February 2025

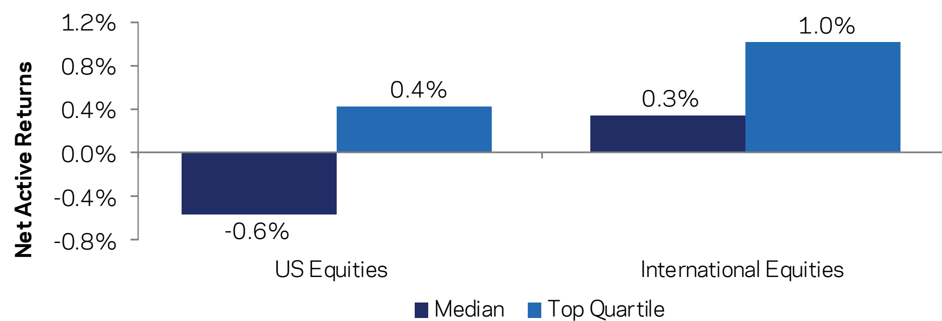
Portable Alpha: Why Now?

The Problems: Elevated Equity Valuations and Macro Volatility

Equities have performed exceptionally well over the last decade, but current valuations are stretched.[1] Even assuming above-average fundamental growth, base case returns over the next 5 to 10 years are still below average.[2] Many investors are hoping to make up this return gap by relying more on alpha from active management. Unfortunately, long-only active management has struggled during recent history. Over the past decade, the median active equity manager has delivered approximately zero value-add in the US and internationally. Even top quartile performance has been only 0.4% in the US and has barely passed 1% internationally (**Exhibit 1**).[3] In addition to the historical evidence, index concentration could provide headwinds for constrained, long-only active management on a go-forward basis.

Exhibit 1: Median and Top-Quartile Net-of-Fee Performance

Trailing 10 Years, January 1, 2015 – December 31, 2024



Source: AQR, eVestment. Chart shows the median and top-quartile trailing 10-year annualized active return, ending December 31, 2024, for managers in the US and EAFE large cap equity universes in eVestment. Investments cannot be made directly into these investment universes. Please refer to the disclosures for more information on the analysis and universes. Past performance is not a guarantee of future performance.

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1 Equities refers to the S&P 500 Index. Valuations are proxied by Shiller's US PE ratio, which is at 37.4 as of writing, in the 97th percentile versus its over-100-year history. Past performance is not a guarantee of future performance.

2 We estimate a 5- to 10-year expected real return of 4.2% for US equities as of December 31, 2024, lower than the long-term average of 5.4% since 1900 – both statistics published in AQR's Alternative Thinking 2025 Issue 1. Please refer to the paper for more information on capital market assumptions.

3 It is important to note that the backward-looking, aggregated results presented here do not rule out the possibility of successful long-only active management. Indeed, some managers may offer active strategies expected to outperform their benchmark indices. However, long-only implementations may be limited in the magnitude of tracking error that they can generate. So, a low tracking error strategy, even with a high information ratio, may still fall short of some investors' return objectives.

Macro volatility is also elevated due to numerous geopolitical factors, such as US domestic/foreign policy uncertainty and multiple wars around the world. This leaves long-only portfolios exposed, as equities historically have not performed well in times of heightened macro risks. Investors, in theory, should be considering long/short diversifiers in an environment like this. However, many investor benchmarks include exclusively long-only traditional investments. Thus, the inclusion of long/short diversifiers means being under-weight traditional beta—the so-called "funding problem". This was a painful experience for many investors over the last decade as stocks performed unusually well.

A Solution: Portable Alpha

Portable alpha is the concept of combining a high-quality, long/short alpha strategy with an equity overlay utilizing equity futures, which provides the desired exposure to the equity market plus the alpha from the hedge fund strategy. Therefore, portable alpha avoids the problems associated with long-only active management and "funding" standalone long/short diversifiers from traditional investments.

In contrast to long-only managers, unconstrained long/short managers have more tools at their disposal, allowing them to better express their investment views by going long securities they like and short securities they dislike. Additionally, long/short managers have access to prudent leverage, allowing them to form highly diversified portfolios (i.e. higher risk-adjusted return) and monetize the diversification (i.e. higher total returns). Lastly, by virtue of being unconstrained, index concentration is irrelevant for the efficacy of long/short active management.

