

The Return Stacking How-To Guide



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Overview

The implementation of return stacking allows investors to solve some potentially pressing problems faced in portfolio construction. In this guide, we explore four case studies that showcase some of the most utilized methods to introduce return stacking to a portfolio.

Introduction

While we hear from many advisors that are excited about the concept of return stacking, one of the first questions we are asked is: “how should we put this into practice?”

In this guide, we will provide a few of our favorite examples on how to use return stacking in an investment portfolio. We have also written a return stacking checklist and included it at the end of this report if you’d like to read about some of the considerations we make when reviewing portfolios and recommending options.

Understanding Return Stacking and Portable Alpha

Investors that have been around for a while may be familiar with the concept of portable alpha. Return stacking shares similarities with portable alpha, where investors seek to enhance portfolio efficiency by overlaying active strategies without altering their core asset allocation.

Helpful definitions:

Return Stacking is an advanced portfolio management technique that allows investors to enhance their capital efficiency by layering multiple investment strategies on top of a core portfolio. This approach involves integrating uncorrelated strategies to optimize returns without altering the original asset allocation.

Portable Alpha is a concept closely related to return stacking. It involves separating alpha (active management returns) from beta (market returns) to build more efficient and diversified portfolios. By overlaying uncorrelated alpha strategies on top of beta exposures, investors aim to enhance returns while maintaining their desired core asset allocation.

[Read more about portable alpha strategies here](#)

The Building Blocks

To keep the guide relatively easy to follow, we will use a few generic asset classes and generic return stacking strategies. The asset classes we will use are equities, fixed income, alternatives, and cash.

Figure 1: Generic Return Stacked Strategies

	Asset Class		
	Equities	Fixed Income	Alternatives
Strategy 1	100%	100%	
Strategy 2	100%		100%
Strategy 3		100%	100%

Source: Newfound Research. For illustrative purposes only.

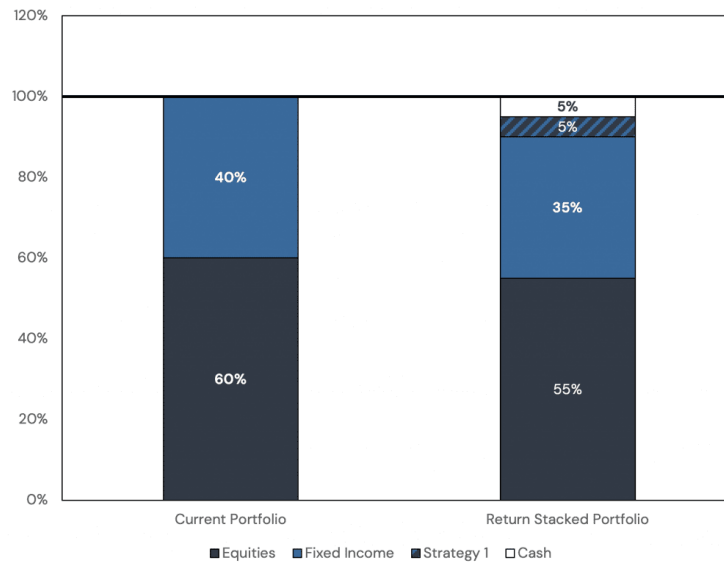
Case Study 1: Adding Cash to a Portfolio

In our first—and potentially most straightforward—case, we would simply like to free up cash in a portfolio without incurring cash drag. Investors may want to do this for a variety of reasons, including managing withdrawals, fees, and capital calls. Often, we even hear about advisors who are required to keep a certain amount of cash allocated by their compliance departments.

If we begin with a 60/40 equities/fixed income portfolio with the desire to add 5% to the portfolio, it makes sense to look to Strategy 1 (100% Equities / 100% Fixed Income) as an addition to our lineup. To accomplish this, we would sell 5% of our equities and 5% of our bonds to add a 5% exposure to Strategy 1.

