

## Alpha: Structural versus Strategic

Alpha. It is a word that is often used by investment industry professionals to describe the “value-add” that they can deliver to their investors. It is the investor’s challenge to determine if the alpha being described is repeatable, reliable, and attributable to the factors that the investment firm has suggested. It is also the investor’s challenge to determine if the alpha is being accurately described.

The technical definition of alpha is *risk-adjusted, excess return*. Investment managers and investors often speak of alpha as merely excess return. This is not technically accurate. If managers outperform a benchmark because they have taken more risk, these managers have not necessarily added value; they have added risk. Risk can pay handsomely when the market moves up, just as it can cost significantly when the market moves down. So, risk-adjusted, excess return is a better definition of alpha if we are defining alpha as the manager’s value-add.

If a manager can generate higher returns than the market net of fee with comparable or lower risk than the benchmark, that is value-added. Even if the manager takes more risk than the benchmark, if the manager produces more return per unit of risk than the market, that can be alpha too. Managers, both traditional and alternative, must be screened to determine if their value-add is risk adjusted or not.

### Strategic Alpha

We define strategic alpha as risk-adjusted, excess return driven by the strategy; long/short, value driven, momentum based, market timing, stock selection are all examples of strategies that are generally associated with alpha or enhanced returns on a risk-adjusted basis. Tactical alpha is generally a component of strategic alpha. An example of tactical alpha is reducing risk at market tops and increasing risk after substantial declines that can result in enhanced return. It is tactical if it is not the primary source of value add but, rather, a tool at the manager’s disposal to enhance return. In either case, the alpha is typically derived from trading.

Whether examining strategic or tactical alpha, it is nearly always manager dependent. The investor must rely on the manager to have a disciplined, repeatable approach to achieve these results through time. Many do, but changes in personnel, ownership, and environment can cause the manager to alter the strategy or to employ tactics that can quickly wipe out years of excess returns or alter the risk such that what had appeared to be alpha will no longer be.

This is a situation that occurs all too frequently within the hedge fund world. Managers often have strategies that generate significant alpha early on but cannot be repeated as time moves forward or as the firm grows and must generate commensurate alpha with significantly more assets.

### **Structural Alpha: Thinking Differently**

We define Structural Alpha as excess return that is generated due to a certain set of circumstances rather than a particular trading strategy. If banks cease to lend to a particular sector, then the rate that borrowers in that sector will need to pay will increase with no change in the underlying risk of the loan (all else being equal). In certain cases, the quality of the loan can actually increase as borrowers may need to provide additional protections, such as increased levels of subordination or additional collateral, as well as paying a higher yield, to attract reliable sources of funding.

Structural alpha can also arise as a result of limited opportunity. Vast amounts of capital are aggregated by financial institutions, pension funds, foundations, and endowments. These organizations have been largely institutionalized and generally seek investments that offer not only value but scalability. Investments that aren't sufficiently scalable are often ignored by these institutions. That can leave these opportunities, no matter how attractive from a risk/return perspective, in need of capital and forced to offer a variety of incentives to attract needed capital.

Structural alpha can also arise from various risk-based capital regimes. Those that are used in banking and insurance are of particular note. Onerous capital requirements can force these investors out of a particular market segment, again causing yields to rise and incentives to increase. Structural alpha, in each of these cases, is derived primarily from enhanced income.

### **The Influence of Liquidity**

When an investment has limited liquidity when compared with publicly traded securities, it will need to offer a higher yield than a publicly traded security with comparable duration and risk to attract capital. The liquidity risk is different and, therefore, the yield is different. The default risk is not necessarily different and there may not be appropriate comparators to use as an index, complicating the investor analysis.

This raises the question, 'Do these opportunities offer alpha or an illiquidity premium?' It is likely a bit of both. We tend to view it from a different perspective and that is, 'What is the cost of liquidity?' And 'Where can we derive attractive levels of risk-adjusted returns?'

Is illiquidity truly a risk? If we are pursuing short-to-medium term investment horizons and we are foregoing intermediate liquidity in order to derive an enhanced return, then we would argue that illiquidity provides a reward; enhanced return with little or no incremental risk.

Alternatively, we could argue that the cost of liquidity for publicly traded securities, both stocks and bonds, is extremely high. This cost doesn't just manifest itself in terms of lower yields, it also enables bad behavior, enabling investors to exit a position when there is stress and add to it as prices increase, ultimately reducing both return and alpha.

Our view is that long-term investors should invest for the long-term, be willing to hold an investment for the length of its natural life, and should not pay-up for liquidity because the cost is just too high. The alternative perspective is that the illiquidity premium is extremely valuable and can represent structural alpha.

### **A Real-World Analysis**

If we compare the yields on US Treasuries, Investment Grade Corporate bonds, and Below Investment Grade Corporate bonds we can draw some inferences as to the size of the illiquidity premium and/or the cost of liquidity.

Based on the data below, we can infer that there is a default premium of 1.20% for Investment Grade Corporate bonds and 4.13% for Below Investment Grade bonds. This is determined by merely subtracting the comparable maturity US Treasury yield from the yield of each index. Neither Investment Grade Corporate bonds nor Below Investment Grade bonds are quite as liquid as US Treasuries despite being publicly traded. Some portion of the yield premium must be attributable to illiquidity but that premium must be significantly smaller than the implied default premium, as default is the primary risk that investors accept when investing in any corporate bond versus Treasury security.

In the chart below, we demonstrate the relative yield advantage of two of these opportunities.

	US Treasury	US Investment Grade	US Below Investment Grade	Trust Deed Certificates	Pre-Settlement Advances
Yield	1.76%	2.96%	5.89%	8.50%	12.00%
Default Premium	0.00%	1.20%	4.13%	4.13%	4.13%
Illiquidity Premium vs. High Yield	0.00%	0.00%	0.00%	2.61%	6.11%
Illiquidity Premium vs. Investment Grade	0.00%	0.00%	0.00%	5.54%	9.04%

As of 6/28/2019

Data sourced from FRED Economic Data, St. Louis Fed -- <https://fred.stlouisfed.org>

Let's select two opportunities that we currently see in the private markets and assume that they have comparable default risk to Below Investment Grade bonds (we actually believe that the default risk of each of these opportunities is less than that for Below Investment Grade bonds due to the fact that each has demonstrated a lower loss experience, is supported by clearly identifiable collateral, and demonstrates little or no correlation to the major equity and bond indices).

Trust deed certificates – first lien loans on real estate targeted for development - currently offer an annual yield of approximately 8.5%. Pre-settlement advances on personal injury cases (Litigation Finance) currently offers an IRR of 15% or greater, so let's assume that equates to a yield of 12%. This would mean that the illiquidity risk premium equals 2.61% for Trust Deed certificates and 6.11% for pre-settlement advances.

Investing in either of these market segments has produced and likely will continue to produce superior returns to publicly traded opportunities with comparable duration and risk. The sources of the excess return can be attributed to illiquidity, complexity, lack of scalability, and/or other factors. In our view, the source of the excess return is structural alpha – a particular set of circumstances that result in higher yields and, potentially, additional protections.

In these opportunities it is the manager's role to identify, procure and monitor these investments. Therefore, this type of alpha is likely more repeatable and more dependable than strategic alpha.

## Conclusion

Clearly, there is room for both structural and strategic alpha in most portfolios. Our belief is that there is too much focus on strategic alpha and insufficient focus on structural alpha. We believe that investors will be well served by exploring opportunities in structural alpha and by adding these opportunities to further diversify portfolio risk and to enhance portfolio return.

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