

Overlaying Returns through Portable Alpha

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In photography there is an editing technique called compositing. Through image-editing software, compositing allows the photographer to layer multiple images on top of one another. This layering creates a new and unique photo, different than any of the stand alone images. The photo below is an example of a composite. The final composite photo, also called a photomontage, uses the unique qualities and characteristics of each individual photo to create a new stand-alone image.



PHOTO 1



PHOTO 2



PHOTOMONTAGE

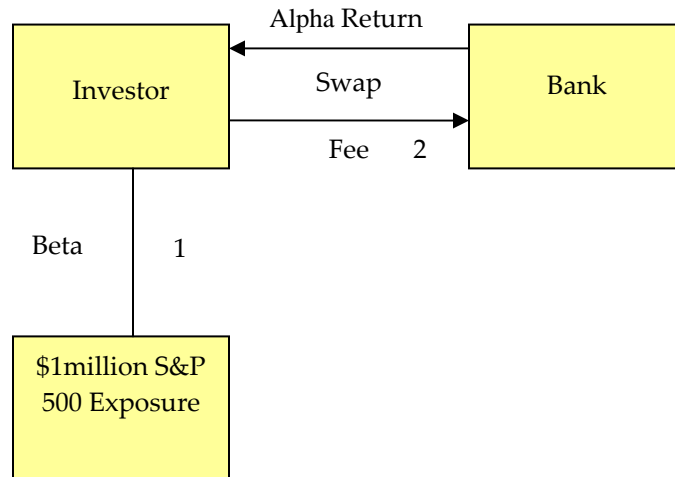
Similar layering can be utilized within an investment portfolio. This is done by using existing investment holdings as “collateral” and adding, or layering, incremental returns through swaps. These “overlay” strategies are intended to reduce portfolio risk, enhance investment income, or add a hedge. The overlay is achieved through an investment technique called Portable Alpha. For purposes of this document, the following term should first be explained. As a footnote, these terms may have other meanings and uses outside the context of my writing:

Beta: The underlying investment holding used as “collateral”. The beta position is a holding in the portfolio that the investor intends to maintain, regardless of the overlay. It is assumed that the investor will achieve the results of the beta position independent of other returns “ported” in. For example, the beta position may be a concentrated stock position owned by a corporate executive. The owner desires to hold this stock position for the foreseeable future. This stock, while being held, can be used as a “beta” position. Others may hold substantial positions in a market index, cash or bonds. These positions can also be used.

Alpha: The incremental return sought by layering additional return vehicles on top of the beta position.

Swap: The exchange of the alpha return for the fees to manage the portable alpha strategy.

The following graphic illustrates the sequence of the swap transaction:



In this example, the investor receives the total return of their S&P 500 exposure (i.e. their beta) as they would regardless (1). The investor pays a fee to the Bank for providing the Alpha (2). The investor's total return is equal to the total return of the S&P 500 (beta) plus the return of the alpha (the overlay) minus the fee. Note that the alpha can generate a negative return in which case the client would experience a loss on the overlay.

With an understanding of these terms and trade dynamics, let's look at some practical applications.

Pension Funds and Endowments: Large institutional investors may already hold beta positions suitable for an overlay. As an incidence of ownership, the holder of a large investment position should avail themselves to all possible return opportunities. Using portable alpha preserves the integrity of the fund's current asset allocation strategy while seeking to enhance overall performance.

Need: Meet annual cash flow requirements. Achieve superior risk adjusted returns:

Portable Alpha can help by:

- Increasing portfolio yield through income based alpha strategies.
- Allowing the manager to invest in a lower risk beta while still achieving results of more risky portfolios through the alpha return.
- Diversify the portfolio by using portable alpha strategies in asset categories non-correlated to the portfolio's dominating asset classes (i.e. hedge fund replication, etc).

Large Bond/Cash Positions: Today's historically low interest rates create a challenge for those holding substantial positions in bonds and cash.

Need: Avoid interest rate risk by investing in short-term treasuries or cash. Avoid market volatility associated with investing in stocks. Maintain liquidity with the assets.

Portable Alpha can help by:

- Utilizing income generating overlays, specifically those with extremely low downside risk, while holding the cash or treasuries as the beta.
- Maintain daily liquidity offered through most portable alpha strategies.

Large Single Stock Holdings: Holders of large single-stock or index positions have the ability to use the holding to earn more than dividends.

Need: Continue to hold the stock position for future growth, tax deferral, dividend income, etc.

Portable Alpha can help by:

- Using the stock or index as the beta position while overwriting alpha strategies designed to add income or hedge the position.
- Allow the owner of the beta stock to continue to receive all benefits of ownership (dividends, voting rights, etc).
- Maximize the benefit of the stock without borrowing costs, margining the position, and subjecting the stock to forced liquidations.

While investors clearly seek for the two well known investment return mechanisms, dividends and capital appreciation, many ignore this third opportunity-portable alpha. As certainly as an individual would not turn down a dividend or coupon payment, investors should also consider other potential return opportunities. Working with our investment banking partners, Watts Gwilliam & Company is able to draw from our menu of portable alpha overlays-ranging from ultra simplistic to highly sophisticated- to create a fully customized overlay strategy specifically designed to meet your investment needs. Please contact one of our advisors for more information or a customized proposal.