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INSTITUTIONAL PERSPECTIVES

An Absolute Return Approach to Portable Alpha

A discussion paper from Franklin Templeton Fixed Income Group

"A fixed income absolute return portfolio is an alternative strategy that seeks to earn positive returns regardless of the interest rate environment or market trends."

An Absolute Return Approach to Portable Alpha

INTRODUCTION

Portable alpha strategies, designed to isolate generation of alpha (excess return over a benchmark) while maintaining the desired asset allocation to traditional beta (market) exposures, have been gaining in popularity among investors. While applications of these strategies may vary in nature, they characteristically have one element in common: the separation of alpha and beta into two components, an alpha-seeking engine and client-specific beta exposure. Such an approach aims effectively to neutralise beta to allow a clear focus on generating alpha.

We see especially strong interest in the application of portable alpha to fixed income investing. The rationale is easy to understand; additional alpha has become more critical to institutional investors, and to pension plans in particular if they are to meet many funding needs, as current yields and projected returns on many traditional fixed income strategies have fallen. We also believe investors are becoming more comfortable with the use of derivatives to replicate beta, as in recent years the derivatives market has improved in terms of both liquidity and transparency.

In this paper we set out the case for global absolute return as a key engine for alpha generation in a portable alpha strategy. We believe the pursuit of diverse sources of alpha across securities, sectors and global markets, using both a top-down and bottom-up approach, is a key component of a successful absolute return strategy. In addition, a diversified group of alpha drivers can potentially decrease the likelihood of market correlations.

In a portable alpha strategy, strong quantitative capabilities are needed to actively manage risk, and, for the beta component, to replicate the index desired by the client. All of these elements are analysed in greater detail herein.

WHAT IS ABSOLUTE RETURN?

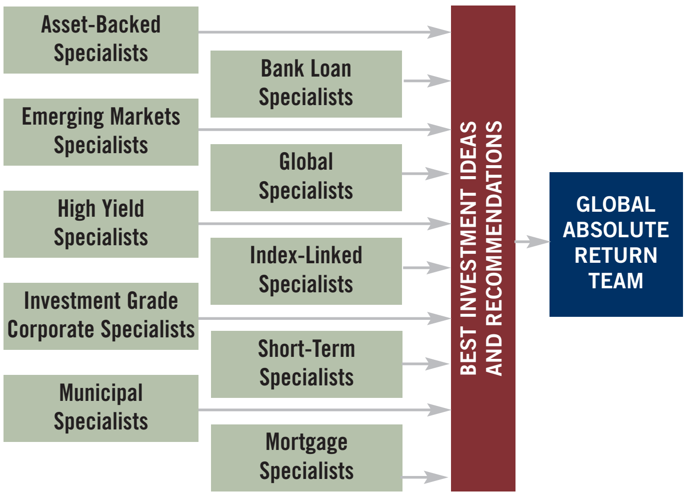
A fixed income absolute return portfolio is an alternative strategy that seeks to earn positive returns regardless of the interest rate environment or market trends. It is not a new asset class, simply a different method of constructing a portfolio. Investment ideas from traditional active fixed income management are replicated over a risk-free cash benchmark, typically Libor, unlike a conventional long-only product that is measured against its particular benchmark. Derivatives are primarily used to control undesired risks that accompany traditional fixed income investment: specifically duration, yield curve, currency, and credit.

At the global level, an absolute return strategy can draw on a large, diverse range of ideas, with the aim of ensuring that no single active position dominates the portfolio (see Figure 1).

Idea Generation: Specialist Alpha Recommendations

- The Franklin Templeton Fixed Income Group's geographic breadth give us a large, diverse array of sources of potential alpha, with the aim of ensuring that no single active position should dominate the portfolio's risk
- Sector specialists provide Global Absolute Return portfolio managers with investment recommendations that reflect their strongest convictions
- Global Absolute Return portfolio managers attend weekly sector team meetings to better understand current trends within the various sectors

Figure 1



We believe that a global investment organisation with extensive resources is best suited to provide the investment ideas for such a portfolio. Bottom-up sector specialists provide security- and sector-specific insights, while senior leaders simultaneously apply a top-down view on sector selection, country duration, yield curve, currency, and volatility. Further, quantitative analysts are an important component of the team, utilising risk models designed to identify potential alpha opportunities and at the same time point out areas of potential risk deriving from position size.

