

Commentary: The case for taking a total portfolio approach — building a better portfolio in a low-return environment

By PETER HECHT AND DANIEL HEFFERNAN

Institutional investors face a daunting problem: expected returns from beta are falling but return targets have not. Stretched equity valuations are lowering future expected returns, with many investors recognizing that beta alone will likely not achieve their long-term objectives.

To address this issue, many investors have embraced “equity-plus” solutions, specifically long-only active management and private equity, but both come with unique limitations. We believe investors are largely missing out on a third equity-plus approach that may be more attractive: portable alpha, which has portfolio benefits best realized through a total portfolio approach (or TPA).

The challenges facing long-only active management are well known. Alpha has been difficult to generate consistently, even for skilled managers. Long-only constraints limit the expression of high-conviction views to being underweight rather than short. Worse still, increasing index concentration means that overweighting smaller stocks now also means underweighting tech stocks — a gamble most managers



From left, Peter Hecht and Daniel Heffernan. (AQR)

are no longer willing to take.

As a result, many investors have turned to private equity as a superior solution. On the surface, its combination of leveraged equity exposure and potential for manager alpha is an attractive source of excess return. Despite its understandable appeal, private equity comes with unique challenges; it is inherently illiquid, understates risk with artificially smoothed pricing, and most notably, charges performance fees on both alpha and beta.

Private equity's performance fee challenge arises from the tendency

for its investors to focus solely on headline returns without investigating its underlying sources. When examined closely, most of a private equity fund's returns typically can be explained by simple market beta. Once catch-up provisions are factored into fees, investors effectively end up paying both for alpha and the beta, which is available far more cheaply elsewhere.

Institutions increasingly realize these flaws, as demonstrated by PE fundraising falling to its slowest pace in a decade. As investors seek an alternative, we believe they

should take a fresh look at portable alpha, which combines a long-short hedge fund alpha strategy with a beta-1 overlay.

Like private equity, portable alpha also combines market exposure with the potential for manager skill, but with better liquidity, fee structures and portfolio outcomes. By relying on liquid instruments to access less constrained sources of alpha, it can also offer anywhere from daily to monthly liquidity. It only charges investors performance fees on its diversifying alpha strategy, with beta exposure coming for free. At the portfolio level, this translates to competitive returns with less downside risk since, unlike private equity, portable alpha isn't using its leverage to magnify the beta — rather, it uses it to provide exposure to the less correlated alpha strategy.

While these advantages may make portable alpha seem like an obvious solution for institutions, it remains niche compared to private equity. We believe that this has less to do with its investment merit than with many institutions' organizational structure.

Many institutions still subscribe to a traditional strategic asset allocation (or SAA) framework built around siloed investment teams, where public equities, hedge funds, private assets and other asset classes are sorted into different "buckets." As a result, CIOs are incentivized to meet varying objectives for stand-alone asset classes rather than an ultimate portfolio outcome.

This framework is not conducive to a solution like portable alpha, which combines hedge fund alpha with cheap equity beta, thus spanning more than one bucket by design.

One of TPA's most valuable benefits is that it encourages institutions to evaluate investments based on their contribution to total portfolio outcomes rather than the asset class silos in which they reside. Viewed through that lens, strategies like portable alpha no longer appear unconventional or difficult to implement but instead become a valuable tool for improving overall portfolio efficiency.

Promising multiasset solutions like portable alpha require a level of cross-silo coordination that institutions may find difficult due to governance constraints, issues of scale and other roadblocks. Consequently, an investment that may be attractive at the portfolio level can become infeasible to implement at the organizational level, demonstrating how organizational structure can influence portfolios more than any investment's merit.

Private markets and long-only active equities will undoubtedly continue to play an important role in institutional portfolios, but investors should ask whether private equity in particular has become the default answer to a problem with better solutions. Investors should prioritize opportunities that add demonstrated value to an entire portfolio rather than limiting themselves to solutions that fit neatly into existing silos or governance

structures. Portable alpha is a powerful example of how a total portfolio approach can materially improve investment outcomes, while providing benefits that extend far beyond any single investment strategy.

Peter Hecht is a managing director and head of the North America portfolio solutions group at AQR Capital Management. Daniel Heffernan is a managing director and senior member of the business development team at AQR Capital Management.

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