PIMCO

Your Global Investment Authority

Understanding portable alpha

EDUCATION SERIES

Passive strategies strive to match the performance of a market index. Portable alpha strategies go further, combining key benefits of active and passive management in an effort to enhance returns while also managing risk – especially important goals in today's lower-return markets.

What is portable alpha?

Portable alpha is an investment approach that provides target market exposure, while adding the potential for additional return (alpha) through a separate investment strategy. Because the source of alpha is independent of the desired market exposure, it can theoretically be transported to any market exposure, hence the term "portable alpha."

How the strategy works

In most portable alpha strategies, market exposure is gained through market-linked instruments such as futures or swaps. These positions require only a small outlay of cash (if any), allowing the manager to both capture the market return and actively manage the bulk of the portfolio's cash in a liquid strategy – an absolute return bond alpha strategy, for example – that may provide additional return.

This arrangement is similar to buying a car or a house without paying the entire price up front. As with an auto loan or mortgage, there is a financing cost associated with buying market exposure using futures or swaps. This cost is usually tied to a short-term money market rate. The alpha strategy must outperform this money market rate in order to deliver excess return.

Why use a portable alpha strategy?

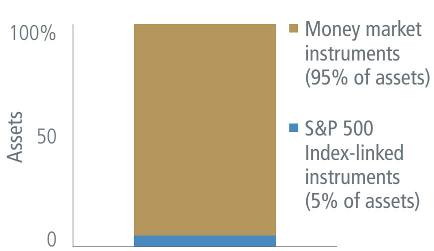
Investors may look to portable alpha strategies for a number of reasons, including:

- **Opportunity for enhanced returns** – Portable alpha provides both exposure to a target market, such as stocks or commodities, as well as the potential to outperform that market. The opportunity for additional return can be especially helpful in an environment in which traditional asset returns are expected to be muted.
- **Maintain an existing asset allocation** – Investors can enhance their portfolios' return potential without making dramatic alterations to a traditional asset allocation model.
- **Diversification benefits** – Because the cash is invested differently than the target market exposure, investors may gain a diversification advantage, helping to manage portfolio risk. Of course, diversification does not ensure a profit or protect against loss.

Portable alpha: market exposure plus an enhanced risk/return profile

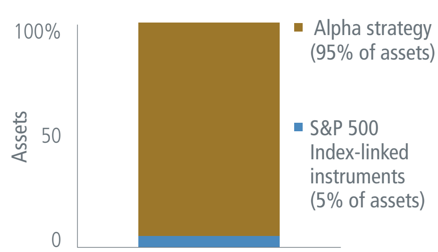
Example: Seeking to match the S&P 500 Index return: two ways

Buy all the securities in the index.



Obtain 100% index exposure using S&P 500 Index-linked instruments; invest cash in money market instruments.

Seeking to outperform the S&P 500 Index



Portable alpha strategies likewise buy S&P 500 Index-linked instruments to gain 100% exposure, but invest the cash in an alpha strategy designed to achieve attractive risk-adjusted returns above the money market cost.

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Types of portable alpha strategies

The portable alpha structure may be used in many combinations to suit specific investment objectives (see table at right). Investors can obtain their desired market exposure, or beta, to a range of large-cap, small-cap, international and emerging market market indexes and smart beta-based strategies. They can also gain exposure to commodities and real estate via instruments linked to those asset classes.

The alpha-generating component, which should have low correlation with the beta component and reasonable liquidity, can vary as well. Because the assets invested in these strategies may be needed in order to meet any margin calls, the securities should be relatively liquid, with a focus on capital preservation. At PIMCO, we typically back our portable alpha portfolios with actively managed, high quality liquid enhanced cash, absolute return bond, Treasury Inflation-Protected Securities (TIPS) or long-duration bond strategies.

Example: Types of market exposure (beta)	Example: Alpha-generating strategies
Stock indexes and smart beta-based strategies including: • large-cap • small-cap • international • emerging market **Commodities** **Real estate**	Enhanced cash Absolute return bond Enhanced Treasury Inflation-Protected Securities (TIPS) Long-duration bond

Skill and risk management are key

While portable alpha is a relatively straightforward concept, there are many factors to consider when implementing these strategies. Fund managers must have the expertise and infrastructure to effectively maintain liquidity and meet cash flows associated with market-linked instruments, with knowledge of the regulatory and legal factors involved. A rigorous process for managing risk is critically important as well, including thorough counterparty assessment. Given these factors, we believe investors should look to a skilled, experienced manager when considering this type of strategy.

Tax considerations

Because portable alpha strategies use market-linked instruments to gain market exposure, there are some tax considerations to be aware of. For example, all daily gains or losses on futures may need to be calculated as realized for tax purposes; these gains or losses may affect either ordinary income or capital gains, depending on the contract. With swaps, the tax treatment varies depending on the terms of the contract. You should consult your tax advisor before investing.

Risk considerations

It is important to understand some of the risks associated with these types of strategies. These funds may experience greater losses or lesser gains than would be the case if they invested directly in a the reference market portfolio – the S&P 500, for example – if the alpha strategy underperforms the money market-based cost. They also may not be perfectly correlated to their underlying benchmarks and/or market exposures over time, and the degree of variation could be substantial. Finally, it's possible for these strategies to experience a negative return.

TERMS TO UNDERSTAND

Alpha: risk-adjusted excess return relative to a target index or market

Beta: market exposure, such as an asset class or market index

Counterparty: the opposite buyer/seller in a swaps transaction

Market-linked instrument (also referred to as derivative instrument): a financial instrument that derives its value from movements in an underlying security, such as a stock, bond or commodity

Futures: a standardized agreement to exchange cash for an asset at a future date, traded on an exchange

Liquidity: the speed with which a security may be bought and sold

Margin: the percentage of a security's current market value, held in a margin account

Swaps: an agreement between two or more parties to exchange cash flows over a set period of time

A word about risk: Derivatives may involve certain costs and risk such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. **Equities** may decline in value due to both real and perceived general market, economic and industry conditions. The value of most bond funds and fixed income securities is impacted by changes in interest rates. **Bonds and bond funds** with longer durations tend to be more sensitive and more volatile than securities with shorter durations; bond prices generally fall as interest rates rise.

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