Alongside global research strength and a dedicated quantitative team, a disciplined risk budgeting process is an essential characteristic of the absolute return strategy. The process is designed to keep the portfolio in line with its risk target range, as agreed with the client who, for example, might

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choose a target return of 175 to 200 basis points above Libor with expected volatility of 2–3%. Risk control techniques restrict the portfolio from deviating from the chosen volatility range. This requires close monitoring of positions both in terms of their size relative to the rest of the portfolio and the historical volatility of the individual security. In addition, overall risk measurement calculates risk going forward (ex ante) and looks back (ex post) to measure the accuracy of risk assumptions (see **Risk Control** below).

Hedging by way of derivatives plays an essential role in the typical absolute return portfolio. Correctly used, derivatives allow the portfolio manager to take an outright view on a particular area of the market or to hedge out exposure to an unwanted area. For example, the manager could hold a position in credits and capture the income from those securities while at the same time using derivatives to potentially protect the portfolio from a change in the overall level of interest rates.

Derivatives also permit the possibility of hedging specific currencies, using currency forward markets. In another example, the portfolio could hold a position in Mexican cash bonds but not in the Mexican peso by hedging out the peso into a currency where the portfolio manager has a more positive view. Alternatively it may hedge Mexican bond duration and keep currency exposures intact or maintain exposure to both. The key is to give portfolio managers the flexibility to position absolute return portfolios where they see the best sources of alpha.

REPLICATING BETA

A typical portable alpha strategy will overlay an active component (in this case global absolute return) on a passive element: the desired beta (market) exposure. Beta exposures have become generally less expensive to replicate and relatively simple to access by way of the expanding derivatives market. As a result, assets that may have been used to create beta in a traditional long-only strategy may be redeployed to generate excess alpha.

Beta replication may be obtained by way of a total return swap or through futures contracts, as illustrated in Figure 2. In the typical swap transaction, the manager enters into an agreement with a counterparty to receive total benchmark returns of any given index in return for a money market-based financing fee. In our hypothetical example the fee is Australian Bank Bills plus seven basis points but, depending on the constituents of the index, it may be higher or lower.

A swap has much less overall tracking error than rolling futures contracts. Slippage or rebalancing occurs as the notional amount of the swap is adjusted monthly or quarterly to take account of flows coming in or going out of the overall strategy. Depending on specific circumstances, this can add slightly to the tracking error during the period leading up to the adjustment.

Alternatively, beta may be replicated through futures: an example is a portfolio that would closely replicate the total return of the Dow Jones Euro Stoxx50.

