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Portable Alpha Revival: A Solution to the Beta/Alpha Mismatch

Investors face a new regime, with heightened geopolitical risks and beta sources expected to deliver lower returns than they have in years past. At the same time, market concentration still poses a challenge for active managers seeking to enhance those betas. We don't think investors should by any means write off active management, but they'll need to think differently about how to integrate it into their portfolios.

Doing this requires addressing a mismatch between desired portfolio beta exposures and the most fruitful alpha sources. Alpha potential is alive and well in less-efficient and less-exploited market segments, such as small-cap and emerging-market (EM) equities, but few investors are willing to budget substantial beta to those areas. Multi-manager hedge funds also seem like effective alpha generators, but how can investors connect their beta and alpha worlds efficiently?

We think one answer lies in a strategy familiar to many investors yet more refined than the version from decades ago: portable alpha. This solution can efficiently tap into a wide range of attractive alpha streams with capital efficiency while keeping strategic asset allocations on track. If investors implement and govern portable alpha correctly, it may be a powerful tool.

Daniel Loewy
Alla Harmsworth

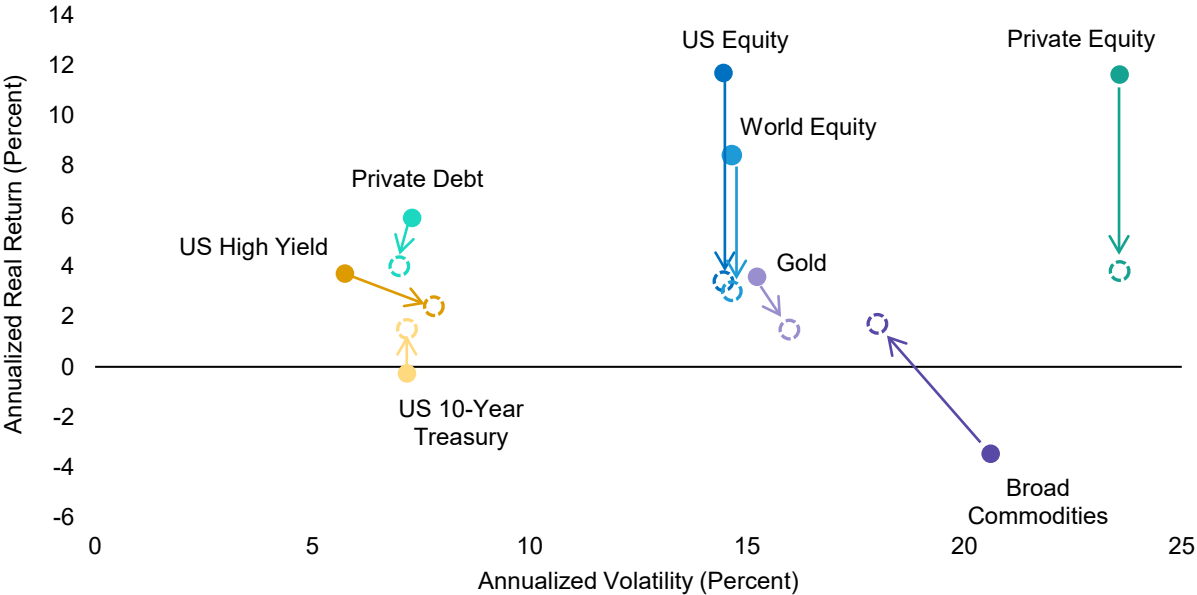
Additional Contributors: Harjaspreet Mand

A Tougher Road Ahead for Most Beta Sources

Investors face a unique mix of structural challenges today: deglobalization, demographics, climate change, record government debt and geopolitical uncertainty. One of the results could be higher inflation and interest rates, which might challenge the role of bonds as “safe” assets and diversifiers to equity exposure. Economic growth will likely be lower, too, implying reduced return potential for many equity markets and growth-sensitive assets. And with valuations high for most key asset types, multiples face mean reversion risk over a strategic horizon.

In our view, all this translates into a worse real-return outlook for many traditional asset-class beta sources (*Display 1*) and fewer diversification opportunities. This landscape is a far cry from 1980–2020, when rates were falling, disinflation was the norm and diversification was plentiful. The bottom line: traditional asset classes are more likely to underdeliver for investors, and the potential return boost from pivoting into riskier betas seems much more muted. This creates a tough spot for investors focused on total return or real return.

DISPLAY 1: A MORE-CHALLENGING LANDSCAPE AHEAD FOR TRADITIONAL ASSETS
 REALIZED RISK AND RETURN VS. FORECASTS



Current analysis and forecasts do not guarantee future results.

Filled dots represent actual real returns and volatility for January 2010 through December 2024. Dashed dots represent the AB Institutional Solutions team's forecasts for the next five to 10 years. Private equity return data is the US Private Equity Index from Cambridge Associates, compiled from 1,562 funds, including fully liquidated partnerships, formed between 1986 and 2019. All returns are net of fees, expenses and carried interest. Data are provided at no cost to managers. Private equity volatility is estimated from the MSCI US Small Cap Value Index with 15% leverage. Private debt historical volatility is the volatility of the Preqin Private Debt return index.

As of March 26, 2025

Source: Cambridge Associates, FactSet, Federal Reserve Bank of St. Louis, Ken French Data Library, LSEG Data & Analytics, Preqin and AllianceBernstein (AB)

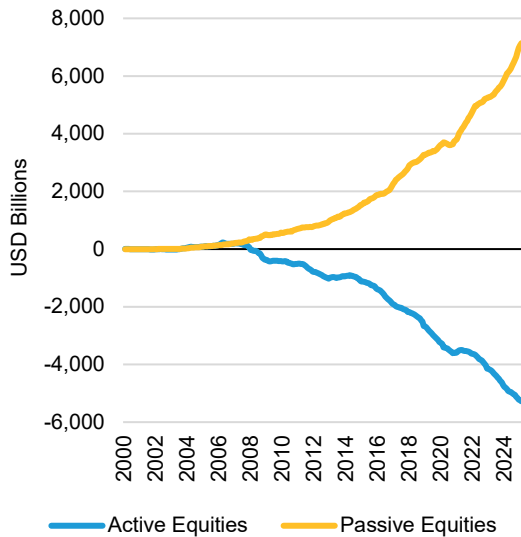
A difficult beta outlook intensifies the need for alpha (the return from active management above the market), but alpha seems harder to find. The median manager in US large-cap equities—the biggest beta pool and largest allocation in many portfolios—has generated zero alpha before fees and negative alpha after fees for at least a decade. Even top-quartile managers have beaten their benchmarks by only 0.6% annualized over the past decade, on average. Managers using other large-cap

developed equity benchmarks—growth, value and core—have also struggled to add value in recent years, a challenge exacerbated by the market’s high concentration in mega-cap tech—the Magnificent Seven problem.

Investors have responded by joining two of the biggest asset-allocation trends of the last two decades: exiting active equity strategies in favor of passive and moving from liquid public markets into private markets, especially private equity (*Displays 2 and 3*). Hedge funds, once a big beneficiary of the move into alternatives, have failed to keep pace, with investors’ allocations to these alpha-centric, low-beta portfolios largely stalling.