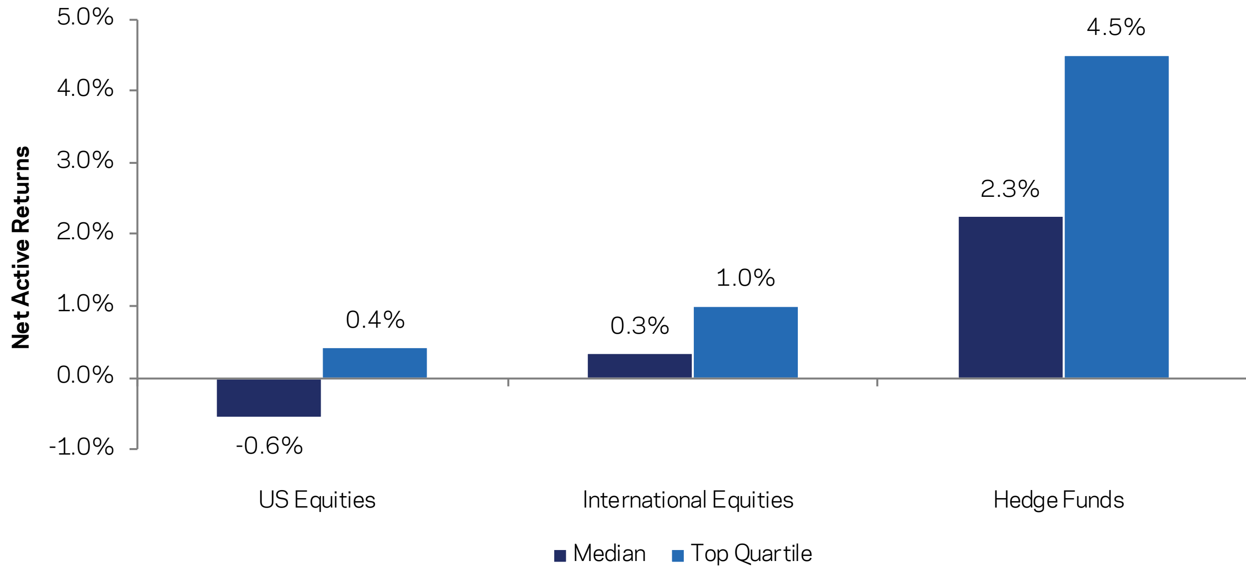
The theoretical arguments in favor of unconstrained long/short active management are supported by actual investor experience. Over the past decade, the median hedge fund delivered a 2.3% active return (i.e., alpha) net of fees, which represents a 6.7% total return less 4.4% due to equity exposure. For those with manager selection skill, a top-quartile hedge fund earned a 4.5% net active return (7.7% total return less 3.2% due to equity exposure), which is substantially more than long-only equity managers (**Exhibit 2**).[4]

In addition to delivering higher quality active returns, portable alpha solves the "funding problem". In the old world without portable alpha, an allocation to an attractive long/short diversifying strategy required selling stocks and/or bonds, i.e. being underweight traditional beta. In the new world with portable alpha, attractive long/short diversifying strategies can be included in the portfolio without being underweight traditional beta since the funding beta is replaced one-for-one by the beta overlay included in the overall portable alpha solution (**Exhibit 3**).

4 This methodology for calculating hedge fund active returns not only isolates the alpha component, but it also makes the numbers comparable to the long-only equity active returns. Past performance is not a guarantee of future performance.

