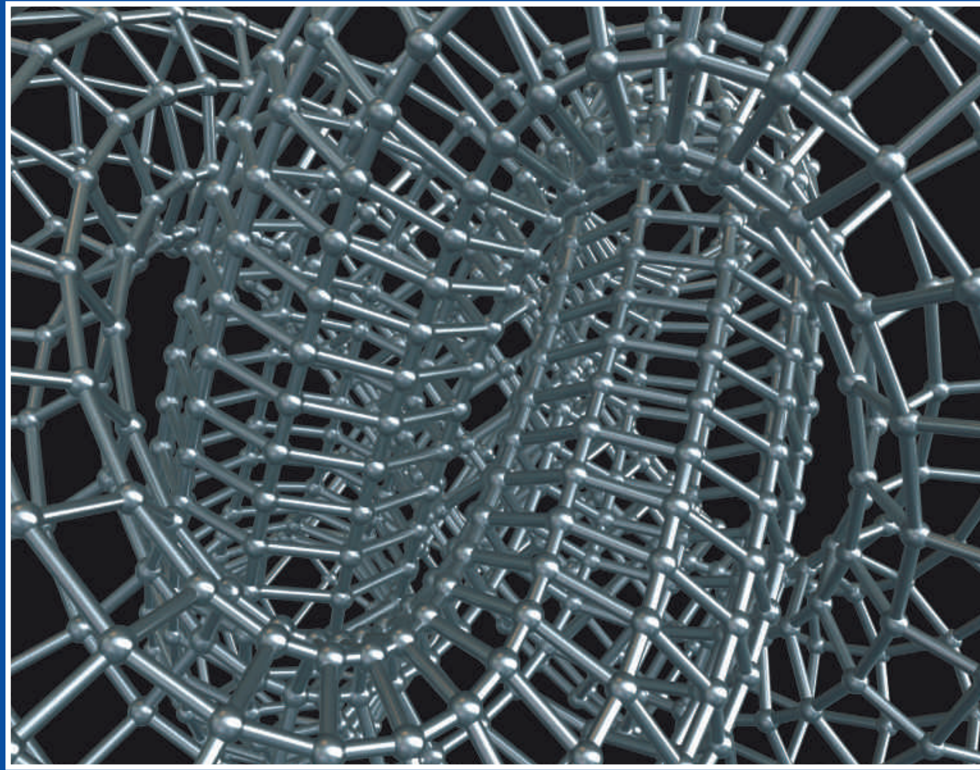
The perfect portfolio partnership



Lynnelle Jones and **Sorina Givelichian** argue that portable alpha and absolute return currency management are a perfect fit

The popularity of portable alpha comes as a result of the fact that it makes good sense, both theoretically and practically. Separating the management of market returns from manager skill and identifying absolute returns with little or no correlation to market exposures focuses fiduciaries on sources of portfolio risk and return.

Since investment return is a function of market exposure (beta) and manager skill (alpha), why pay high fees for exposures which are easily replicated via an index or derivative? Instead, investors are best served by allocating scarce resources, cash and risk, to markets and active managers where the expected return to risk is the highest.

The key to successful portable alpha programs is cost efficient market exposure and capturing non-correlated sources of excess return. Portable alpha enables investors to (i) budget risk, namely what an investor can afford to lose, and (ii) deploy capital more efficiently than traditional asset allocation.

Typically, the alpha manager is fully funded and the beta is captured via an index or a derivative exposure. However, not all betas or market exposures are easy and cheap to replicate and not all alpha sources require full funding.

Examples of strategic asset allocations that need to be funded are private equity, venture capital and infrastructure. Foreign exchange (FX) absolute return is one of the purest forms of non-correlated alpha and, unlike many alpha sources, requires little or no funding.

Unique asset characteristics

FX is often overlooked as an alpha source because people simply do not view FX as an asset. Currency is the only asset not valued in currency, but by another currency.

If one currency goes up, another currency goes down, pure relative value. It takes two currencies to value one, meaning the asset is not one currency, but a currency pair. Currency pairs do not have cusip numbers and they do not have dividends, but they are assets.

Another and equally important feature is the fact that currency markets, spot and forward markets, the largest most liquid markets in the world, are based completely on credit. It does not take cash to trade FX if an entity is creditworthy.

There is no cost for going long or short, no charge for borrowing a currency, no fee for lending and no central market or record of trade volume or price. Tourists, corporations and hedgers trade currency for exchange purposes only, but that doesn't change the fact that it is a unique asset and profitable currency trading is pure alpha.

International diversification introduces the currency asset – the base currency and international currency – into portfolios. Many investors have learned about the diversification aspect of currency the hard way, as relative currency movements have produced unanticipated, uncompensated and unwanted volatility.

Interestingly, but not surprisingly, when the currency pair produces positive value, the international asset manager is quick to take credit for adding value through skill. The reality is that currency is the source of diversification. International equity, fixed income and real estate markets are highly correlated without currency exposures.

Economic, political and psychological factors affecting values of currency pairs are very different from factors affecting other asset markets. Supply is controlled by Central Banks, many use markets only for exchange values and skilled absolute return FX managers can produce returns regardless of market environments.