DISPLAY 2: INVESTORS ARE EXITING ACTIVE EQUITIES FOR PASSIVE

GLOBAL FLOWS INTO EQUITY FUNDS

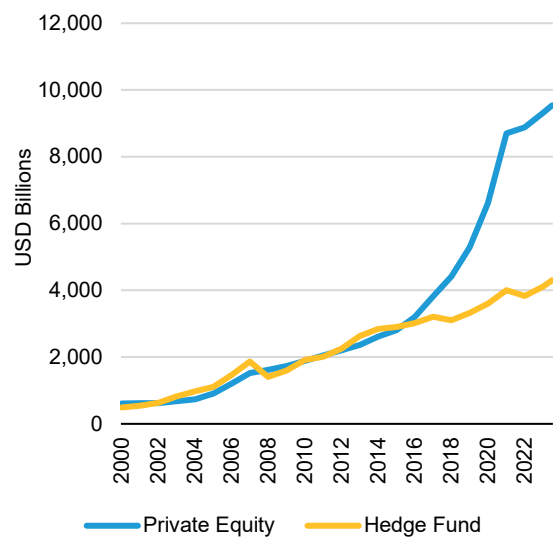


Historical analysis does not guarantee future results.

Through February 28, 2025
Source: Emerging Portfolio Fund Research Global and AB

DISPLAY 3: PRIVATE EQUITY ASSETS HAVE SURGED

ASSETS UNDER MANAGEMENT (AUM)

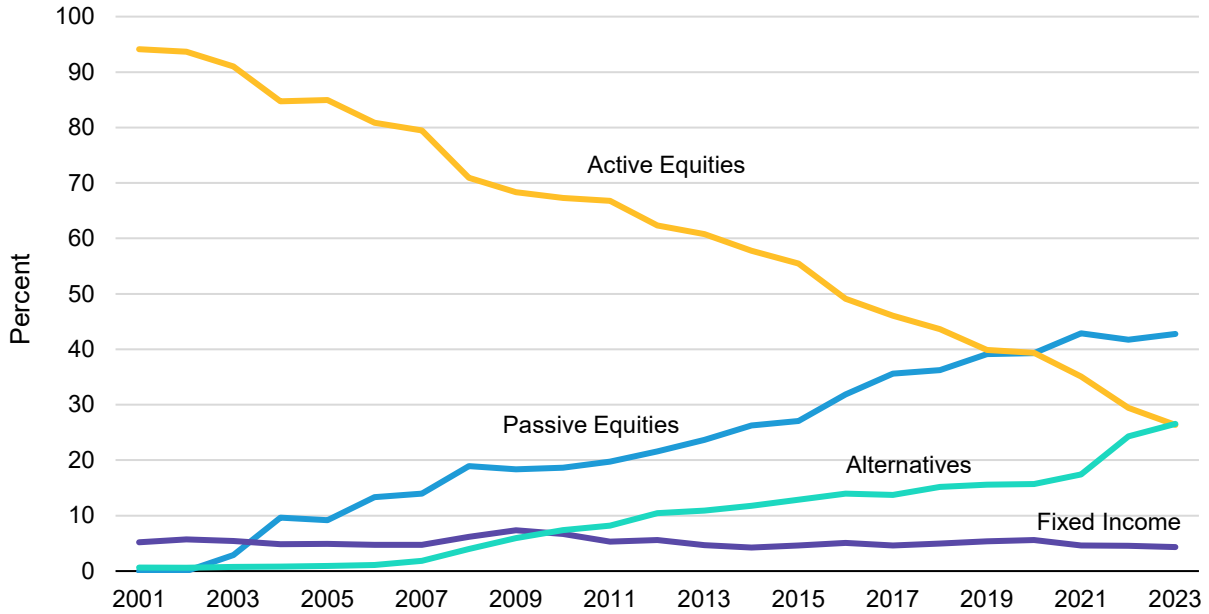


Historical analysis does not guarantee future results.

Through June 31, 2024
Source: Prequin and AB

How can we get a feel for the scope of this shift? Investors have been directing capital into passive indices on the one hand and into illiquid private equity on the other (less so into other private assets such as debt, real estate, infrastructure and natural resources assets). As a result, the shares of total portfolio risk accounted for by active public equity and private equity (and other alternatives) have crossed over for the first time (*Display 4*).

DISPLAY 4: CHANGING OF THE GUARD IN PORTFOLIO RISK CONTRIBUTIONS
RISK CONTRIBUTION FOR US PENSION FUNDS BY ASSET CLASS



Historical analysis does not guarantee future results.

We use the capital allocation of US pension plans as the base and assume that “alternatives” is a 50/50 combination of private equity and hedge funds. For private equity, we use a public-market-equivalent time series (essentially a smaller-cap, value-tilted index with leverage). For hedge funds, we use the HFRX Aggregate Index. Given constraints on data availability for alternatives, we use a constant variance/covariance matrix over the full time period, rather than a rolling one. For fixed income, we use the Bloomberg Global Aggregate Total Return Index.

Through December 31, 2023

Source: Bloomberg, Hedge Fund Research (HFR), LSEG Data & Analytics, Public Pension Plan Database and AB

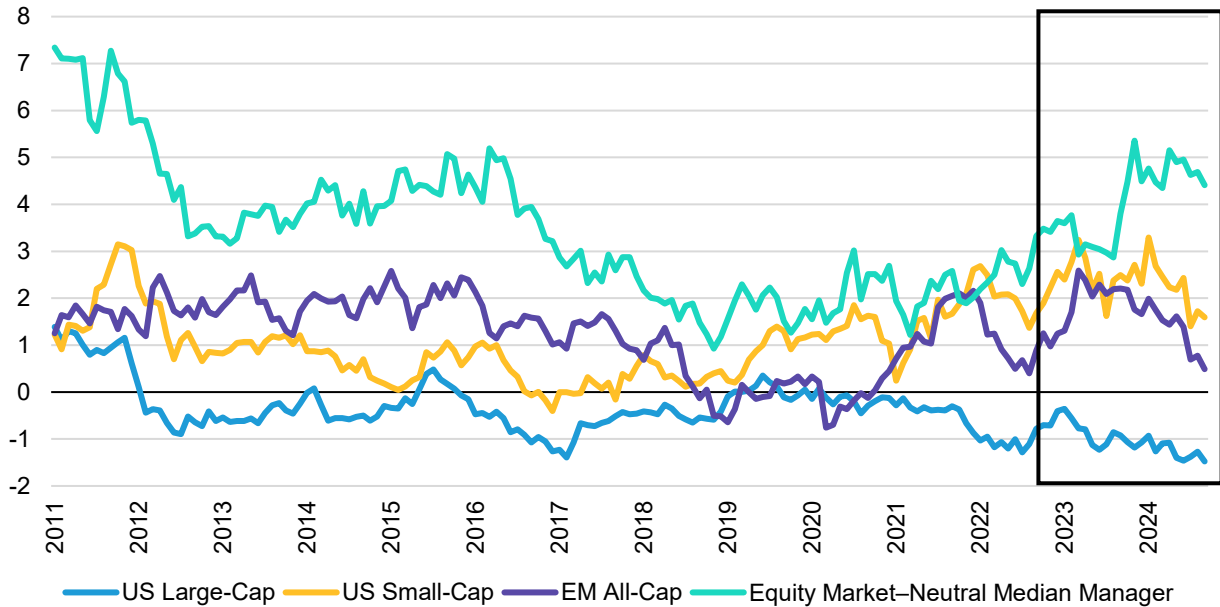
While the shift to passive and private equity may have been beneficial in a market that has clearly favored US large-cap beta, we question whether this is the correct positioning going forward in a low-return environment. We think investors should be cautious about seeing private equity as a panacea—it poses liquidity risk and is subject to the same valuation risks as public equities. With a record amount of dry powder chasing private equity, returns will likely experience the same (or more) downward pressure as other asset classes.

Yes, private equity (and other private assets) plays an important portfolio role, but the glut of capital inflows may lead returns to fall short of expectations and produce unexpected systemic risks—particularly if these illiquid investments continue to find their way into portfolios that need liquidity in times of market stress.

