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Return of Portable Alpha Strategies

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In the past few years we have seen a resurgence of the use of portable alpha strategies tied to hedge fund investments (and the financing arrangements that accompany them), a trend that this old-timer last encountered more than 15 years ago prior to the global financial crisis. For those that are not familiar, the concept of portable alpha is simple. A manager that is charged with outperforming a specific market index will invest in two categories of assets: (a) the assets comprising that index and (b) an uncorrelated asset that the manager expects to outperform that index. The index assets provide the manager's "**beta**" return, and the uncorrelated assets (hopefully) provide the "**alpha**" return that enables the manager to beat the return of its benchmark index.

This strategy presents an opportunity for hedge fund managers to be the source of alpha, as the goal of many hedge funds is to provide absolute returns – positive returns regardless of market conditions – through the use of derivatives, arbitrage, short selling, leverage and other unconventional assets. We are increasingly seeing hedge funds offer investors (such as pensions, and endowments) that are seeking returns indexed to a benchmark a pre-packaged portable alpha strategy, that works something like this.

The hedge fund manager will set up a dedicated vehicle for the investor. The vehicle will invest in (1) a total return swap on the benchmark index and (2) one or more hedge funds managed by the hedge fund manager. Since investing in a swap provides the same exposure to the index, but requires much less capital than investing in the index assets themselves (a swap just requires a small amount of upfront margin), that frees up the majority of the vehicle's cash to invest in the hedge funds. As long as the net return on the investment in the hedge funds exceeds the financing cost embedded in the index swap, the strategy will provide a higher return than investing directly in the assets comprising the index.

Such vehicles often enter into a credit facility. The credit facility provides access to cash for the vehicle to meet variation margin requirements on the swap, and also provides capital to rebalance the targeted exposure between the index swap and the hedge fund investments. Such credit facilities are typically secured by a pledge over the interests in the hedge funds. Unlike private equity funds, hedge funds are semi-liquid due to the ability of investors to redeem their interests in the hedge fund periodically. In connection with underwriting a credit facility, it is important for lenders to understand the timeline for redemptions from the hedge funds that are pledged, as well as the ability of the hedge fund manager to suspend or delay redemptions or impose gates. The exact terms for redemptions in a default scenario are often detailed in side letters with each of the hedge funds.

Since the collateral may consist of a limited number of hedge funds (and sometimes just one fund), it is also important for lenders to look through to the trading strategy of, and assets owned by, the hedge funds. The hedge funds often provide detailed reporting as to the overall profile of their investment portfolio (detailing gross leverage, net leverage, amount of level three assets, VAR, volatility, etc.), and the value of the hedge fund interests for purposes of determining borrowing base compliance under the credit facility, may be subject to adjustment if the investment portfolio fails to stay within certain parameters.

Portable alpha vehicles can be beneficial both to the investor (helping the investor to beat its benchmark) and to the hedge funds (bringing in additional investment to the underlying funds). We often see periods of market volatility result in increased allocation of capital to hedge funds. In the current environment, it would not be surprising to see strong continued interest in these vehicles.