July 2024

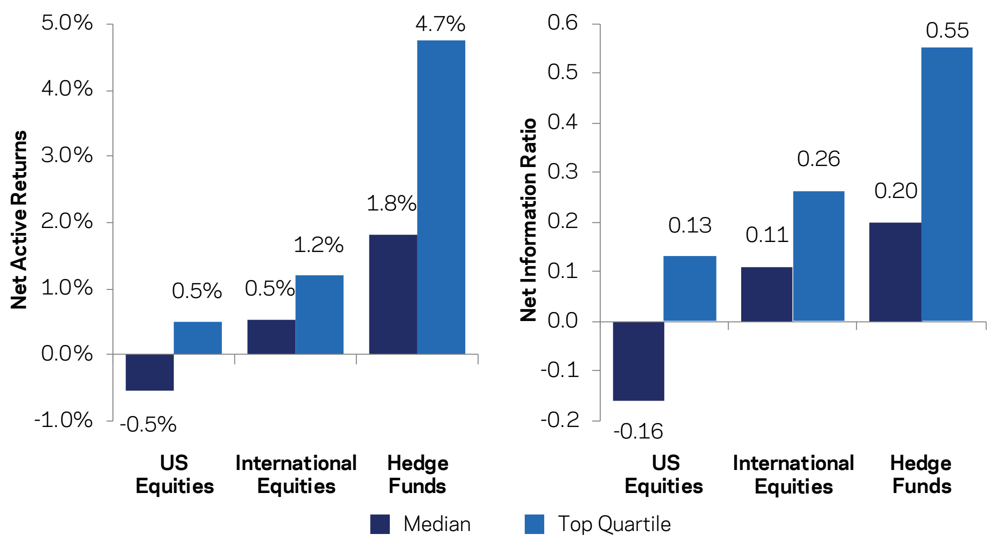
Portable Alpha:

Still A Great Solution For Improving Return Outcomes

Equities are the largest component of most asset allocations and, thus, receive the most attention from investors. With equity markets priced to deliver lower-than-average returns over the next 5-10 years, many investors are re-underwriting the case for active management. Unfortunately, evidence supporting this approach in long-only equities has been lackluster for a long time. 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 0.5% in the US and barely passed 1% internationally.[1]