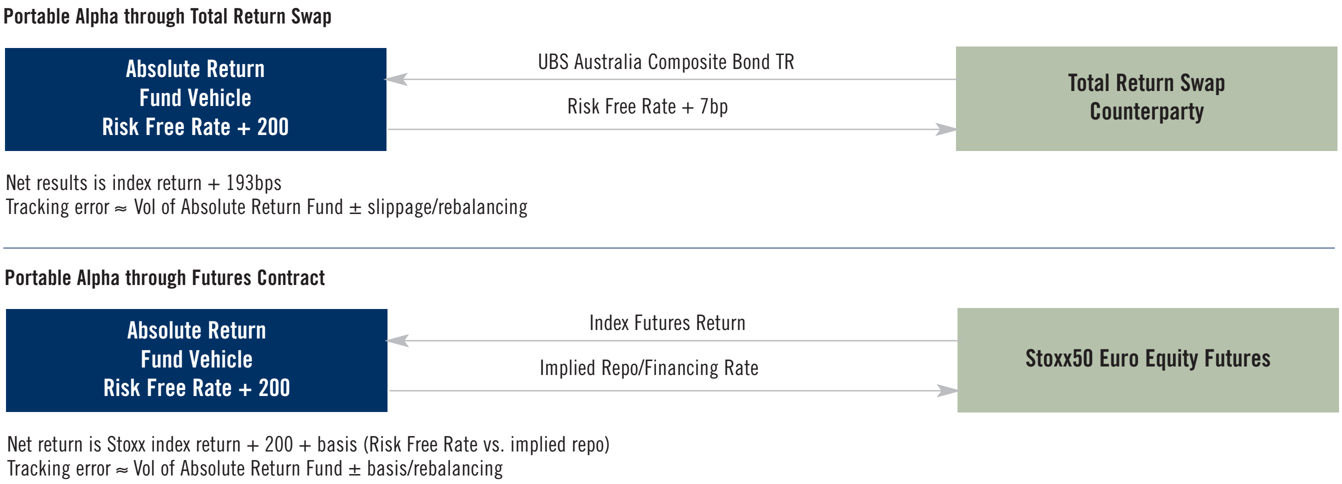
RISK CONTROL

Arguably the greatest challenge in executing a portable alpha strategy is monitoring and managing risk within the portfolio. An ex ante risk model complemented by ex post analysis is utilised in the absolute return component; however this may well bring about changes in our risk assumptions.

Incorporating such assumptions into the risk model is the first step. But one also needs to know where the sources of risk originate—for example whether in credit or duration—so that risk levels can be adjusted if necessary to conform to the overall risk budget. Specifically, in terms of positioning a portfolio to be in line with the risk budget, we favour the following procedures:

Figure 2

Portable Alpha Strategies—Mechanics



Information is provided for illustrative purposes only and does not represent any actual or predicted return.

1. Ensure that no single active position dominates the portfolio's risk. Portfolio managers draw on as many ideas as possible from the global opportunity set.
   - Diversify across sub-sectors
   - Utilise currency for alpha generation
2. Monitor daily risk and returns for internal purposes and clearly show performance attribution to clients monthly. Quantify marginal contributions relative to the risk/return profile of each position and see if investors are being compensated for taking on additional risk. Done repeatedly, this exercise also helps to identify sources of out-performance.
3. Mitigate systemic risk in the portfolio by using derivatives as a hedging vehicle. For example, very recently we hedged our credit exposure by using credit default swaps to buy protection for the portfolio when it was priced relatively cheaply and then tactically unwinding pieces of the CDS position when we felt the cost became prohibitive.

COUNTING THE BENEFITS

In conclusion, we believe there are very clear potential benefits to be gained from adopting an absolute return approach when constructing a portable alpha portfolio:

- By utilising the right manager(s) investors are well positioned to tap diversified sources of alpha in global fixed income markets, where the opportunity set has increased substantially in recent years. A diversified set of actively managed positions provides the flexibility to move between different sources of alpha in line with changing fundamentals.
- Investors have an increasingly wide choice of options when it comes to replicating the underlying beta through the use of derivatives. The development of the derivatives markets provides the potential for more indexes to be easily replicated on a broader scale—including equity, commodity and real estate indices—as the derivatives market continues to expand.
- Derivatives themselves typically offer investors the opportunity to gain their required beta exposure at a fraction of the cost of assembling a portfolio of cash bond positions. This releases funds that can be put to work in the alpha engine, offering the potential to boost overall returns.
- While individual needs and circumstances vary, we believe the absolute return strategy will appeal especially to investors who have specific constraints on risk and restrictions on leverage. Absolute return aims at consistency through hedging (to seek to minimise pure market exposure), short-selling (designed to manage downside risk) and derivatives exposure (which may enhance efficiency and limit volatility).

About Franklin Templeton Institutional

Franklin Templeton Institutional offers a full range of institutional investment capabilities from six distinct investment management platforms: Franklin Global Advisers, Templeton, Franklin Templeton Fixed Income, Franklin Templeton Real Estate Advisors, Darby, and Mutual Series. While each investment platform's process and approach remain autonomous, they share a single distribution platform incorporating business development, relationship management, and consultant relations. With offices in New York, San Mateo, Fort Lauderdale, Hong Kong, London, Melbourne, Tokyo, and Toronto, Franklin Templeton Institutional offers its clients access to more than 400 investment professionals worldwide and, through its investment platforms, manages over US$188.7 billion in institutional assets (30 September 2007).

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