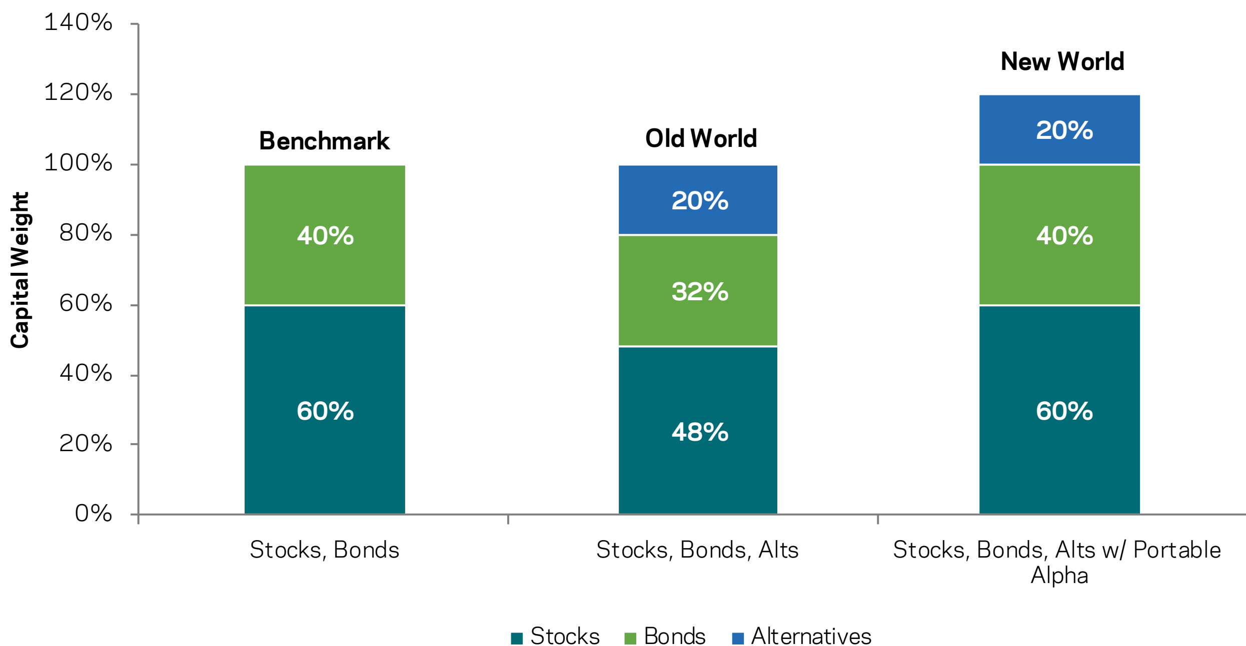
Exhibit 2: Median and Top-Quartile Net-of-Fee Performance

Trailing 10 Years, January 1, 2015 – December 31, 2024



Source: AQR, eVestment, Hedge Fund Research. Chart shows the same annualized active returns for managers in the eVestment US and EAFE large cap equity universes as shown in Exhibit 1, as well as results for "Hedge Funds". "Hedge Funds" shows the trailing 10-year annualized, beta-adjusted return, ending December 31, 2024, for constituents of the HFRI Fund Weighted Composite Index. Returns are beta-adjusted for equity risk, using regressions on the MSCI World Index. Please refer to the disclosures for more information on the analysis and universes. Past performance is not a guarantee of future performance.

Exhibit 3: Illustrative Portfolio Capital Weights



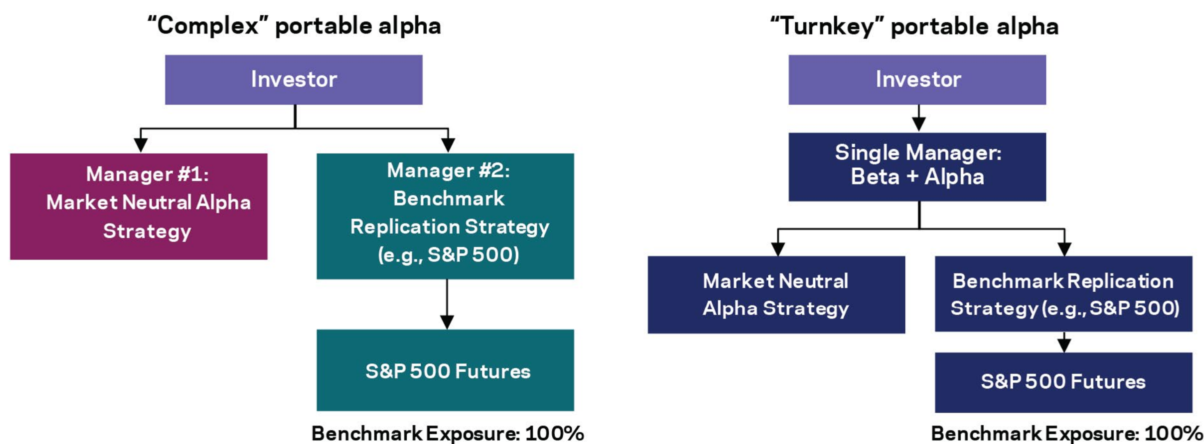
Source: AQR. For illustrative purposes only. Please read important disclosures in the Appendix.

