How hard is it to beat the S&P 500?
It depends on how you try to do it…

Marty Dirks

January 2016

The challenge

Almost every institutional investor would like to find an investment manager with a high probability of outperforming the S&P 500. It is widely acknowledged to be one of the most efficient markets and most difficult benchmarks to beat. For a typical pension plan, 35-40 % of all capital is invested in the S&P 500.

In the large cap core U.S. equity sector, it's difficult to find managers who consistently outperform their most common benchmark – the S&P 500. As of December 31, 2015, of the 1,127 investments within the Morningstar US OE Large Blend universe with a 5-year track record, only 137 outperformed the S&P 500 after fees for the past five years. That equates to only 12%. Nearly every institutional investment portfolio has a substantial allocation to U.S. equities.

This conundrum has led many institutional investors to passively manage their large cap core U.S. equity allocation. With only 10% - 20% of active managers outperforming, and it being a difficult challenge to choose a manager who will fall into this top 20% five years from now, many institutional investors have chosen to essentially "not play the game" and invest passively.

A possible solution

It is indeed difficult to find managers who consistently outperform in the large cap equity space. However, while beating a benchmark is difficult in any portion of the market, there are other areas where a manager can achieve more consistent outperformance of a benchmark. An "enhanced index" approach, sometimes referred to as "portable alpha," could be used to add performance to a large cap core U.S. equity investment.

What does this mean? If we wish to invest $100 in the S&P 500, we may obtain the profit (or loss) of $100 invested in the S&P 500 by using futures. If we allocate $10, we can secure a position in S&P 500 futures representing a $100 investment in the S&P 500. This investment will provide our equity market profit or loss – often referred to as the "beta" portion of our investment return.

With the futures position in place, secured by the $10 contribution, we still have $90 we can invest elsewhere. S&P 500 futures are priced by the market such that a combination of 10% held as collateral for futures and 90% invested in a LIBOR-yielding investment will have a return very close to the S&P 500. The goal then is to invest the remaining 90% of capital at a return above that of LIBOR. As long as we earn more than LIBOR with our other investment, we have added performance to the S&P 500 investment return. This additional return that is "ported" from a source uncorrelated to the S&P 500 is what creates the portable alpha strategy.

Now, consistently earning more than LIBOR might seem trivial, but it's not. However, the investor gets to explicitly choose how much risk of loss and liquidity risk he or she takes with this "bet" versus LIBOR.

The key insight is that it is not necessary to obtain the market return (beta) and outperformance (alpha) from the same source. Note that the portable alpha generation chosen could at times be correlated to the S&P 500. In a period when the S&P 500 is down, the alpha strategy could lose money too resulting in greater losses. While this may be a better solution than the traditional approach to investing in the S&P 500 (or most other indexes), it is not a "miracle" that cannot lose money.

While portable alpha is not a widely used strategy, neither is it some new, wild idea. The primary enhanced index manager I have used has a track record beginning in 1986 and manages more than $50 billion in assets in this manner. It has outperformed the S&P 500 in 86% of rolling 3-year periods (net-of-fees) since inception.

This manager employs a global macro/fixed income approach to generate the outperformance, or alpha. Other managers in the enhanced index space use various approaches and methodologies to generate the outperformance with success. Selecting a specific enhanced index manager should only be done with careful consideration of the characteristics of other alpha sources in the investment portfolio.

Marty Dirks
Investment Strategy & Analysis
268 Bush Street, # 3631
San Francisco, California 94104
InvestmentStrategyAnalysis@gmail.com
https://isacm.com
415 845 7829