



Introduction

In the summer issue of Perspectives we would like to address a topic that has attracted a lot of attention recently: The concept of alpha transfer. With both bond and equity markets stuck in single digit performance space, the incremental return ('alpha') from active management becomes an increasingly important part of a portfolio's total return. Furthermore the development of sophisticated financial instruments makes it possible to derive alpha from an asset class that is unconnected to the actual market ('beta') exposure of the portfolio. In our first article Deborah Hazel, Managing Director, explains in detail the workings of this 'alpha transfer' process.

In our second article we look at investment opportunities for global fixed income portfolios that lie further afield than the typical indices allow for: Icelandic housing bonds have provided a high real return and diversification through decorrelation from global fixed income markets. Orlena Yee, Portfolio Analyst in FFTW's Sovereign Bond Team, sheds some light on this recently developed part of the fixed income market.



Deborah Hazel - Managing Director

De-mystifying the Concept of (Portable) Alpha

Much has been written in recent months about the concept of portable alpha. The more that has been written, the more questions we find ourselves answering from our clients. This attempts to explain briefly what portable alpha is, why it is important and who can effectively deliver.

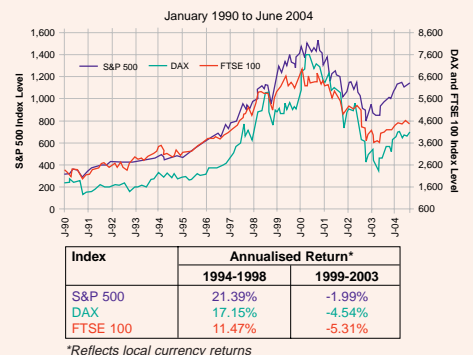
Whereas 'alpha' is the excess return generated above a given benchmark, the term portable alpha refers to the excess return generated independently from any given benchmark. It results from the separation of the alpha generating process from the beta construction process. Historically, investments have typically been structured within an asset allocation framework, and investors have sought to replicate and enhance the benchmark returns within their sector of the aggregate framework. This has traditionally been undertaken through optimally managing the benchmark and creating overweight or underweight positions relative to the benchmark that are expected to generate positive returns above the benchmark return. Clients' guidelines may include a degree of symmetry in so far as equally overweight or underweight positions relative to the benchmark may be taken. However, they more usually have an asymmetric bias in absolute return space. For example, a portfolio managed against a sovereign benchmark may allow off-benchmark exposure to corporate credit which allows a portfolio to be long but not short credit exposure or duration parameters, allow a certain duration range around the benchmark, but still maintain a long absolute bias. The concept of portable alpha is to introduce complete symmetry to guidelines in absolute return space, and to separate the alpha generation process from both the risk and the investment parameters inherent in an underlying benchmark. In other words, the alpha universe may no longer be connected with the beta (market return) to which it is attached or over which it is 'transported.'

Most clients, in engaging an active fixed income asset manager, have generally understood that the manager is paid to generate alpha whereas the beta component (or benchmark management)

is expected as a free good in the delivery process. A manager who consistently achieves benchmark returns may not be regarded as effective, yet the cost-efficient management of the beta component also requires skill. In most traditional portfolios, alpha and beta are intertwined and generating excess returns requires an equal focus on both aspects of the portfolio. The concept of portable alpha completely separates the alpha and beta management, to the point that the manager of the alpha may not be the manager of the beta. Furthermore, the beta construct may have no similarities in terms of instruments or parameters relative to the alpha generating component, and indeed there may be no correlation between these two different paths of return.

Why is this concept becoming more prevalent and why is it argued by some as being the most significant change in portfolio management thinking in the last two decades? Firstly, as with many new ideas, there is a catalyst for the change in thinking. As equity markets suffered during the period 1999-2002, the positive alpha that managers may have generated above negative benchmark returns gave little comfort to many investors facing significant negative absolute returns and led many equity investors to question their exposure to systematic risk (Chart 1).

Chart 1: Index Levels of S&P 500, DAX and FTSE 100



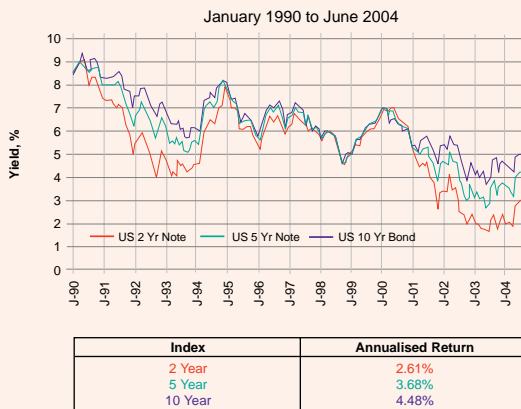
Source: Bloomberg

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De-mystifying the Concept of (Portable) Alpha *continued*

Secondly, in the world of fixed income, bond returns have on the whole been strongly positive over the previous decade. However, the current absolute low level of yields, particularly at the short end of the curve, and the prospect of an end to the long term bull market in bonds (Chart 2) are causing investors to rethink traditional portfolio management theory in respect to asset allocation, prompting a search for ways in which to generate consistently positive returns in what may not be consistently positive bond market conditions.