Median and Top-Quartile Net-of-Fee Performance

Trailing 10 Years, April 1, 2014 – March 31, 2024

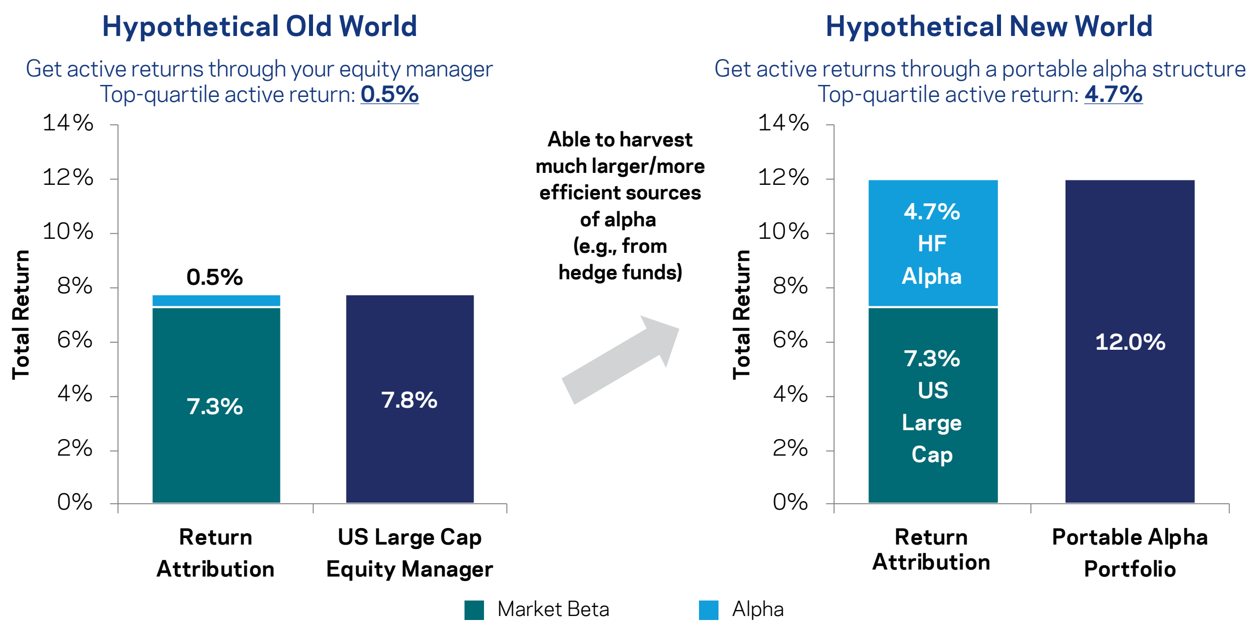


Source: AQR, eVestment, HFRI, MSCI, Bloomberg. US Equities refers to the US Large Cap eVestment universe and International Equities refers to the EAFE Large Cap equities eVestment universe. We remove all managers who do not have complete return series over the 120-month period. Manager active returns 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. Hedge Funds refers to the HFRI Fund Weighted Composite Index constituents. Hedge fund excess returns are calculated using the BofAML US 3 Month Treasury Bill Index. All HFRI manager returns are reported net of fees. HFRI returns are beta-adjusted for equity risk. The return series used in the equity risk regressions is the MSCI World Hedged USD Index in excess of the BofAML US 3 Month Treasury Bill Index. Time period is the trailing 10-year period ending March 31, 2024. Please refer to the disclosures for more information on the universes.

1 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' investment objectives.

In response, some investors have considered private equity (PE) to make up the return gap, but PE is illiquid, difficult to rebalance, and not immune from headwinds in public equities. What about liquid market solutions? In theory, active management in less-constrained liquid strategies, such as hedge funds, should have a better track record—and this is supported by actual investor experience. Over the past decade, the median hedge fund delivered a 1.8% active return (i.e., alpha) net of fees, which represents a 5.4% total return less 3.6% due to equity exposure.[2] For those with manager selection skill, a top-quartile hedge fund earned a 4.7% net active return (8.3% total return less 3.6% due to equity exposure), which is substantially more than long-only equity managers. In addition to better headline active returns, top-quartile hedge funds were also more consistent, as demonstrated by the materially higher 0.55 information ratio versus 0.13 and 0.26 for long-only US and international equities, respectively.

Given hedge funds' edge in active management, many investors have asked: are there practical ways to utilize the active management skill of hedge funds in a long-only equity mandate? The answer is yes. This concept is known as portable alpha. The hedge fund manager can put on an equity overlay using equity futures, providing desired exposure to the equity market plus the alpha from the hedge fund strategy. Conceptually, it really is that simple.



Source: AQR, eVestment, HFRI, Bloomberg. US Large Cap refers to the eVestment equity universe. 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. HF refers to the HFRI Fund Weighted Composite Index constituents. All HFRI manager returns are reported net of fees. For both the HFR and the eVestment universe, we remove all managers who do not have complete return series over the 120-month period. Time period is the trailing 10-year period ending March 31, 2024. For the HFR data, excess returns are calculated using the BofAML US 3 Month Treasury Bill Index, and then are beta-adjusted for equity risk. The return series used in the equity risk regressions is the MSCI World Hedged USD Index in excess of the BofAML US 3 Month Treasury Bill Index. For both the eVestment and HFR universes, we report the top-quartile average excess return. The Market Beta total return is AQR's capital market assumption for US Large Cap Equities total return as of March 31, 2024. Please see disclosures for more information about capital market assumption methodology. Portfolio returns and attributions are hypothetical estimates and for illustrative purposes only. They are not a guarantee of performance and are subject to change. Hypothetical data has inherent limitations, some of which are noted in the disclosures. Please refer to the disclosures at the end for important information.

2 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.

The total return impact of a portable alpha program has the potential to be material. Assuming top-quartile manager selection skills, a US equity portfolio utilizing long-only equity active management has a base case return of 7.8%. An additional 4.2% can be added to the base case return—12% in total—by implementing a portable alpha structure with a top-quartile hedge fund.