Alpha Is Essential, but Scarce in the Largest Markets

We don’t believe that abandoning active management and the pursuit of alpha in public markets is the answer: alpha plays an important role in a low-return world. While it’s hard to consistently find positive and lasting alpha, it has by no means gone away. Large-cap active managers have struggled over the past decade and particularly the past few years, but small-cap, emerging-market and equity market-neutral hedge fund managers have consistently beaten their benchmarks (*Display 5*). In our view, this demonstrates the value of seeking active returns in public markets.

DISPLAY 5: ALPHA GENERATORS REMAIN AVAILABLE IN PUBLIC MARKETS
 ROLLING 36-MONTH EXCESS RETURN OF AVERAGE MANAGER (PERCENT, NET OF FEES)



Data do not represent past performance and are not a promise of actual results or a range of future results.

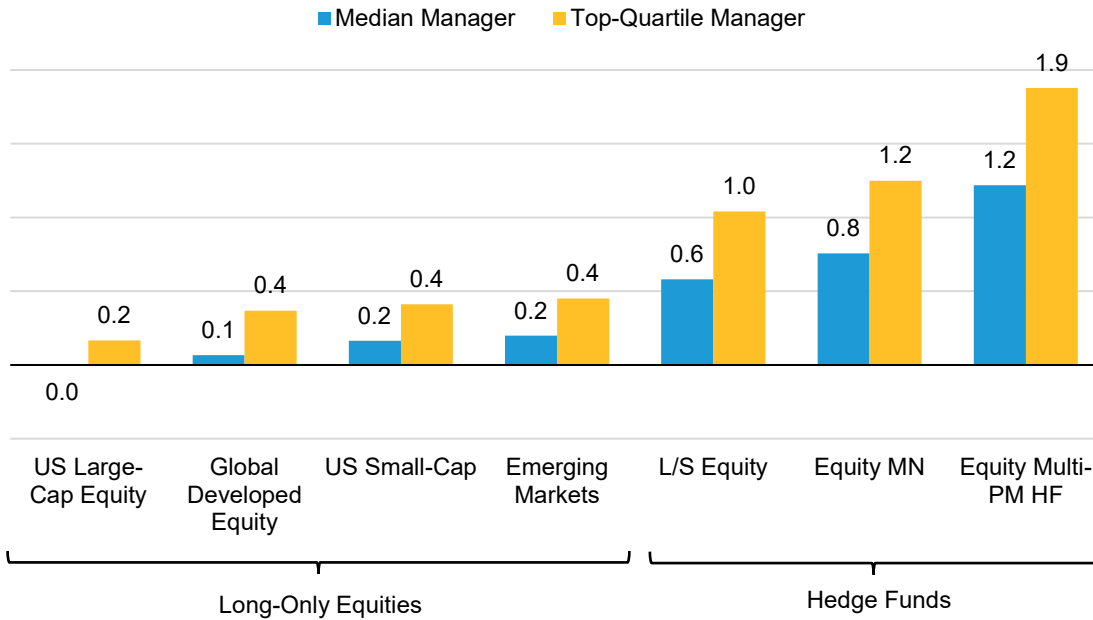
Data based on USD gross returns of a sample of 10,000+ equity funds and 3,000+ fixed-income funds sourced from eVestment and Morningstar. Hedge-fund data are sourced from Hedge Fund Research (HFR). Net-of-fee returns are calculated assuming a 25 bps annual fee for US large-cap equity and a 50 bps annual fee for US small-cap and emerging markets. eVestment and Morningstar geographic focus, style and market focus are used to group funds into subcategories. Funds' individual stated primary benchmarks are used to estimate excess returns. Display shows long-term average excess returns for the median and top-quartile manager in fund categories estimated over rolling 10-year periods from April 1999 to September 2024. Morningstar data is © 2025 Morningstar, Inc. All rights reserved. The Morningstar information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete, or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information

Source: eVestment, HFR, Morningstar and AB

Investors face a beta/alpha mismatch as they pursue alpha. They must broaden their view beyond large, efficient market segments to find alpha potential in less-explored regions and segments that enable higher information ratios—active return per unit of tracking error (*Display 6*). In small-cap and emerging markets, the rewards (on average, over the long term) are 0.2 units of return per unit of volatility for the median manager. For top-quartile managers in those categories, and in larger, developed global equity benchmarks, return-to-risk ratios are 0.4 or above.

Equity-centric hedge funds have demonstrated impressive alpha-generating capabilities. Their edge in active-return generation makes them fruitful areas for sourcing alpha, and the more market beta they've hedged out, the better their risk-adjusted returns have been. Equity multi-manager hedge funds stand out with the strongest risk-adjusted active returns, as they also benefit from broad alpha diversification: the top-quartile manager produced an information ratio of 1.9.

DISPLAY 6: ALPHA IS RICHER IN HEDGE FUNDS AND LESS-EFFICIENT MARKETS
INFORMATION RATIOS OF MEDIAN AND TOP-QUARTILE MANAGERS (NET OF FEES)



Data do not represent past performance and are not a promise of actual results or a range of future results.

Data based on USD gross returns of a sample of 10,000+ long-only equity funds and 3,000+ long-only fixed-income funds sourced from eVestment and Morningstar. Hedge-fund data are sourced from Albourne and HFR. Net-of-fee returns and information ratios are calculated assuming a 25 bps annual fee for US large-cap and global developed equity and a 50 bps annual fee for US small-caps and emerging markets. We use eVestment and Morningstar geographic focus, style and market focus to group funds into subcategories. We use the funds' individual stated primary benchmarks to estimate excess returns. Display shows long-term average excess returns for the median and top-quartile manager in fund categories, estimated over rolling 10-year periods from April 1999 to June 2024. Morningstar data is © 2025 Morningstar, Inc. All rights reserved. The Morningstar information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete, or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

Source: Albourne, eVestment, HFR, Morningstar and AB

Unfortunately, most investors have been unwilling or unable to add much underlying benchmark risk to support a meaningful allocation in these richer alpha segments. Small-cap and emerging-market stocks account for small shares of cap-weighted indices, and hedge funds typically hedge out most, if not all, beta risk explicitly. This forces investors to choose between attractive but uncertain alpha and owning equity or bond risk premia in their asset mixes.

This dilemma highlights the lack of alignment between the asset allocation investors may want and the availability of alpha sources in those markets: alpha is scarce in the largest markets that play the biggest roles in portfolio beta allocations. This issue also hints at a possible solution that endured a shaking-out period during the global financial crisis (GFC) and, with lessons learned, seems poised for a revival: portable alpha.

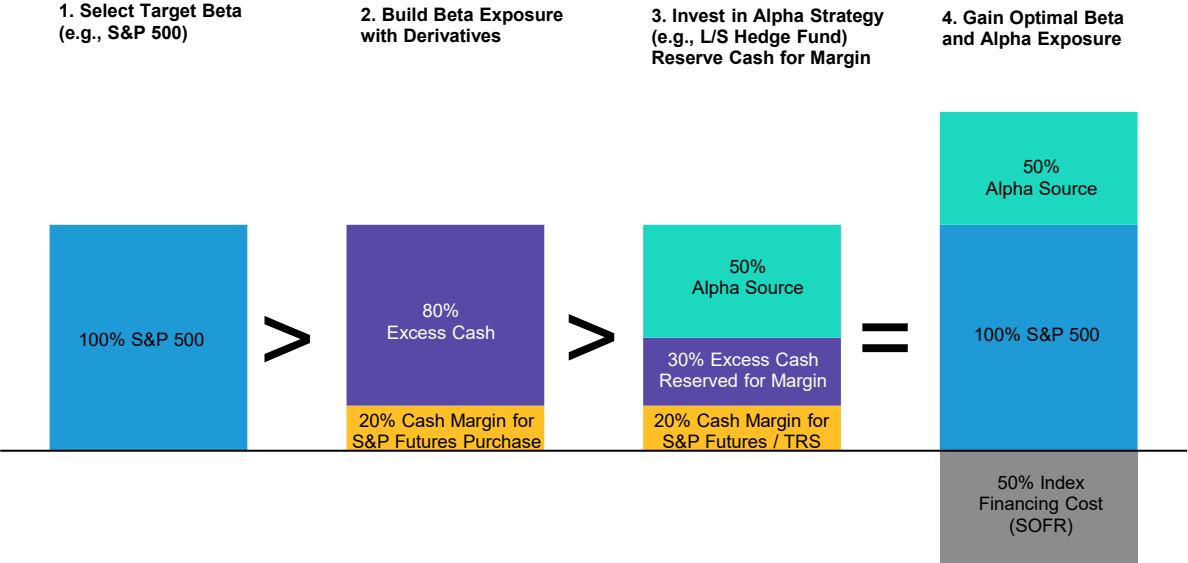
Portable Alpha: An Approach to Tackling the Beta/Alpha Mismatch

