Prescient
INVESTMENT MANAGEMENT

Prescient Portable Alpha Bond Fund offering

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Portable alpha investment strategies emerged in the late 1980’s and early 1990’s as an innovation within institutional portfolio management, driven by the increasing demand for investment approaches that could generate excess returns, or "alpha," independent of market-related risk exposures, generally referred to as "beta." Strictly speaking, alpha is the return that is not explained by the beta-adjusted return.

The conceptual foundation of portable alpha lies therefore in the separation of these “alpha” and “beta” components, enabling investors to achieve market returns through managed beta exposure while simultaneously pursuing alpha generation through alternative, and preferably uncorrelated investment strategies.

This bifurcation allowed for greater flexibility and diversification in portfolio construction, aligning with modern portfolio theory's emphasis on uncorrelated return sources to optimize risk-adjusted returns. The development of portable alpha strategies coincided with advancements in financial derivatives, particularly the proliferation of futures contracts, swaps, and repo strategies which provided mechanisms for efficient beta management.

Prescient Investment Management has for a long time employed portable alpha strategies in certain of our fund propositions wherein the base assumptions for price formation in the asset market relate to the strong forms of *market efficiency*. If an asset market is void of opportunities to harvest alpha in a scalable, repeatable and coherent fashion – for Prescient Investment Management, the South African equity space is such an example – then the best course of action would be to replicate the entire market (i.e. buy beta) as cheaply and efficiently as possible, whilst harvesting alpha from an uncorrelated source. This is precisely the mechanism we have employed in our equity offerings for more than a decade.

With regard to the South African fixed income space, our historical assessment has been that there are indeed opportunities to harvest alpha via tactical decisions relating to predicted changes in the level, slope and curvature of the South African term structure of rates, along with circumspect instrument selection in credit markets. The decision to introduce a portable alpha proposition within the SA Bond space therefore does not relate to the absence of harvestable alpha in the fixed income market, but rather to offer an alternative product for investors seeking an SA bond return profile that minimises benchmark-relative risk, while delivering a stable and predictable alpha profile from uncorrelated sources.

The Prescient Portable Alpha Bond Fund provides systematic exposure to the All-Bond (ALBI) Index (beta component) whilst also offering exposure to an optimised alpha portfolio that aims to produce an additional 1.0% before fees. The alpha portfolio has been systematically optimised across various risk metrics including tracking-error, expected shortfall, and generates a low-volatility income-asset-like portfolio that has the highest statistical likelihood of outperforming the associated funding costs of the strategy.

Another motivation for the SA portable alpha bond proposition is purely empirical: examining typical ALBI-cognisant manager performance survey tables reveals several, generalisable characteristics of the data, which helps to position the product.

The first is that the *annualised return dispersion* among SA bond managers generally decreases as the measurement period increases. That is, very simply, the average deviation from the overall survey mean decreases as the measurement period increases.

Secondly, the *quantum of annualised outperformance* from a given index (in this case the ALBI), tends to be fairly pedestrian as the measurement period increases. By way of example, looking at 10-year SA nominal bond performance tables reveal that in order to rank in the 90th percentile of outperformance, an SA bond manager would only need to have an annualised outperformance of 40bps over the ALBI net of fees.

Combining these observations, over the long-term one could say that SA bond returns *between* managers start to look remarkably similar, and the annualised quantum of alpha (relative to the ALBI) for even the very best of these managers is not particularly sizeable. If one could therefore manufacture an SA bond performance profile of ALBI+1.0% p.a. before fees in every calendar year, this would automatically see such a proposition drift towards the very top of performance survey tables as the measurement period moves beyond the initial (noisy) few years.

Aside from the projected competitiveness on the basis of the arguments above, the segment of the market which the Prescient Portable Alpha Bond Fund would emphatically like to target is the purely passive ALBI tracker space. If one accepts that the best possible outcome a pure ALBI tracker could ostensibly deliver is the *underperformance* of ALBI each year by the quantum of manager fees, then a proposition that offers ALBI + 1.0% before fees each year with extremely high predictability and very low tracking error, becomes extremely compelling for investors in that space.

The performance of a portable alpha process is by construction highly path-dependent, and notwithstanding its conceptual simplicity, there are several obstacles that could potentially derail the strategy. It is fair to say that the strategy relies heavily on several inter-connected cogs working in well-synchronised fashion in order to keep the overall machine moving appropriately.

Some of these obstacles relate to having the requisite liquidity in both the beta and alpha segments, being cognisant of bid/offer spreads and carefully curating the alpha portfolio with genuinely uncorrelated exposures to the beta segment. What may conceptually look like an attractively engineered solution conceptually, may of course not work in practice. We note also that the alpha portfolio is typically “funded”, and this means that “unfunded” (synthetic formats) will be needed elsewhere, such as the ability to short beta through futures or repo transactions. A thorough understanding of the mechanics around taking synthetic exposure is critical for the overall success of the proposition.

Prescient Investment Management, given our systematic expertise and strong legacy in fixed income markets is in many respects the ideal manager for effecting SA Bond portable alpha strategies. Whilst the overall ideas around portable alpha investment strategies are not very conceptually taxing, they nonetheless require expertise at every facet of the process, and very importantly, the overall success of the proposition depends heavily on the robustness around the construction of the alpha portfolio.

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