Chart 2: US Treasury Yields



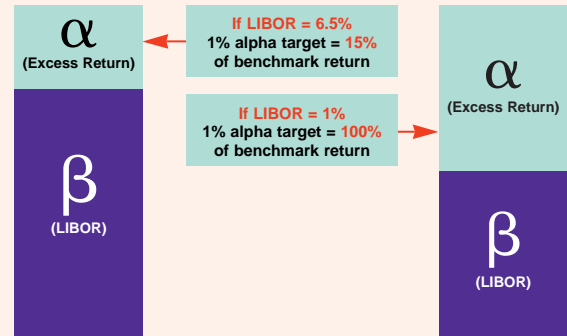
Source: Bloomberg

The current low level of bond yields has led investors to focus on the relative importance of alpha rather than beta. Because traditional benchmarks offer insufficient expected return, the excess return is likely to constitute a more significant component of total return (Chart 3). This has led to an inevitable move towards the quest for optimal conditions for alpha generation and a re-evaluation of traditional alpha generation parameters. Investors are recognizing that the best opportunity set may not be represented by any particular benchmark and are focused on creating an optimal opportunity set relative to current market conditions. This may include instruments not found in the benchmark as well as new utilizations of these instruments.

Whereas traditional investors tend to be comfortable taking long positions, the alpha only concept requires being able to short, not just underweight, positions in order to be able to generate alpha irrespective of the interest rate or spread direction. This is necessary in order to achieve a low correlation between alpha and the systematic or directional risk inherent in benchmarks. It also generates the homogenous, high quality, risk-adjusted alpha proposition which investors have been seeking.

Global investors are arguably more used to this approach as currency management is an area in which the portability of alpha and the long / short management style has been more broadly adopted. Currency overlay is the most common use of portable alpha, though many investors may not view it as such. The separation of the underlying asset allocation and the currency allocation decision within a multi-currency portfolio is the first step towards portable alpha. Currency is generally managed

Chart 3



using forward foreign exchange contracts, which are implemented as an overlay above the underlying invested assets and are easily executed given the high liquidity of the forward FX market. The ability to manage a fully-hedged base currency position within +/- bands e.g. 75% to 125% introduces the concept of shorting positions that are not actually held. This is an important element of currency management which ensures the positive alpha is not dependent on the single direction of the base currency, but that positive returns can be created across all FX environments.

This approach to currency investing and the growing adoption of currency as an independent overlay strategy is now being transported to a broader investment arena. It has in part been made possible by the relatively recent increase in the variety and liquidity of derivatives available in the market (see table below) which has greatly facilitated the extensive use of overlay strategies in multiple areas of bond market investing, where it had previously not been possible, including duration, yield curve, country allocation, corporate credit and structured credit.

Market	Overlay Instrument
Interest Rates	Futures, Options, Swaps, Swaptions
Foreign Exchange	Forwards, Futures, Options
Credit	Credit Default Swaps
Structured Securities	Mortgage Derivatives, TBAs

The main points of differentiation between alpha generated independently of the benchmark and the more traditional alpha generated in tandem with the management of the benchmark are (i) symmetry vs. asymmetry of guidelines and (ii) guidelines related vs. unrelated to any type of systematic or directional risk. The key to both alpha/beta and alpha-only strategies lies in the discipline of decision making, stringent risk management and detailed and specific guidelines. Depending upon the client and the client's risk tolerance, guidelines may be narrow or broad, alpha may be targeted as low as 50bp per annum or exceed 200bp + per annum. However, all have clearly specified asset classes, risk limits and well defined investment criteria, which clearly differentiates this from hedge fund investing. We see this as a path for the future and one in which we expect there to be continued interest, research and investment.

Icelandic Housing Bonds: Attractive Yields and Low Correlations Offer Portfolio Diversification

Inflation-linked Icelandic housing bonds offer an opportunity to add alpha and reduce risk in portfolios benchmarked against a global multi-sector universe.