We believe portable alpha offers an avenue to incorporating a broader set of alpha opportunities in a flexible, risk-efficient and capital-efficient way, enhancing returns while preserving strategic asset allocations. It may help address return shortfalls, and it can be tailored to specific risk budgets and illiquidity tolerances for active return sources.

Simply put, portable alpha is a portfolio-construction technique (*Display 7*) that enables investors to combine any independent source of manager alpha with any beta exposure. It's usually implemented through derivatives—futures, forwards or swaps—

that create “synthetic” exposure to a beta stream, usually a passive index such as the S&P 500 in our example. In our opinion derivatives are a more capital-efficient way to access beta, because the investor uses cash to fund only a small fraction of the beta exposure—the initial margin needed to secure a futures position.

DISPLAY 7: PORTABLE ALPHA—THE BASICS



For illustrative purposes only. There can be no assurance that any investment objective will be achieved.

Derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments, and may be more volatile, especially in a down market.

As of October 31, 2024

Source: S&P and AB

That approach to beta exposure frees up the rest of the “excess” cash to invest more capital into an alpha source that has the potential to outperform cash and enhance the beta return. Investors end up with a combination of derivatives that provides 100% exposure to the index, reserving some cash collateral for margin variation (50% in our example) and an allocation to one or more alpha streams (50%) funded from the rest of the cash.¹ The total economic exposures exceed the value of the underlying assets, so the position uses leverage—associated financing costs must be included when assessing the portable alpha strategy’s performance.

An Example: Portable Alpha in Action

A brief example demonstrates the potential benefits of a portable alpha program. As a starting point, basic beta combinations of passive global stocks and bonds generate annualized return and risk combinations ranging from a 4.8% return and a 5.9% risk for all bonds to a 6.3% return and a 15.7% risk for all equities (*Display 8, left*). A 60/40 stock/bond blend produces a return of 5.7% and risk of 9.9%.

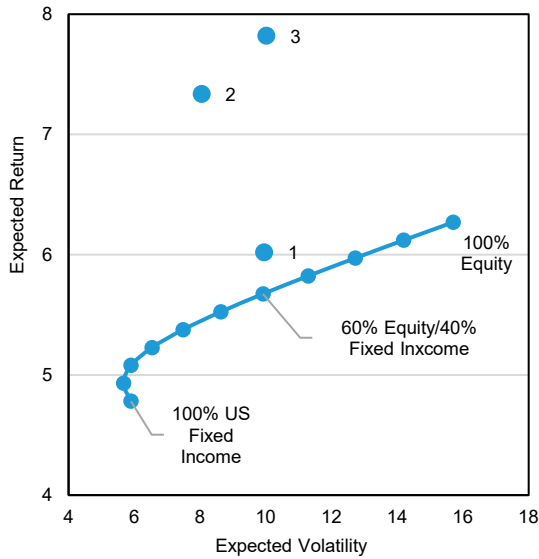
What if we stick to a 60/40 stock/bond strategic allocation but implement 50% of it actively, using a top-quartile global bond manager and a global portfolio of top-quartile long-only equity managers? We can move beyond the passive frontier to option

¹ This is just one example of an implementation. An investor can also spend cash on beta and source alpha synthetically through a derivative exposure, such as via a total return swap from an investment bank that references the underlying alpha strategy.

one, with the excess return and tracking error versus the 60/40 passive benchmark shown in *Display 8, right*. That's an improvement, but still a relatively modest one, even with the best managers.

DISPLAY 8: PORTABLE ALPHA MAY IMPROVE RISK-ADJUSTED RETURNS

Annualized Risk and Return of Portfolio Mixes (Percent)



Risk/Return of Portable Alpha Implementations

	Investment Approaches	Expected Return (%)	Tracking Error (%)	IR
1	60/40 Long-Only 50% Active/50% Passive	0.4	0.8	0.49
2	50% Equity/35% Fixed Income/15% Hedge Funds 50% Active/50% Passive	1.1	1.7	0.64
3	60/40 with 15% Hedge Funds using Portable Alpha 50% Active/50% Passive	1.5	1.0	1.50

Past performance is not necessarily indicative of future results. There can be no assurance that any investment objective will be achieved. Investors should not assume that they will have an investment experience similar to the hypothetical, back-tested, or simulated performance shown.

IR: Information Ratio
As of December 31, 2024
Source: AB

In Option 2, we scale down the 60/40 allocation (still 50% passive and 50% active) to 85%, investing 15% in a top-quartile equity market-neutral hedge fund. This approach beats the passive 60/40 benchmark by a much bigger margin of 1.1% annualized, and meaningfully improves the information ratio.

But portable alpha enables a bigger improvement. Option 3 shows the result of allocating 15% to portable alpha using a top-quartile equity market-neutral hedge-fund manager, funded by shifting 15% of the equity position to futures from the cash index. The excess return improves further to 1.5%, with the same volatility as the 60/40 and a much better information ratio of 1.5. The strategic allocation is intact, with the intended underlying beta mix and volatility. Given current market forecasts and the flatness of the expected-return curve, our analysis suggests that adding portable alpha improves return more than moving toward an all-equity portfolio does.

How should investors approach the implementation of a portable alpha strategy to avoid the pitfalls that surfaced in past episodes of market stress? We think thoughtful rules of the road can improve the chances of success—starting with the need to choose managers best suited for an alpha engine.

Getting the Alpha Manager Mix Right Is Critical

Even at the surface level, assembling and maintaining an effective stable of alpha managers seems daunting. It's not possible to simply "earn" alpha the same way investors earn a risk premium through buying and holding a passive stock or bond portfolio. Picking skilled managers is a prerequisite to benefiting from a portable alpha solution.

To do so, investors should increase their focus on alpha pools that tend to be better. In equities, market-neutral strategies, for example, are fertile ground because they focus on staying beta-neutral and tend to limit persistent factor risks. No matter which pools investors source alpha from, they should zero in on managers that can consistently deliver compelling idiosyncratic alpha—the alpha remaining after adjusting for common, commoditized factor beta exposures. Our research suggests that [managers able to deliver high levels of idiosyncratic alpha are more likely to do so consistently](#). Projected returns must also be large enough, in absolute terms, to exceed the higher cash rates of the post-pandemic period and the significant fees many hedge-fund managers charge.

In the end, this task really comes down to identifying skilled individual managers through a thoughtful, thorough and repeatable process. Investors may have—or may seek to build—such a process in-house, or they can consider tapping the alpha-identification capabilities of an outsourced CIO, fund of hedge funds or multi-manager hedge-fund platform.

