Contents

Foreword by William Gross ix
Preface xi
Acknowledgments xv

CHAPTER 1
Overview of Book and Key Concepts 1
Sabrina Callin
Borrowing to Achieve Higher Returns 3
Leverage—The Good, the Bad, and the Ugly 4
The Confusion Surrounding Alpha and Beta 7
Portable Alpha Definitions and Trends 9
Back to the Basics: Investments 101 10
Asset Allocation and Portable Alpha 10
Alpha, Beta, and Alpha-Beta Separation 11
Global Sources of Portable Alpha, Associated Risks, and Active Management 11
Derivatives-Based Beta Management 12
Portable Alpha Implementation 13
The Real Holy Grail: Risk Measurement and Management 13
Liability-Driven Investing 14
Portable Alpha Theory and Practice: Wrapping It Up 14

CHAPTER 2
Portable Alpha Definitions and Trends 15
Sabrina Callin
The Value of and Components to Porting Alpha 16
The Derivatives-Based Market Exposure (Beta) 20
The Alpha Strategy 21
Common Misperceptions 22
The Evolution of Portable Alpha 24
A New Paradigm? 28
CONTENTS

The Importance of Return—And Risk 30
Conclusion 38

CHAPTER 3
Back to the Basics: Investments 101 39
Alfred Murata and Sabrina Callin
The Optimal Investment Portfolio 40
Utility Functions and Risk Aversion 41
Portfolio Selection and the Efficient Frontier 42
The Capital Market Line 45
CAPM and Factor Models 47
The Benefits of Diversification 48
Risk Premiums 49
Theory versus Reality 51
Conclusion 57
Appendix 3.1 Option Pricing 58
Appendix 3.2 Merger Arbitrage Example 61

CHAPTER 4
Asset Allocation and Portable Alpha 65
Rob Arnott and Brent Harris
A World of Lower Returns 66
The Classic Model for Portfolio Construction 69
Challenges with the Classic Model 70
Portable Alpha, Level One 71
Portable Alpha, Level Two 73
Pitfalls of Porting 75
Risk Budgeting: An Imprecise Science 77
Sustainable Spending in a Lower-Return World 79
The Constituent Parts of a Spending Policy 80
The Risk Premium and the Building Blocks of Return 81
The Role of Alpha in Setting Expectations 81
Contributions 82
The Implications of a Slender Risk Premium 83
Stocks for the Long Run? 84
Dividends and a Slender Risk Premium 86
Benchmarking at the Portfolio Level 87
In Search of a Better Risk Measure 88
What Is Success? 90
Conclusion 93
Contents

CHAPTER 5
Alpha, Beta, and Alpha-Beta Separation 95
Sabrina Callin

Beta and Alpha Defined 96
CAPM, Alpha, and Beta 97
Alpha and Beta in a Portfolio Evaluation Context 98
The Relevance of Alpha versus Excess Return 100
Key Challenges of Alpha-Beta Separation and Estimation 101
Alpha Is Not Alpha without Beta 104
Porting Can Be Costly 105
Is the Alpha Actually Alpha? 109
Beta + Beta (+ Beta . . .) + Alpha? 117
Conclusion 126
Appendix 5.1 The Trouble with Alpha by Jamil Baz 127

CHAPTER 6
Global Sources of Portable Alpha, Associated Risks, and Active Management 135
Sabrina Callin, Alfred Murata, Don Suskind, Steve Jones, Richard Clarida, and Lisa Kim

Overview by Sabrina Callin and Alfred Murata 136
The Equity Markets by Don Suskind 141
The Fixed-Income Markets by Steve Jones 146
Global Diversification and Currency by Richard Clarida 154
Hedge Funds Strategies by Lisa Kim 165
Conclusion 179

CHAPTER 7
Derivatives-Based Beta Management 183
Jim Keller and Mihir Worab

Securities Lending as a Form of Low-Risk Portable Alpha 183
Futures 185
Swaps 189
Beta Management: Basis Risk 192
Examples of Proactive Beta Management 194
Beta Management: Operational Risk 198
Recommendations 199
Conclusion 201
CONTENTS

CHAPTER 8
Portable Alpha Implementation 203
Sabrina Callin

The Alpha Strategy 204
The Derivatives-Based Market Exposure (Beta) 205
Liquidity for Margin or Collateral Calls 205
Consolidated Risk Management, Monitoring, and Reporting 211
Integrated Approaches 214
Segregated Approaches 215
Semibundled Approaches 216
Comparing and Contrasting Different Approaches 218
Implementation Costs 219
Evaluating Portable Alpha Implementation Approaches 220
Conclusion 221
Appendix 8.1 Segregated Portable Alpha Case Study by Bruce Brittain 221

CHAPTER 9
The Real Holy Grail: Risk Measurement and Management 225
Vineer Bhansali

Identifying Risks: Alpha, Beta, and Leverage 226
Liquidity and Correlation 229
The Consequences of Leverage 233
Stress Testing: Measuring Risk in Portable Alpha 235
History and Time Horizons 240
Conclusion 241

CHAPTER 10
Liability-Driven Investing 243
Jim Moore

What Is LDI? 244
Less Room for Complacency 249
Examining the Liabilities 252
Liability-Driven Investing 255
Case Study: Into Phase III 263
Beyond LDI: Incorporating Factors outside the Pension Plan 267
Conclusion 269
Appendix 10.1 Building Better Betas through Financial Engineering 269
## Contents

### CHAPTER 11

**Portable Alpha Theory and Practice: Wrapping It Up**  
*Sabrina Callin*

- Ability to Borrow through the Derivatives Market Sets the Stage for Portable Alpha  
  274
- Central Underpinnings to Modern Portfolio Theory Are Highly Relevant  
  275
- Alpha and Beta—It’s the Combination That Matters  
  276
- A Wide Variety of Alpha Sources Are Available  
  278
- The Key Is Identification, Measurement, and Diversification of Risk Factors  
  279
- It’s Important Not to Lose Sight of the Policy Portfolio  
  280
- Prudent Derivatives-Based Beta Management Is Not Free  
  281
- Portable Alpha Implementation Can Be Complex and Costly  
  282
- Risk Management Is a Critical Component of Success  
  282
- Portable Alpha Is Also Valuable for Investors Focused on LDI  
  284
- Portable Alpha Provides Tools for Better Investment Results  
  285

### EPILOGUE

**Portable Alpha—The Final Chapter: Schemes, Dreams, and Financial Imbalances: “There Must Be More Money”**  
*Chris P. Dialynas*

- Risk Asymmetries: Volatility, Spread, Leverage  
  290
- Absolute Return Dynamics  
  293
- The U.S. Current Account Deficit, War, and Hedge Funds: Briefly  
  295
- Public Policy Implications  
  296
- Conclusion  
  297

#### Notes  
299

#### Bibliography  
303

#### About the Authors  
306

#### Index  
311