Not All Portable Alpha Implementations Are Created Equal

In today's marketplace, there are two common ways to implement portable alpha solutions. The first way, denoted as "complex", separates the beta overlay function from the alpha manager function. The investor hires a separate beta overlay manager or manages the beta overlay internally. In contrast, the second way, denoted as "turnkey", integrates the beta overlay function with the alpha manager function, i.e. the alpha manager puts on and is responsible for the beta overlay (see **Exhibit 4**).

While the complex approach provides the investor additional flexibility, it comes with additional risks. By separating the beta overlay function from the alpha manager function, the investor bears additional operational risk, collateral/cash management risk, beta estimation risk, and performance reporting risk. These types of risks make the complex portable alpha implementation only accessible to the most sophisticated institutions. All of these real-world risks are mitigated with the turnkey approach.[5] The turnkey implementation "walks and talks" like any other beta-one, benchmark-oriented mandate, making portable alpha accessible to any investor as a core equity solution.

Exhibit 4: Illustrative Portable Alpha Implementations



Source. AQR. The example above is for illustrative purposes only and not representative of a portfolio AQR currently manages.

5 By allowing the alpha manager to implement the beta overlay, cash can be efficiently managed between the alpha and beta to reduce cash margin risk, estimate and track beta with greater granularity, and merge operations and reporting of both components to be more transparent.

Portable Alpha Fair Fees

In addition to offering different risks, portable alpha implementations can also differ along the fee dimension. When it comes to the performance fee, there are two common structures. The first structure, denoted as "unfair", pays a performance fee to the alpha manager whenever the alpha strategy makes money. The second structure, denoted as "fair", pays a performance fee only when the overall portable alpha total return beats the stated benchmark—the investor's ultimate objective. Under the "unfair" structure, the alpha manager can be paid a performance fee even though the overall portable alpha program is underperforming the benchmark, which we believe is unfair to the investor. By comparing the portable alpha total return to the stated benchmark, the "fair" structure automatically holds the "turnkey" portable alpha manager accountable for operational expenses, financing frictions, and a proper hurdle rate, which we believe is fair to the investor. Note it is impossible to implement a "fair" performance fee structure with the "complex" portable alpha approach.

Fair Portable Alpha Fees	Unfair Portable Alpha Fees
Performance fees are earned only when the total return of the portable alpha program beats the stated benchmark	Performance fees are earned when the alpha strategy makes money. Leaves investors exposed to operational costs/slippage

Concluding Thoughts

While the concept of portable alpha isn't new, and sophisticated institutional investors have been users of portable alpha for years, its implementation has evolved since its founding in the early 2000's. In the early days, many portable alpha implementations used a separate beta overlay manager, held too little cash for managing the equity futures position, assumed the hedge fund was 100% alpha, and/or used illiquid alpha sources. Thankfully, implementation has improved markedly over two decades. Turnkey approaches with fair fees are now available, making portable alpha a safe, accessible, core equity solution for all investors, and, importantly, an appropriate response to the current market environment of low expected returns and elevated macro volatility.

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The eVestment and HFRI active and total return figures provided are based on returns from the eVestment US Large Cap and EAFE Large Cap equity manager universes, and the HFRI Fund Weighted Composite Index constituents, respectively. We include only managers who report all monthly returns over the trailing 10-year period ending September 30, 2024. For eVestment, manager active returns are calculated by eVestment relative to manager preferred benchmarks and are reported either gross or net of fees. For managers who report returns gross of fees, we convert the returns to net using the median fee of the universe. Reported manager fees range anywhere from 10 to 300bp, depending on manager and investment vehicle. The eVestment US

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