Diversifying Across Managers Within an Alpha Engine

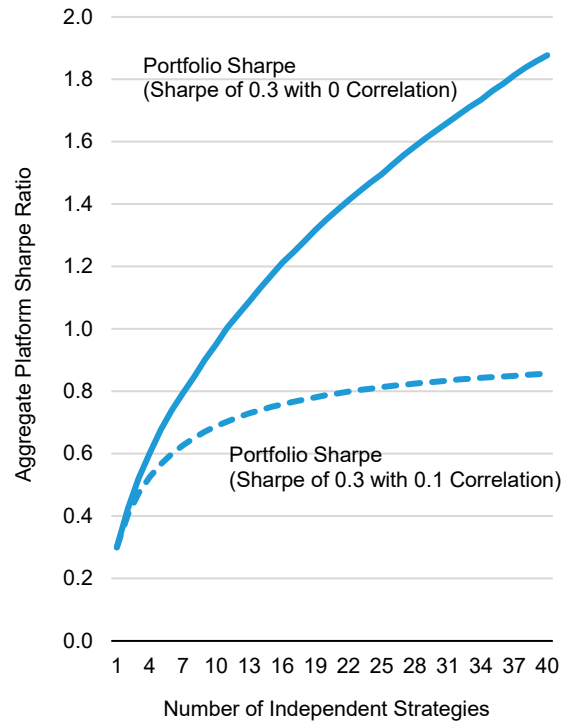
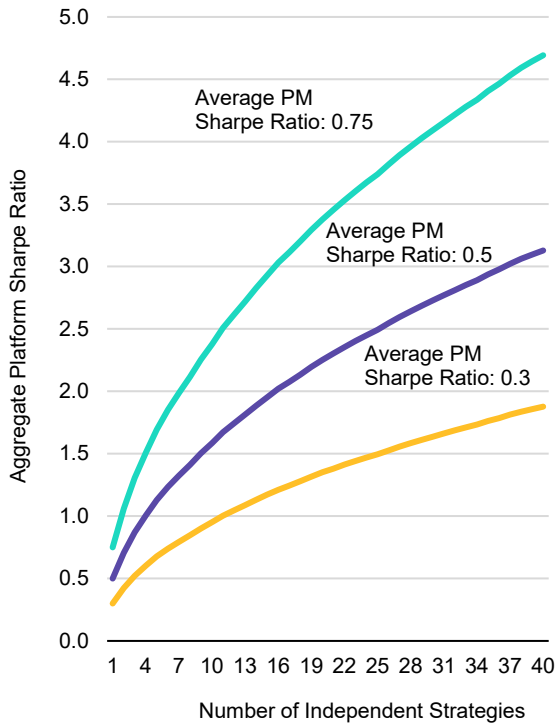
Diversification is also a vital component of an alpha engine. Adding diversifying managers has the potential to improve outcomes, which could reduce portfolio volatility and drawdowns while enhancing return. Strategy diversification is also critical: for example, combining fundamental and systematic sources of returns has often led to more consistent results. Beyond equity alpha strategies, macro hedge funds tend to have low correlation to major asset classes and can be attractive in building a more diversified solution.

As shown in *Display 9*, adding managers to a portable alpha portfolio meaningfully increases the overall Sharpe ratio of the allocation—even if we assume individual managers' Sharpe ratios are a modest 0.3, on average (*Display, left*).² With 10 managers, the expected Sharpe ratio increases by a factor of more than three, improving to 1.0. Identifying 10 managers that generate a 0.5 Sharpe ratio increases it to 1.5. But simply hiring more managers doesn't guarantee a high or optimal Sharpe ratio, because correlations among managers (as well as manager skill) play a big role in outcomes.

Even a modest increase in the average pairwise correlation between portfolio managers from 0.0 to 0.1 could materially reduce the improvement in risk-adjusted returns from adding managers (*Display, right*). And if managers' exposures are correlated to the beta allocation, it could magnify volatility and downside risk, potentially derailing a solution when beta struggles. This point reinforces the critical nature of low-correlation managers, transparency in their portfolios and risk management of the alpha engine.

² The right display assumes an average Sharpe ratio of 0.3 for the individual portfolio managers—well below the Sharpe ratios achieved by the median manager across our long/short equity (0.47), equity market-neutral (0.55) and multi-manager (0.99) samples.

DISPLAY 9: THE IMPORTANCE OF DIVERSIFICATION



Current analysis does not guarantee future results.

Diversification does not eliminate the risk of loss.

As of December 31, 2024

Source: AB

Managing Multidimensional Risks—Dynamically

The ongoing effort of managing risk in a portable alpha solution has many facets. These include monitoring the performance of the alpha engine and its individual managers over time: idiosyncratic alpha, volatility, Sharpe ratio, and the correlations between managers and the portfolio's beta exposure. It's also important to have the capability to adjust unwanted exposures to factors such as beta sources, sectors and industries, and geography. These can accumulate over time when multiple managers wind up pursuing similar opportunities.

The leverage ratio in a portable alpha strategy also must be optimized to maximize returns while managing risk. It should remain aligned with the investor's risk tolerance and investment objectives, and with the return and volatility characteristics of the portfolio's alpha engine. Investors who seek to combine diversified alpha sources and get the calculus wrong could end up with a far worse risk/return than they intended.

Liquidity management plays a huge role in the success of a portable alpha strategy, as we'll explore in the following section. Managing liquidity effectively enables key aspects such as manager rebalancing, alpha and beta rebalancing, and satisfying margin calls when episodes of market dislocation arise. The level of liquidity also affects the scope of alpha exposure in the overall portfolio.

Liquidity: A Vital Dimension with Alpha Managers

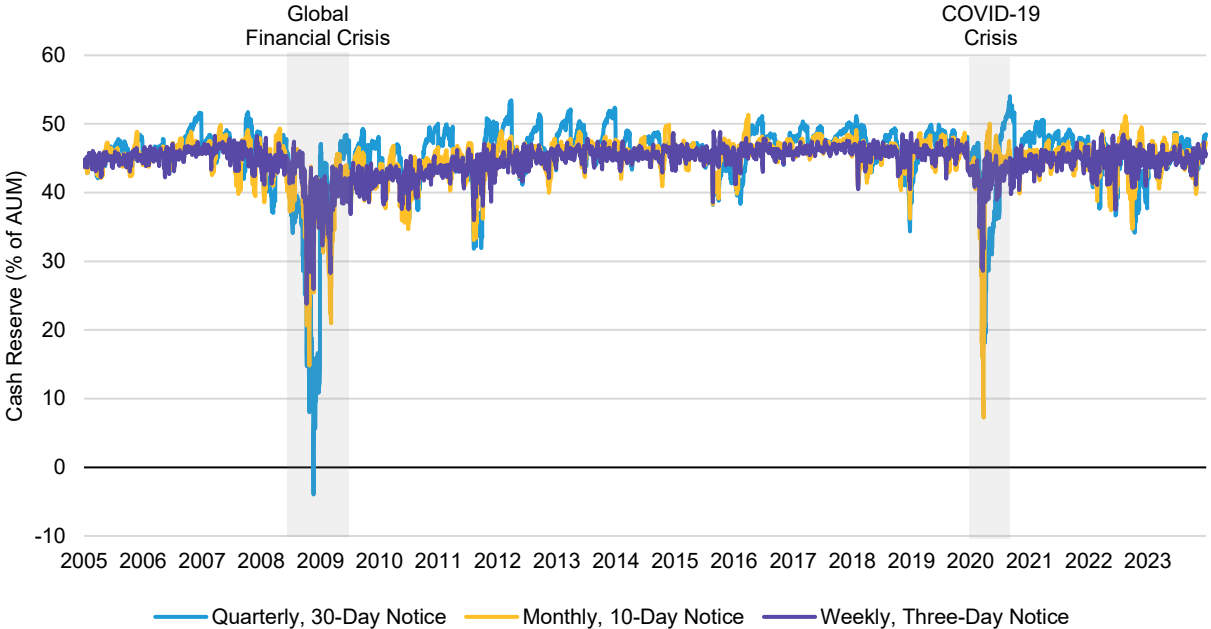
Good liquidity is vital for the alpha component of a portable alpha solution. That's why equity market-neutral and macro managers, who both tend to trade in the most liquid instruments, are the most widely used alpha engines. It's also why strategies that may include private-market assets or hard-to-value securities should be avoided. Further, liquidity among alpha managers enables investors to adjust or rebalance managers in a timely way based on changes in market conditions, risk

exposures or conviction in the alpha engine. The ability to rebalance also allows investors to maintain a consistent proportion of alpha and beta risk in the portable alpha solution—a proportion consistent with strategic allocation targets.