Identifying asset classes with such traits is increasingly important in an environment where major bond markets are becoming more positively correlated. For example, the three-year rolling correlation between 10 year US and European yields has increased from approximately 0.4 in 1992 to 0.85 currently, resulting in scarcer investment opportunities and making sufficient portfolio diversification a greater challenge. Off-benchmark allocations can also be useful when yields are range-bound. When yields are non-trending, it can be difficult to obtain incremental return through duration positioning. In this type of environment, yield becomes very important, and for the most part, off-benchmark sectors typically offer a higher yield. Finally, in a rising yield environment, inflation-linked bonds have historically outperformed nominal bonds given that the inflation element which could be part of what drives nominal yields higher is removed from real yields.

Attractive Yields

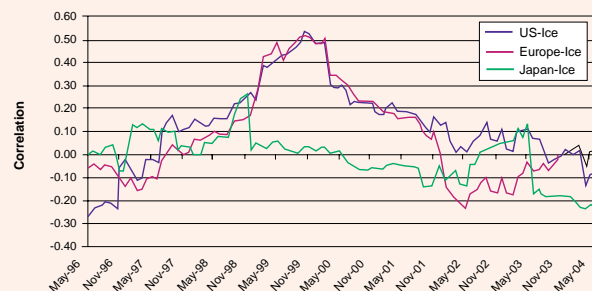
Since inflation-linked Icelandic bonds were first issued in the mid-1990's real yields have ranged from 4-8%. When we add inflation on top of this, yields in Iceland are much higher than yields offered on bonds issued by other countries with a similar Aaa/AA+ rating and that are backed by a government guarantee. In fact, Icelandic yields look more like those offered by some emerging market debt. However, unlike an emerging market, Iceland's per capita GDP is currently USD 29.6 thousand. Furthermore, in March 2001, the Icelandic krona was floated and the central bank gained full independence and adopted an inflation targeting mandate. The inflation target is 2.5% with symmetric tolerance limits of +/-1.5%. Inflation is currently running just below 4% year-on-year, at the higher end of the tolerance range. Historically, Iceland's inflation rate has been one of the highest amongst OECD countries and GDP growth has been volatile, which could explain why yields are higher in Iceland when compared to other investment grade countries.

Low Correlation

Over time, the rolling three-year correlation between monthly changes in Icelandic and G-3 bond yields averages close to 0 and has been as high as 0.5 and as low as -0.25. Given this low correlation, historically, an allocation to Iceland would have increased returns to a global portfolio without adding to risk, or even reducing overall portfolio risk.

Some of the diversification benefit comes from investing in the Icelandic krona. For optimal portfolio diversification, an allocation to Iceland should be made on an unhedged basis. However, the argument for a 50% hedge comes from the idea that the impact of currency affects inflation fairly directly in Iceland, with the pass through being about 0.5. This means that for every 1% appreciation in the trade-weighted krona, inflation decreases by roughly 0.5% with a time lag of 12-18 months. A 50% currency hedged position is a natural hedge in that currency appreciation should compensate for lower inflation and vice versa. FFTW currently manages the currency hedge opportunistically, with an allocation to Iceland being 0 to 50% hedged at any given point in time.

3-year Rolling Correlation of Monthly Changes in Yield



Source: Bloomberg

Allocating Iceland to Global Portfolios

In local currency terms, the 25-year housing bond has enjoyed an annualised return of 13.15% and a standard deviation of 4.22%, with inflation carry, real coupon and price appreciation each making up about a third of the total return. The Lehman Global Aggregate Index hedged in USD terms has returned 6.67% with a standard deviation of 3.08%. Higher return along with low correlations means that historically, combining Icelandic housing bond returns with LBGA returns should increase returns while reducing risk, as shown in the charts overleaf.

FTW's typical allocation range to Iceland is from 0-3%, below the optimal allocations as seen in the charts above, primarily due to the small size and relative illiquidity of the Icelandic domestic bond market. Comprising close to 60% or approximately USD 5 bn of the domestic bond market, housing bonds are the most liquid issues, with domestic pension funds being the primary market participants. However, the Icelandic bond market is still much less liquid than, for example, the New Zealand bond market, which most investors would also view as a smaller and less liquid market. The bid offer spread in Iceland is several bps higher compared to that in New Zealand despite arrangements in place requiring market makers to quote bids and offers on a regular basis in Iceland.