Most currencies have only freely floated since the 1970s and many are still controlled by Central Banks. Due to the unique nature of currency and FX markets, there is no expected return, no beta, to holding any currency pair.

The skills required to understand and trade FX profitably are very different from the skills required to passively hedge currency exposure or actively manage equities and other assets. FX trading strategies, such as carry, trend and value, can be modelled and have been turned into indices, even referred to as exotic betas, but no one trading style has consistently been successful in currency markets. Simple indices, which may work for short periods of time or in back testing, do not represent skill, or alpha.

Separating risk from return

Currency risk is much better understood than currency return, although they are two sides of the same coin. FX exposure is easy to decompose and is an important risk to understand and measure.

Currency management, predominately risk reduction, grew from the desire to mitigate volatility from FX moves in international portfolios. Traditional "overlay", the passive management of neutralising currency exposures through hedging or offsetting positions, is well understood, mechanical as opposed to skill based and today outsourced for only a few basis points, much cheaper than only a few years ago.

Naturally, just as FX can bring unwanted volatility and losses, it can also bring profits, but the point is it can be identified, measured, neutralised and managed. Hedging 100% of currency exposure completely eliminates FX volatility and decreases portfolio risk exposure.

Risk, like cash, is a scarce resource and through portable alpha strategies is most efficiently and effectively allocated. An international portfolio's total risk budget is substantially increased by eliminating all FX risk or hedging 100% of exposure.

Leaving currency exposure unhedged or partially hedged (a more expensive proposition which is by nature constrained, managed to a benchmark and more difficult to measure) does not make sense in the discipline of implementing portable alpha.

Just because currency exposure can be actively managed without changing the underlying international asset exposures, does not mean this is optimal. The essence of portable alpha is to separate risks, remove constraints and understand sources of return, not mixing objectives or managing to benchmarks.

The unfunded alpha

Because currency trading does not require cash, it does not make sense to fully fund absolute return currency trading in portable alpha programs. Funding requirements should not be confused with trading leverage.

Trading leverage, controlled by managers, increases return and risk, a well understood concept. FX funding, on the other hand, is controlled by investors and funding requirements are a function of credit. Like everything in FX land, this is unlike other assets and best understood when carefully examined and evaluated.

A 5% return on US$100m invested in an unleveraged investment will give 5% or $5m. A 5% return on $100m invested in an actively managed currency account, funded with 10% or $10m, results in $5m or a 50% cash-on-cash return. A currency trader, like any trader, can use leverage, something transparent in a managed account structure, but this is very different from efficient funding.

The philosophy of separating beta and alpha makes risk budgeting and risk allocation important aspects of asset allocation. This approach to portfolio management allows traditional assets to be optimally diversified, with a variety of asset strategies improving overall portfolio performance via true diversification and high absolute return. In this context, FX risk is easy to decompose and cheap to neutralise, freeing capital at risk and increasing risk budgets.

Hedging 100% of FX exposure in international investments is cost efficient and highlights the correlations of markets and skill of active equity and fixed income managers. As a portable alpha strategy, FX offers attractive risk adjusted returns because it is uncorrelated to market exposures, easy to measure, efficient to implement and capital at risk is always controlled. The trick is finding positive alpha and skilled absolute return FX managers.

Mixing FX risk and return objectives, managing to international benchmarks or confusing passive or simple FX strategy indices with skill will inevitably result in expensive and undesired results.

The beauty of portable alpha is that risk capital can come from any asset class without having an effect on desired market exposures or the asset allocation of the overall portfolio. This is why portable alpha and unfunded absolute return currency management are a perfect fit.

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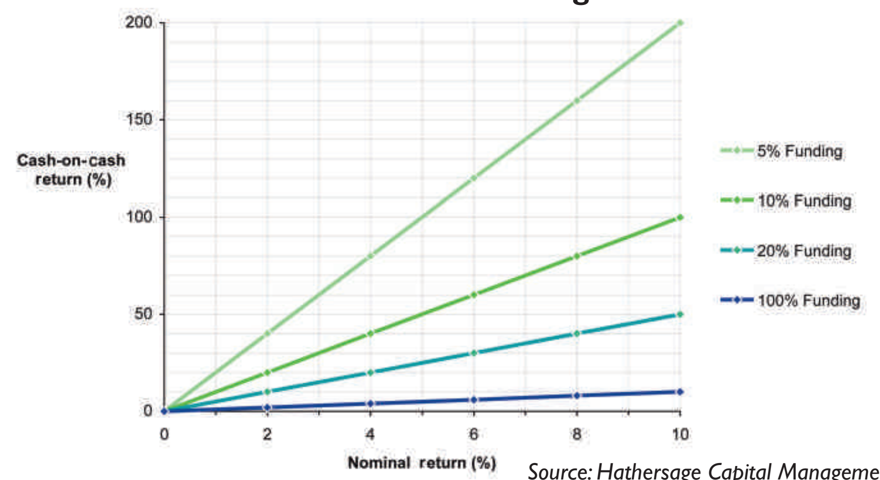
Chart 1: Cash-on-cash return versus nominal return at different notional funding levels



Source: Hathersage Capital Management