Liquidity also comes into play in meeting margin calls on the beta component in difficult markets. Very sharp stock declines—like those in 2008 and 2020—can drive high demand for cash to meet margin requirements, a crucial function for maintaining the solution’s beta exposure. If the alpha strategy is held in a separately managed account or has daily liquidity, a portable alpha solution can often be run with a significant alpha allocation. But when the alpha strategy is tied up in an illiquid, commingled fund, investors risk either being forced to cut their market exposure or requiring a cash infusion to maintain the beta, if it’s not sized appropriately.

In general, alpha content can be higher the more liquid the alpha source is, the less correlated it is with the beta component, and the lower the beta’s volatility. It’s important to stress test a portable alpha solution during extreme bouts of market volatility to ensure that it’s sufficiently liquid. *Display 10* shows a historical stress test of various solutions where 50% of the capital is invested in an alpha source with 6% volatility, targeting S&P 500 beta. We use the cash margin rates available at the time and vary the liquidity of the underlying alpha source—from quarterly to weekly—to test if the solution will maintain access to enough reserve cash to meet its obligations over time.

DISPLAY 10: MORE-LIQUID ALPHA COMPONENT REDUCES CASH NEEDS IN STRESS PERIODS
 PORTABLE ALPHA SIMULATION: S&P 500 BETA AND 50% ALPHA ALLOCATION



Past performance does not guarantee future results.

Simulated or hypothetical performance results have certain inherent limitations. Simulated or hypothetical trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve returns or a volatility profile similar to those being shown.

Portable alpha solutions invest 50% of capital in a 6% volatility alpha source and target the S&P 500 as beta. Cash margins rates are those available at the specified time.

Through December 31, 2024

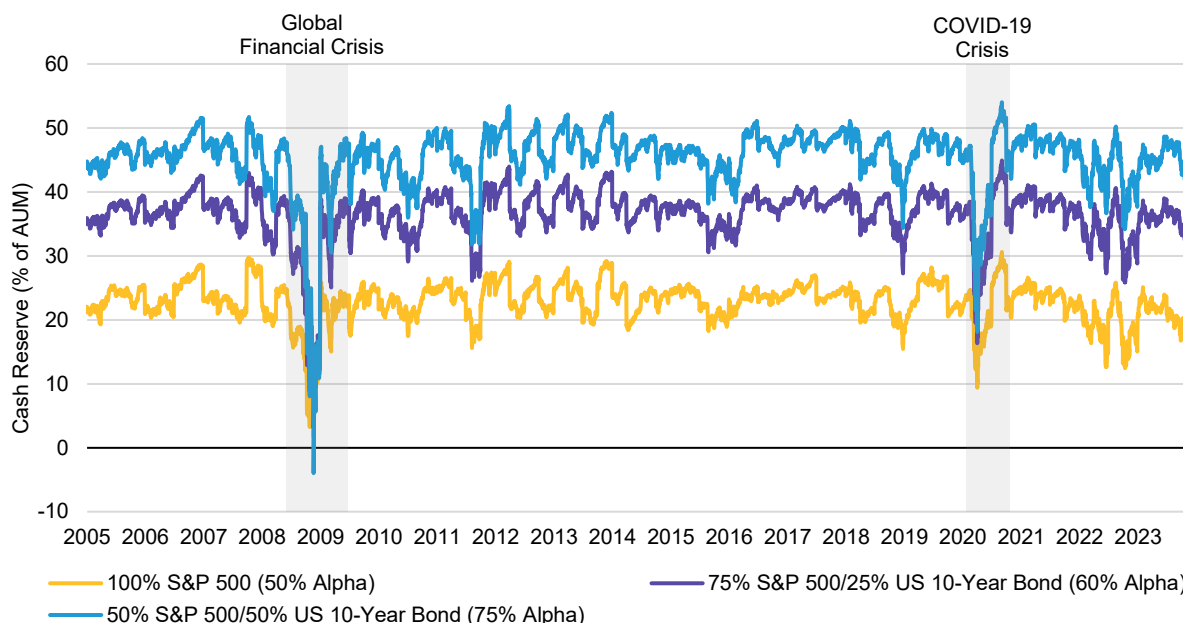
Source: S&P and AB

As shown, monthly and weekly liquidity alphas provided enough liquidity to rebalance and maintain margin requirements during stresses. But quarterly-liquidity vehicles didn’t—highlighting the challenges during the GFC. Investors seeking to reduce the risk of forced beta liquidation during this type of event can either negotiate better liquidity terms, invest less in the alpha source or reduce the volatility of the beta. Cutting the beta’s volatility by targeting stock/bond mixes instead of an all-equity allocation

(Display 11) reduces cash needs during stresses and can support higher alpha allocations. For example, a 50/50 stock/bond mix could support an investment of up to 75% in the alpha engine without depleting cash reserves.

DISPLAY 11: LOWER-VOLATILITY BETA ALLOCATION REDUCES CASH NEEDS IN STRESS AND SUPPORTS MORE ALPHA

PORTABLE ALPHA SIMULATION: VARYING BETA AND ALPHA MIXES*



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*Assumes alpha engine offers quarterly liquidity with 30-day notice period

Portable alpha solutions invest 50% of capital in a 6% volatility alpha source and target the S&P 500 as beta. Cash margins rates are those available at the specified time.

Through December 31, 2024

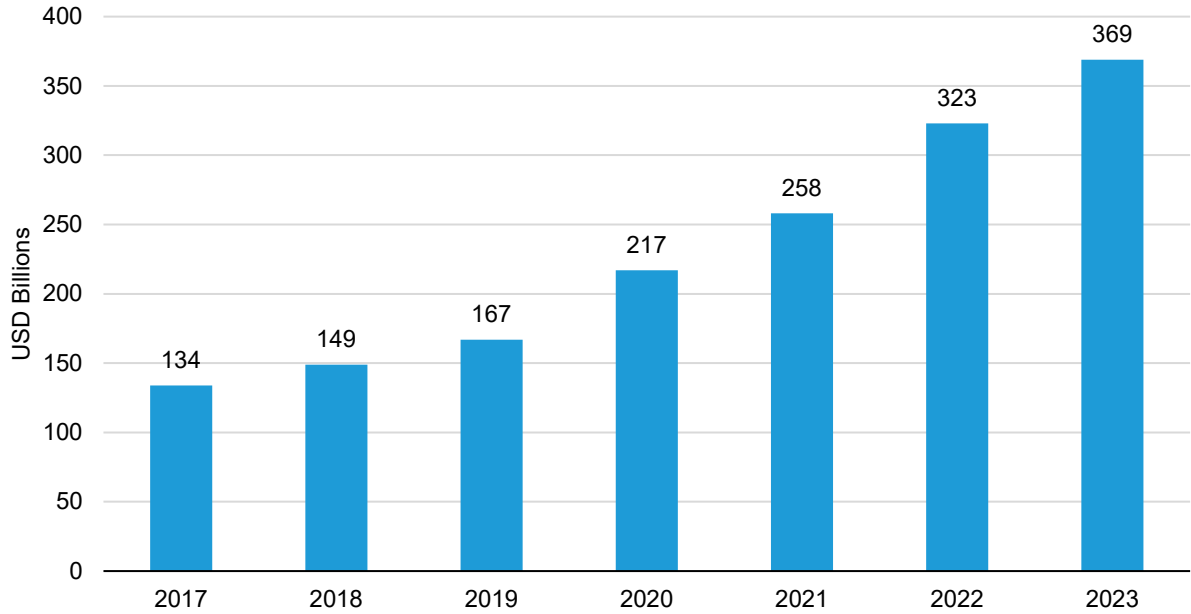
Source: S&P and AB

Multi-Manager Hedge Funds: The Most Potent Alpha Engine?