The concept of portable alpha isn't new. Many institutions, such as the Teacher Retirement System of Texas and the Public School Retirement Systems of Missouri, have been users of portable alpha for years.[3] However, the implementation of portable alpha has evolved since its founding in the early 2000s. 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. Implementation has improved markedly over two decades. In today's marketplace, investors have access to bundled products (i.e., hedge fund alpha plus the beta of your choice) that are simple, single line items alongside typical long-only investments. We believe that today more investors (finally) have a viable way to get higher, and higher quality, excess returns into the equity sleeve of their portfolios.

3 Teacher Retirement System of Texas and Missouri PSRS/PEERS have employed the core concepts of portable alpha, i.e., investing in hedge funds while obtaining beta exposure via derivative overlays. Additional information for both implementations can be found in their respective publicly-available investment policy statements.

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Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index.

Index Definitions:

The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.

The **ICE Bank of America Merrill Lynch 3 Month T-Bill Index** tracks the performance of the U.S. dollar denominated U.S. Treasury Bills publicly issued in the U.S. domestic market with a remaining term to final maturity of less than 3 months.

The **HFRI Fund-Weighted Composite Index** is a global, equal-weighted index of single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in US Dollar and have a minimum of $50 Million under management or $10 Million under management and a twelve (12) month track record of active performance.

There is a risk of substantial loss associated with trading commodities, futures, derivatives and other financial instruments. Before trading, investors should carefully consider their financial position and risk tolerance to determine if the proposed trading style is appropriate. Investors should realize that when trading futures, commodities, derivatives and other financial instruments one could lose the full balance of their account. It is also possible to lose more than the initial deposit when trading derivatives or using leverage. All funds committed to such a trading strategy should be purely risk capital.

Capital market assumptions are an active area of research and may evolve based on both market movements and new research resulting in new assumptions.

The information generated regarding the likelihood of various investment outcomes is hypothetical in nature, does not reflect actual investment results, and is not a guarantee of future results. No representation is being made that any asset manager, fund, or account will or is likely to achieve profits or losses similar to those shown herein. All data as of March 2024.

The primary index of our US Large Cap Equities Capital Market Assumption is described below.

Our 10YR return forecasts for equities are related to starting yields. We take the average of two measures: an earnings-yield-based measure (0.5*Shiller EP plus estimated real EPS growth), and a payout-based estimate (dividend yield + net buyback yield + estimated aggregate payout growth). This gives a real yield estimate; we then add a survey-based forecast of inflation. We assume zero mean reversion in equity yields.

Volatility estimates are based on an average of since-2008 and since-1990 (or maximum of available data, if less than 24 years) monthly volatilities of the primary index for equities.

Our cash return expectations are calculated using the average of the current 3M yield, the current 10Y yield, and a survey-based forecast.

For the purpose of this analysis all performance data for public assets is gross of fees and transaction costs.

Indices Used For Volatility and Correlation Expectations

US Large Cap Equities: S&P 500 Index

All performance figures contained herein reflect the reinvestment of dividends and all other earnings and represent unaudited estimates of realized and unrealized gains and losses prepared by AQR Capital Management, LLC. There is no guarantee as to the above information's accuracy or completeness. Past performance is not an indication of future performance. Existing Investors, please refer to the monthly statements provided by your custodian or administrator for actual returns.

Hypothetical US Large Cap Manager and Portable Alpha Portfolio Construction ("Old World vs New World")

US Large Cap Manager return is proxied by our latest simple yield-based forecast of US Large Cap Equity returns, the methodology of which is described above. We take this US Large Cap Equity return assumption and add our yield-based US cash estimate. Finally, we add eVestment US Large Cap Equity universe top-quartile alpha (net-of-fee returns excess of manager preferred benchmark).

To construct the portable alpha portfolio, we add the top-quartile HFRI manager return with an equity futures overlay of beta 1.0. The HFRI manager return is the top-quartile return from HFRI Fund Weighted Composite Index constituents, which is net-of-fee, excess of cash, and beta-adjusted for equity risk. The return series used in the equity risk regressions is the MSCI World Hedged USD Index in excess of the BofAML US 3 Month Treasury Bill Index. The equity futures overlay of beta 1.0 is proxied as our latest simple yield-based forecast of US large cap equity returns, as described in the previous three paragraphs.

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