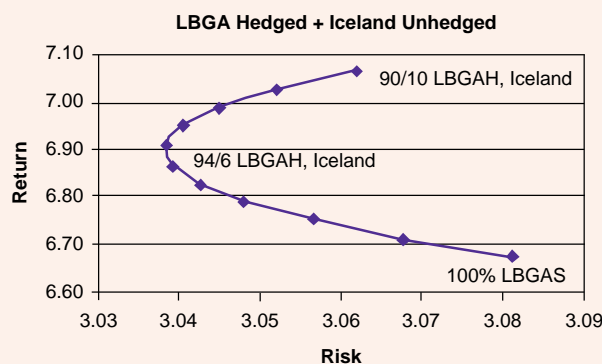
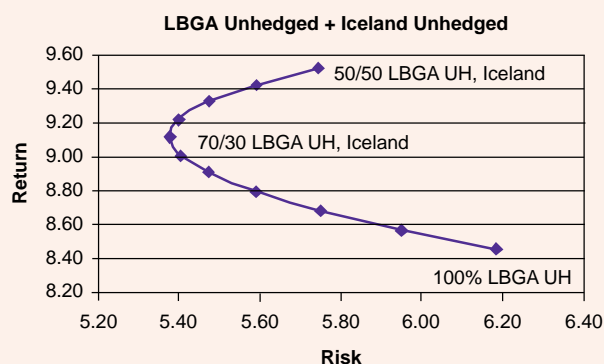
However, liquidity in the housing bond market has improved recently due to changes making the Icelandic bond market more accessible to foreign investors. In a successful bond exchange in early July 2004, all 7 of the old housing bond issues were consolidated into 3 benchmark bonds each roughly making up one third of the total outstanding housing bond issuance. In addition, the new bonds are non-callable and amortise on a pre-set schedule, unlike the old bonds, which were exposed to prepayment uncertainty. Furthermore, while the old housing bonds could only be settled domestically, making it operationally difficult for foreigners to participate in the Icelandic bond market, the new bonds are eligible for settlement on Euroclear and Clearstream. Finally liquidity should also increase, with plans to model and price the bonds on Bloomberg in the near future.

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Icelandic Housing Bonds *continued*

Table Showing Allocation of Housing Bonds to Iceland

30 June 2000-30 June 2004	25 year Icelandic housing bond Local currency return	25 year Icelandic housing bond Unhedged (against trade-weighted basket of currencies)	25 year Icelandic housing bond 50% hedged return (against trade-weighted basket of currencies)	LBGA Unhedged in USD	LBGA Hedged in USD
Risk	4.22	8.90	5.80	6.18	3.08
Return	13.15	10.32	11.80	8.45	6.67



Source: Bloomberg, Lehman Brothers

Bond	ISIN	Duration	Yield	Maturity
HFF150224	XS0195066146	8.5	3.97	15-Feb-24
HFF105434	XS0195066575	12.2	3.92	15-Apr-34
HFF150644	XS0195066678	15.2	3.865	15-Jun-44

Source: Islandibanki – As of 9 August 2004

Outlook for Iceland

Icelandic real yields are currently slightly below 4%, at the low end of their historical range, which still appears high when compared to real yields elsewhere. Longer maturity real yields in the US and Europe, for example, are currently just above 2% and about 2.4% in Sweden. Even after accounting for a higher liquidity premium, it can be argued that real yields in Iceland still belong closer to 2% than 4%. A case can be made for the normalisation of Icelandic real yields which may have remained at a relatively high level due primarily to limited access to the market.

However, the story is slightly different when we look at the fundamental economic environment. Given the magnitude of the large GDP boosting aluminium projects taking place in the next couple of years in Iceland and the inflationary pressures that will probably accompany these projects, combined with a central bank that is keen on gaining credibility, it is likely that Icelandic interest rates will have to be increased by more than in a typical hiking cycle and at a more rapid pace. From this perspective, Icelandic yields are clearly less attractive. However, given that the impact of these large scale industrial projects is temporary in nature, interest rates in Iceland may need to be taken down quite quickly after the initial construction phase of the aluminium plants is concluded. This is a potential opportunity for the medium term.

Correlations Likely to Remain Low

The more compelling case for an allocation to Icelandic housing bonds in a global bond portfolio is one of overall portfolio diversification and risk reduction. The long term zero correlation between Icelandic housing bond yields and US and European yields is unlikely to change meaningfully in the near future. Despite being a relatively open economy where global economic forces affect Icelandic yields as they do G-3 yields, which should increase the correlation between them, the economy in Iceland is also subject to economic pressures that are unique to Iceland, such as aluminium projects that harness vast geothermal energy sources (still only a fraction of that resource is being tapped) and the fact that Iceland is still very much an economy that is largely dependent on fishing. Finally, despite efforts to increase the liquidity and transparency of the Icelandic bond market, there will always be a fairly substantial liquidity premium embedded in Icelandic yields, which is partly what keeps the correlation so low.



Orlena Yee – Portfolio Analyst