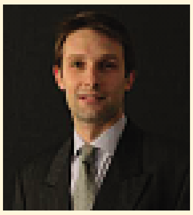
NEW AVENUES TO ALPHA GENERATION

The private banking industry must respond to the downturn in global returns by adopting innovative asset management techniques



Following a decade of straightforward stockmarket gains, the financial markets' meltdown at the turn of the Millennium drastically modified private investors' mood towards portfolio returns. The traditional stick-to-benchmark or relative performance philosophy gave way to the quest for alpha. This absolute return mindset, however binomially myopic pending on market trends, led to the blossoming of guaranteed capital structures as, faced with bear markets, even intrepid private investors favoured these capital protection instruments.

Despite this new "preservation" credo, like any emotional paradox, few investors are nonetheless willing to surrender performance for "peace of mind" insurance.

Consequently, to remain attractive, the private banking industry urgently needs to adjust its asset management approach.

REVOLUTION?

Rather a quickened evolution. Indeed, asset management techniques applied by private banks during the 1990s where coherent with a bullish environment:

- Strategic asset allocation invested in traditional asset classes based on long-term historical returns;
- Tactical asset allocation within tight bandwidths: why risk big divergences in a one-way up-trending market? Mirroring the benchmark in face of uncertainty proved to be a golden rule;
- Performance-driven portfolios where risk was a secondary perception.

Along came the market crash, the industry faced shrinking revenues, declining assets under management, pressured margins and growing client discontent, who questioned fee-based management practices in moribund markets resulting in wealth shrinkage. The industry was ripe for a change, putting into practice:

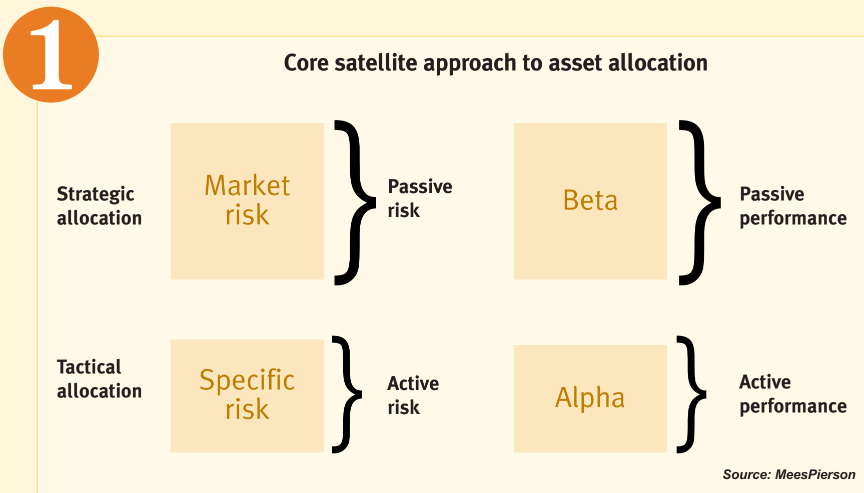
- Optimised strategic asset allocation encompassing all instruments that could contribute to improve active risk/return pattern;
- Active and sizeable tactical asset allocation;
- Risk-budget driven portfolio management;
- A maximised proportion of alpha in the active risk;
- The introduction of derivatives in the investment policy.

Concisely, today's environment requires exploiting new methods to manage private assets more efficiently, and in harmony with private clients' disposition. This is a persistent evolution using modern and sound financial engineering inherited from the institutional financial industry.