Manager selection, diversification, risk management and liquidity management: a lot goes into running an effective alpha engine. Many investors have upgraded their due diligence and manager-selection processes over the years and have better risk and portfolio-analytics tools today. But rather than taking a “do-it-yourself” approach to running an alpha engine, some investors may prefer strategies that serve as one-stop shops: multi-manager hedge-fund platforms.

The strong growth in these strategies (Display 12) likely has a lot to do with their track record of being the highest and most consistent alpha and risk-adjusted return generator. The self-contained approach, in our view, offers advantages over single-manager hedge funds—notably diversification and centralized risk management.

DISPLAY 12: STRONG GROWTH OF DIVERSIFIED ALPHA STRATEGIES
ASSETS UNDER MANAGEMENT OF MULTI-PORTFOLIO-MANAGER HEDGE FUNDS



Current analysis does not guarantee future results.

Through September 30, 2024

Source: Goldman Sachs and AB

Traditional hedge-fund managers can often own popular trades and carry explicit or “hidden” market betas and systemic risks. Many investment ideas and holdings may be correlated with each other and with those of other managers, both in the same category and across other strategy types. Investors assembling portfolios of hedge funds must handle strategy selection, manager selection, and multifaceted portfolio construction and risk management—including liquidity and leverage risk. This requires much expertise and resourcing.

Multi-manager platforms have more flexibility to address these challenges. The underlying managers focus on pursuing alpha while the platform manager focuses on selecting managers, monitoring them and managing risk. This work includes hedging out unwanted exposures, managing and optimizing leverage and liquidity, and ensuring that managers stick to risk-budget guidelines.

Let’s see how multi-manager hedge funds might stack up against a “do-it-yourself” approach of selecting and combining portfolios of individual managers.

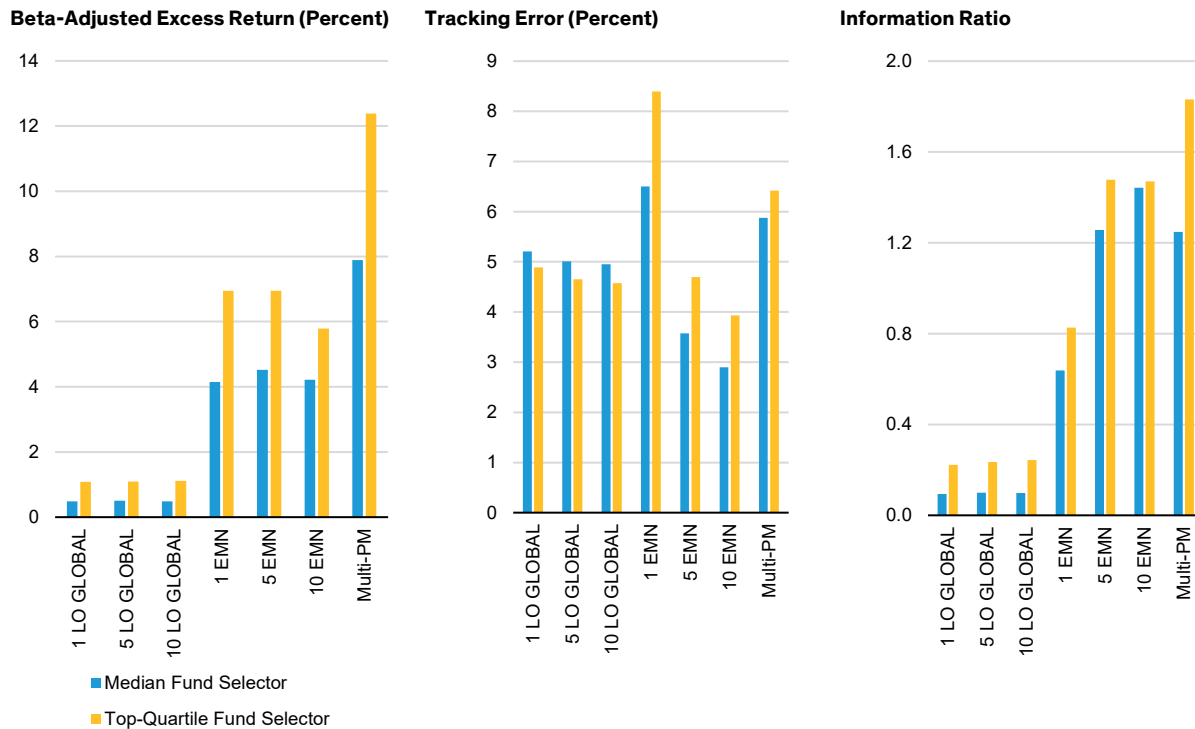
We compare the performance of the median and top-quartile fund selector (which creates portfolios of one, five and 10 long-only and long-short managers) with that delivered by multi-portfolio-manager platforms. We assume that our do-it-yourself fund selectors rebalance the portfolios annually, and we simulate the results for each manager combination 1,000 times to get an accurate outcome distribution. For long-only manager allocations, we create both US-only portfolios and regionally diversified ones, which we combine into global portfolios with regional weights based on the MSCI ACWI.

On average, multi-manager platforms delivered better outcomes than a do-it-yourself investor allocating to either multiple long-only managers or multiple individual hedge funds (*Display 13*). Alpha returns per dollar invested are much lower for long-only managers than for hedge funds, so investors would need to deploy a lot more capital to generate comparable levels of excess return—making it a far less efficient option.

Because an equity market-neutral hedge-fund manager’s portfolio can use leverage and diversify, its returns become more attractive and its risk reduction increases, but it still falls short of the multi-manager hedge fund. The multi-manager approach enables the highest absolute return as it diversifies, with prudent leverage and effective risk-management techniques

extracting the most efficient alpha per unit of capital deployed. We believe that this makes it an effective alpha engine for portable alpha solutions.

DISPLAY 13: MULTI-MANAGER HEDGE FUNDS OUTPERFORM “DO-IT-YOURSELF”



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LO: long only; EMN: equity market-neutral; Multi-PM: multi-manager hedge fund

Through September 30, 2024

Source: AB

Multi-manager platforms are not without their risks. Some have become very large and complex and deploy significant leverage across many strategy types. They’re not immune from episodic drawdowns that can impact an individual fund or a large portion of the hedge-fund complex. Because they’re so focused on minimizing drawdowns, and have the flexibility to quickly fire managers, they may move to quickly unwind large, losing positions, which can magnify market volatility. In addition, some may have onerous terms such as high fees and long capital lockups. However, those that provide quarterly or more frequent liquidity along with more transparent, reasonable fees may be attractive components of a portable alpha solution.

