactions occur at the market close of the respective local EM countries around the globe, executing the futures through a BTIC transaction was the optimal method for aligning the offsetting exposure. Our pure agency, multi-venue trading strategy is to compete BTIC transactions with multiple bank counterparties to achieve the best execution for the client. In most instances, there was a cost savings of several basis points between the winning bid and the average bid.

An EFP transaction is often the lowest cost and lowest risk solution for converting a passive physical portfolio into futures and cash, and vice versa.

Other considerations

While the MSCI EM futures contract was the most frequently used instrument for managing the EM exposure for this client, other instruments were considered and used when appropriate. In cases where overnight liquidity (particularly during Asia Pacific trading hours) was necessary for reducing intraday risk, a basket of local EM country futures was utilized. In addition, total return swaps were considered for longer-term, strategic positions on EM, Small Cap, and Large Cap. Swaps are an excellent way to obtain beta exposure (long or short) with minimal tracking error risk to an investor's benchmark while locking in a financing rate for an extended period. Swaps are not ideal in cases where flexibility to adjust exposures is desired.[2]

Liquidity management and ongoing monitoring is critical to a successful portable alpha program. Since the Overlay program will tend to have larger synthetic positions when implementing portable alpha, maintaining an adequate buffer of cash is important for protecting against adverse market movements or unexpected changes in correlation between the long and short derivative positions. Larger synthetic positions also require greater amounts of cash to pay for initial margin. An efficient method for meeting broker margin requirements is to pledge government securities directly from a liquidity pool—essentially using the same security for two purposes and thus reducing overall cash needs.[3]

Another consideration is the difference in futures mispricing or swap financing levels between the long and short synthetic positions. These levels fluctuate due to many factors such as investor supply and demand, and bank balance sheet appetite. Financing levels may present opportunities or headwinds to the overall performance of a portable alpha strategy. For example, as of February 2019, a client could lock in a swap to pay the total return on the MSCI EM Index and receive three-month Libor plus seven basis points and simultaneously enter a swap to receive the total return on the S&P 500 Index and pay three-month Libor plus seven basis points. In this case, the financing rates equally offset each other, thus neutralizing the impact to holding synthetic positions. For reference, back in September 2018, there would have been a headwind of 43 basis points to execute the same set of swaps. This was due to unfavorable financing levels that reflected a higher demand for synthetic U.S. Large Cap exposure relative to EM exposure at that time.

The results

Over a multi-year period, the Overlay program was a critical tool in accomplishing the client's objective for implementing a portable alpha strategy. The Overlay helped maintain the desired beta exposures by taking long and short derivative positions in the appropriate asset classes, which resulted in a 70% reduction in the risk of unintended exposures (i.e., the risk associated with deviations from the SAA). Additionally, the partnership with Russell Investments benefited the organization through a number of strategies aimed at reducing the cost and risk of implementing manager fundings and redemptions.

[1] See Causey, B. (2014). "Rebalancing with EFPs". *Russell Investments Strategy Spotlight*.
[2] See Babst, R., Causey, B. (2014). "Equity Index Futures vs. Total Return Swaps". *Russell Investments Strategy Spotlight*.
[3] See Saucier, P., Causey, B. (2019). "Enhanced cash and liquidity management". *Russell Investments Strategy Spotlight*.

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For more information

Call Russell Investments at **800-426-8506** or

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