POLICY CHANGES

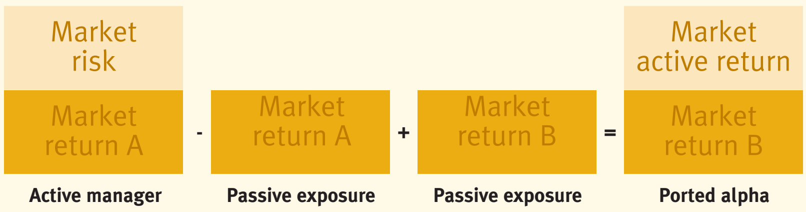
Changes to the investment policy have binary dimensions:

- Those increasing the total level of active risk;
- Those improving the efficiency of active return.
- Each component can be analysed in terms of impact on the total risk budget. An efficient way to manage a portfolio is to split it into two groups: the beta drivers and the alpha drivers (figure 1). A parallel with a core-satellite approach can be established where the core is beta and the satellite is alpha.



Core satellite approach to asset allocation

2 **Alpha portability**



Source: MeesPierson

Beta (or core) is mainly designed to passively replicate a broad “market” exposure. It has a perfect linearity with the financial markets and has rationally a tracking error, the difference between the return of a portfolio that is constructed to replicate an index and the return of the index itself, of zero. Hence, it is efficient (in terms of transactions cost, management cost, research cost) to use “market replicas” like exchange-traded funds, index certificates, or any form of index derivatives. Products that provide beta exposure should be offered as efficiently (low cost) as possible.

Alpha drivers are used to outperform the market and in nature have a high risk/return target. They are particularly useful when combined with beta drivers to change the overall return distribution of the strategic asset allocation. Unquestionably, they should have a non-linear return distribution to the market. Alpha drivers may be identified by their high tracking error to a benchmark (or by their lack of benchmark) and their least correlation (a standardised measure of the relationship between two series ranging from -1.00 to +1.00) with financial market indices. Finally, preeminent alpha drivers should have high capital intensity; maximised alpha per unit of capital invested.

Recent empirical evidence challenged whether alpha drivers deliver pure alpha (Jensen and Rotenberg found that event-driven hedge fund managers had a performance correlation of 0.66 altogether). Actually, active returns in each asset class or instrument may be considered having two components: the return attributable to market movements, and the residual return or alpha. When implemented, a pure alpha strategy has to take into account the “market” exposure for every alpha generator without adding distorting market dependency. At portfolio level, alpha and beta aggregates must be seriously controlled in order to avoid unbalanced effects, such as correlation factors.

Furthermore, active risk allocation should be made independently to strategic asset allocation (beta risk exposure). Techniques such as alpha portability may be employed to allow this and refers to the use of derivatives (alternatively by short positioning) to shift the source of active risk from one benchmark to another or simply to neutralise the “market” component of an investment as illustrated in figure 2.

Alpha can summarily be generated by:
- Identifying asset classes with sustainable potential alpha;
- Isolating best-in-class managers (alpha is an expertise-based business);
- Finding capacity, many premier hedge funds being closed to new investors due to scarcity of alpha sustainability;
- Being equipped with adequate quantitative tools.

The higher alpha generators per unit of capital are:
- Active overlay strategies using currencies or commodities for example. Currency markets are both highly liquid and inefficient allowing best-in-class managers to opportunely exploit attractive investment at low cost. These investments are mainly available through funds, or managed accounts;
- Global tactical asset allocation (GTAA) overlays are based on long and short positioning in index futures (asset classes, regions, sector) according to quantitatively forecasted returns. These investments are mainly available through funds, or managed accounts;
- Hedge funds using both directional or market neutral strategies;
- Active traditional managers via long-only stock-picking strategies;

NEXT STEPS

These investment strategies have already been successfully tried-out and are nowadays the norm within the institutional financial world. Eager to improve on its service offering, or left to struggle in survival mode, the private banking industry ought to respond to this environmental change by efficiently adopting and effectively offering these techniques to private investors.

Notwithstanding implementation barriers (actors’ technical knowledge, intricate regulation constraints), answering alpha portability remains an essential provisional competitive advantage. This conclusively explains the sudden attention surrounding the chase for alpha to the greatest benefit of private clients.

Eric Ebermeyer, global chief investment officer, MeesPierson

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