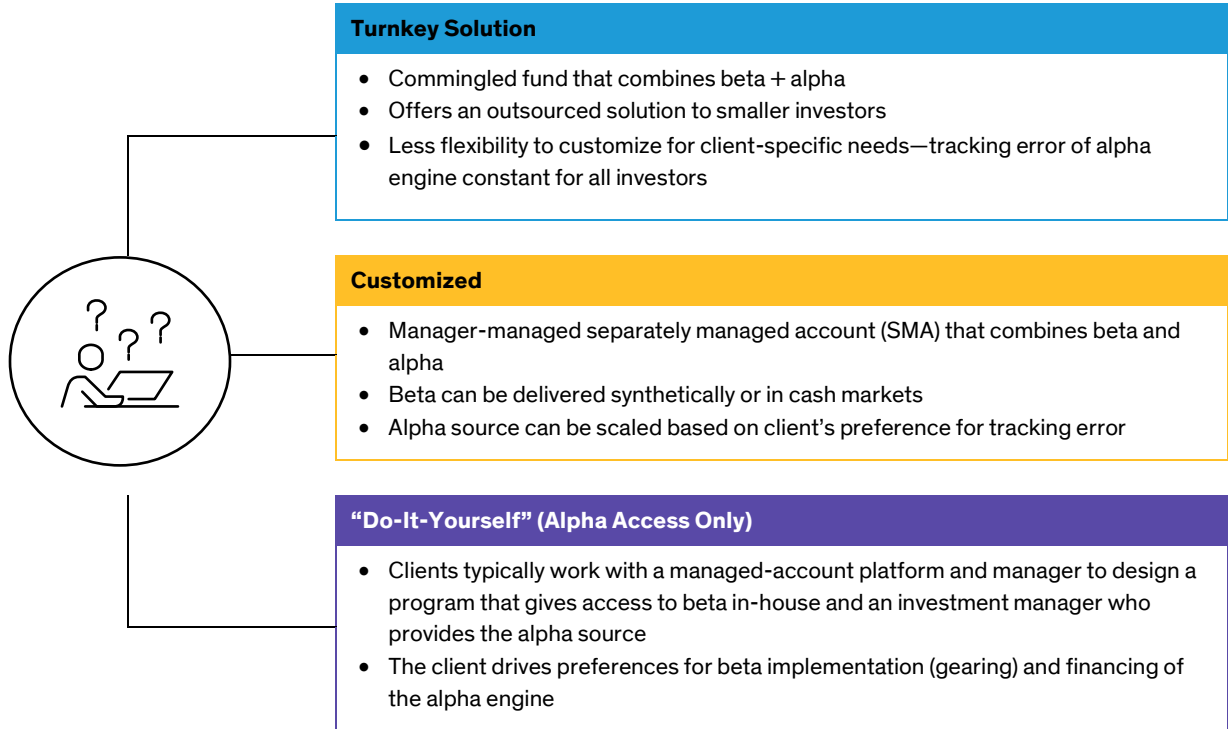
Implementing Portable Alpha: More than One Approach

Investors have multiple options for portable alpha programs (*Display 14*), depending on their specific requirements, infrastructure and in-house expertise in aspects such as trading, margin management and collateral optimization.

Turnkey solutions use a commingled fund that combines the beta and alpha components—an outsourced option that may appeal to smaller investors. For investors seeking more flexibility to customize a portable alpha program to their needs, a tailored design might be preferable. In a do-it-yourself implementation, investors typically work with a managed account

platform and investment manager to design a program that enables access to in-house beta exposure, with an investment manager providing the alpha source.

DISPLAY 14: PORTABLE ALPHA: DIFFERENT WAYS TO EXECUTE AN INVESTMENT



For illustrative purposes only. There can be no assurance that any investment objective will be achieved.

Source: AB

The ability to use SMAs and total return swaps offers investors the flexibility to use more alpha exposure and customize to a greater extent than with traditional portable alpha setups.

In the pre-GFC era and the years immediately thereafter, the dominant portable alpha approach was to fully fund alpha with cash via pooled vehicles. This limits the cash on hand to run the program—including the need to meet margin calls on beta exposures and boosting the beta mix. Using pooled vehicles to invest in hedge funds also reduces transparency, can create liquidity shortfalls and introduces implementation friction, impairing the ability to change quickly.

An important evolution came with hedge funds introducing SMAs within prime brokerages. This advance enabled portable alpha clients to partially fund alpha allocations, eliminating many drawbacks associated with fully funding alpha through pooled vehicles.

But other challenges remained. The onboarding process could be cumbersome and expensive. SMAs often required high minimum-investment levels, limiting asset allocators' ability to diversify across multiple alpha managers and adjust the AUM dedicated to a particular manager as needed.

A solution arrived via innovations in investment banks' technology and infrastructure, and the growth of their quantitative-investment-strategies platforms and new synthetic prime-brokerage offerings. These developments enabled clients to gain direct access to the desired alpha source and own it efficiently through total return swaps—with considerable advantages. Low initial margins for the swap improve liquidity and capital efficiency. Exposures can be achieved with low minimum AUM.

Investors can adjust notional exposure daily, and positions are fully transparent. These benefits make portable alpha more efficient: investors can use a given AUM level across additional betas and access a more diverse manager set.

The synthetic approach can be deployed in all three implementation scenarios: turnkey, custom and do-it-yourself, depending on investors' preferences. In general, higher tracking-error implementations of the alpha engine would argue for more exposure via swap, enabling better cash management and the ability to scale the alpha source to preferred levels. In our view, this synthetic approach should provide greater flexibility for a portable alpha solution during significant stress periods—even a GFC-like drawdown.

Conclusion

Today's low-return outlook from multiple beta sources and the challenges for active managers in concentrated markets require investors to think more broadly and be more innovative in generating returns. We don't believe they should give up on active management, because alpha will be more valuable in a lower-beta world. Instead, they should seek alpha in less-efficient and less-exploited market segments—such as small-cap and EM equities—where the opportunity is richer.

Our research suggests that long/short equity strategies can be a strong alpha source, with many hedge funds outperforming even the best long-only managers. Multi-manager hedge-fund platforms seem particularly skilled at delivering high, persistent alpha and risk-adjusted returns after fees. They can be an attractive addition to the alpha engine. With strong risk management and true diversification among managers, they may be able to deliver more than the sum of their parts.

With effective alpha engines, portable alpha may be an elegant solution for a beta/alpha mismatch. It can access a wide span of alpha streams in a capital-efficient way while enabling investors to maintain their desired strategic asset allocation. It isn't a panacea, with potential drawbacks including complexity, leverage and liquidity risks, as well as the challenge of sourcing reliable, consistent alpha. But its potential is compelling in today's environment: a greater alpha opportunity as well as better capital efficiency and flexibility, fostering more precise, timely management of exposures and potentially more efficient fee allocation.

Portable alpha's past challenges have informed what we see as rules of the road for effective solutions:

- Identify skilled active managers.
- Emphasize manager diversification and low correlations.
- Manage risks effectively and dynamically.
- Ensure liquid alpha streams; manage cash and collateral effectively.

Adhering to these rules, in our view, boosts the chances of success for portable alpha solutions. Well-designed and well-managed solutions equip investors with what could be a potent tool for enhancing returns in a new investment regime that's likely to be less generous with traditional beta returns than it has been in past decades.

<p>Nashville 501 Commerce Street Nashville, TN 37203 United States (212) 969 1000</p>	<p>New York 66 Hudson Boulevard East New York, NY 10001 United States (212) 969 1000</p>	<p>London 60 London Wall London EC2M 5SJ United Kingdom +44 20 7470 0100</p>	<p>Singapore One Raffles Quay #27-11 South Tower Singapore 048583 +65 6230 4600</p>
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