Investment
INSIGHTS

PORTABLE ALPHA SEES RESURGENCE

Philip Seager
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Portable alpha in quantitative investing is making a comeback. After debuting in the mid-1980s, the strategy thrived until the great financial crisis, when it fell out of favor in the ensuing bull market. Pensions & Investments' annual survey of the 200 largest U.S. retirement plans showed that assets in portable alpha strategies peaked at $50.3 billion in 2007 and declined in successive years.[1]

Now, market shifts, the rise of alternative data and investors' greater need for uncorrelated returns are turning in portable alpha's favor. According to Philip Seager, Head of Portfolio Strategy at Capital Fund Management, or CFM, institutional investors are once again considering the strategy because of its capital efficiency, diversification and ability to substitute for an asset class while generating an enhanced return for portfolios.

WHAT IS PORTABLE ALPHA?

At its most basic level, the strategy aims to invest in market exposure for an asset class while freeing up cash to generate "portable" alpha from other assets that have little or no correlation to the beta asset. The source of the portable alpha is independent of the desired beta exposure and thus can be transported to any market exposure.

The strategy uses leveraged derivatives or other instruments to gain synthetic exposure to the beta asset class, Seager explained. "A real money equity portfolio can substitute real equity exposure with synthetic exposure through the use of an equity derivative. In so doing, cash is freed up which can then be used to invest elsewhere. Ideally, this cash is then invested in something producing alpha with low correlation to the equity portfolio."

Investors can reap several benefits by using portable alpha, which include:

- **Capital efficiency.** Freeing up cash via derivatives is an efficient use of capital. Portable alpha invests in both beta and alpha by using cash that normally would be allocated only to beta.

- **Enhanced return potential.** Portable alpha offers the potential to outperform the beta asset class across different market cycles.

- **Diversification.** Diversification is always in demand, perhaps more so in today's market and macro environments. "As we go through time, the need for diversification remains unchanged," Seager said. "So today, there is definitely a need for diversification that portable alpha can satisfy."

HOW LEVERAGE CAN REDUCE RISK

Portable alpha involves leverage through the use of derivatives. Investors commonly — and not incorrectly — associate leverage with risk, but Seager sees this view of leverage as being the "bogeyman" of investment, due to its misuse at various times in history, as being somewhat unfortunate. CFM has long pursued a systematic and scientific approach for its investment strategies.

The use of leverage, he said, requires "the relevant experience to be able to use it appropriately and effectively. We use leverage to control our risk and maintain it at a constant level. We run high levels of unencumbered cash in our products precisely for this reason." Seager said that leverage can actually reduce risk when properly deployed by experienced managers.

WHAT DOES THIS LEVERAGE COST?

Much has been written on the subject of the cost of using derivatives to generate equity exposure. "Using a derivative effectively requires borrowing," Seager said. "The fact that you're borrowing money is embedded in the price of derivatives. The cost of the priced interest rate will fluctuate with supply and demand patterns as the market looks to use derivatives for synthetic exposure and market providers step in to lessen any mispricing." He added that similar to the U.S. Treasury market and the corresponding futures market, "the basis trade in fixed income markets serves to increase the level of efficiency in these markets. Much the same mechanism exists in equity derivatives markets."

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IS IT LUCK OR SKILL?

CFM's portable alpha investment process is systematic and rules based. It incorporates scientific thinking, so much so that the firm intentionally recruits scientists and others with an academic background who believe in scientific rigor. They test data sets and strategies to determine whether data is sufficiently viable to contribute to outperformance.

As a systematic strategies manager, CFM is statistically able to distinguish luck from investment skill, Seager said. "If someone buys a stock on a given day and it goes up, they've made money. If they do that on a few consecutive days, they may confuse that with genuine skill. It's easy to reach that conclusion, but it often comes down to good luck."

Through its systematic process and statistical framework, CFM can differentiate between strategies that are lucky and those that generate alpha based on data signals that have a chance of succeeding in the future, he explained. This quantitative, systematic approach contrasts with that of discretionary investors, who typically go on a gut instinct that doesn't necessarily have any grounding in statistics.

"If you were to go down to the pub with discretionary investors and talk to them about their track record, they will describe their most successful trades with more clarity than their losing trades. This is a bias that people have in not being able to distinguish between skill and luck. Our ability to statistically make that distinction is an advantage," Seager said.

RISE OF ALTERNATIVE DATA

Seager partially attributes CFM's ability to be more skillful than lucky to what's become known as "alternative data," the proliferation of which has risen over the past few years. Around 2010, the firm began to analyze satellite and weather data, which it used to forecast pricing for agricultural and energy futures contracts.

Perhaps the most stereotypical alternative data is credit card data, according to Seager. "Computers are very good at churning massive amounts of credit card transactions. These transactions, at least for consumer-facing companies, provide a more timely estimate of a company's sales than a company's financial filings," he said. "More and more alternative data is powering a big part of our systematic strategies."

Machine learning is one of CFM's primary tools in analyzing data and finding patterns that it can use to build algorithms. "Machines are very good at processing large amounts of information, so we are better informed than any individual human just through the fact that our computers are able to crunch all of this data and use it in algorithms," Seager said.

Improvements in data and machine learning will eventually benefit systematic investing as a whole. "The systematic, data-driven quant-style techniques will be better informed and more robust in producing performance as we go forward because the technology is advancing and the amount of data is increasing," he predicted. "Although machine learning isn't new, the sheer level of data and computing power available now is constantly growing. In our view, systematic techniques will dominate and ultimately take over in the investment industry," he predicted.

Looking ahead, Seager said he expects the basic underpinning of portable alpha — synthetically investing in beta while potentially generating alpha from uncorrelated assets — won't change much. Yet it will continue to progress with more data availability, better technology stacks and the nurturing of better technologies. CFM commits considerable resources to technology and research, which Seager said will remain in a continuous state of development. "We'll never be able to put our feet up and say we've found everything," he said. "It's simply a question of always taking your success and reinvesting it back into the firm, which to us means doing more and more research." ■

[1] Pensions & Investments article, April 8, 2025, https://www.pionline.com/alternatives/portable-alpha-gaining-popularity-again-hedge-fund-investors-and-managers-will-time-be/

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