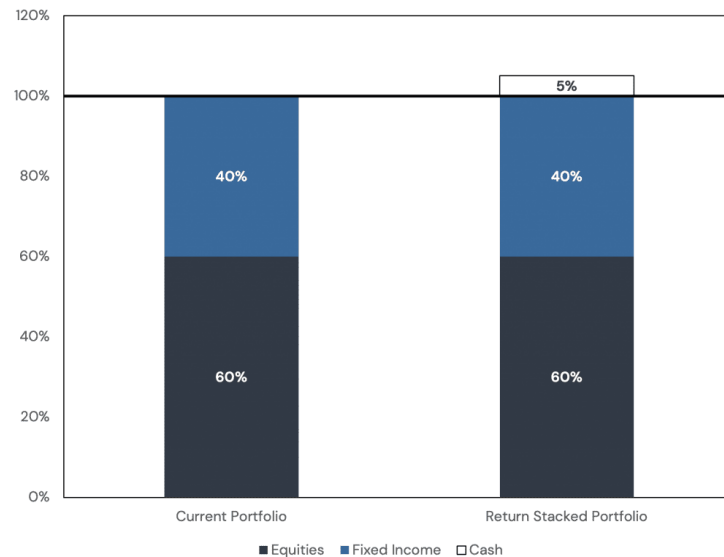
Since the 5% allocation to Strategy 1 provides us with 5% exposure to both stocks and bonds, our previous allocation is preserved, and we now have 5% free to leave in cash.

Figure 2: Freeing Up Cash in a Portfolio – Portfolio Allocation



Source: Newfound Research. For illustrative purposes only.

Figure 3: Freeing Up Cash in a Portfolio – Notional Allocation



Source: Newfound Research. For illustrative purposes only.

While stacking an “extra” 5% cash may seem appealing from a return perspective, we should note that Figure 3 is slightly misleading. Although we have freed up 5% cash while maintaining our pre-existing 60/40 exposure, the extra 5% cash return would be in excess of the prevailing borrowing rate.

Since the interest rate earned on cash and the embedded cost of leverage are similar, this means that the return profile of the Current Portfolio and the Return Stacked Portfolio should be nearly identical. In other words, a capital efficient strategy, like Strategy 1, can allow investors to hold more cash without necessarily incurring the penalty of cash drag on their portfolio. By utilizing capital-efficient instruments—similar to techniques employed in portable alpha strategies – we maintain our portfolio’s exposure while freeing up cash. In other words, a capital efficient strategy, like Strategy 1, can allow investors to hold more cash without necessarily incurring the penalty of cash drag on their portfolio.

If you would like to learn more about this idea, we have written a deeper dive on this topic, available [here](#).

Case Study 2: Adding Stock/Bond Exposure to a Conservative or Aggressive Portfolio

In many cases, investors may exist on the extremes of being a conservative or aggressive investor, with the extremely conservative investor being entirely invested in fixed income, and the extremely aggressive investor being entirely invested in equities.

Both investors, however, are missing out on the potential diversification benefits between equities and fixed income.

It may be, then, that either of these two investors want to keep their existing asset allocations but include the other asset class on top to improve the diversification of their portfolios. This approach echoes the principles of portable alpha, where investors overlay additional exposures to achieve diversification without modifying their core holdings.

The conservative investor is subject to the large risk that their portfolio may not be able to keep up with inflation. By stacking equity exposure on top, the portfolio can gain access to a growth asset without compromising the nominal safety of fixed income.

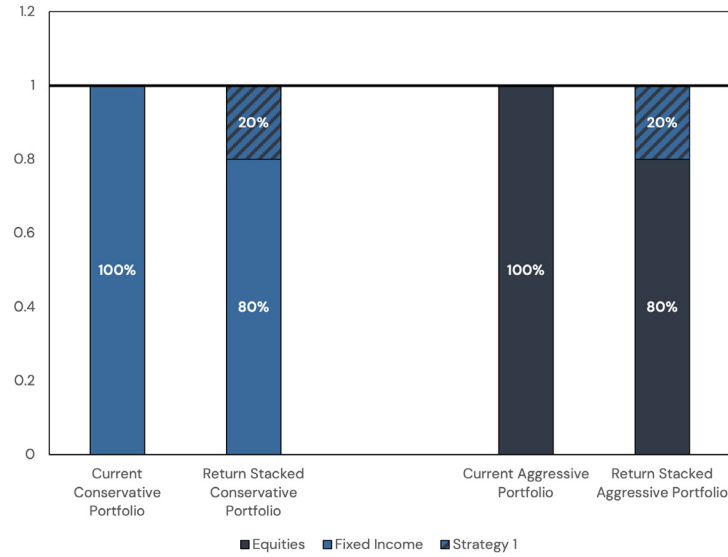
The aggressive investor, on the other hand, is entirely exposed to equity market risk (We refer the reader to [Why Not 100% Equities](#) by Cliff Asness at AQR for an in-depth article covering this use-case). By stacking fixed income on top of the equity portfolio, the investor has now gained access to a potentially diversifying asset and introduced an *additional* source of return to their portfolio.

If we say that each investor wants to add 20% of the left-out asset class, then each investor would sell 20% of their existing portfolio and replace the exposure with Strategy 1 (100% Equities / 100% Fixed Income).

More specifically:

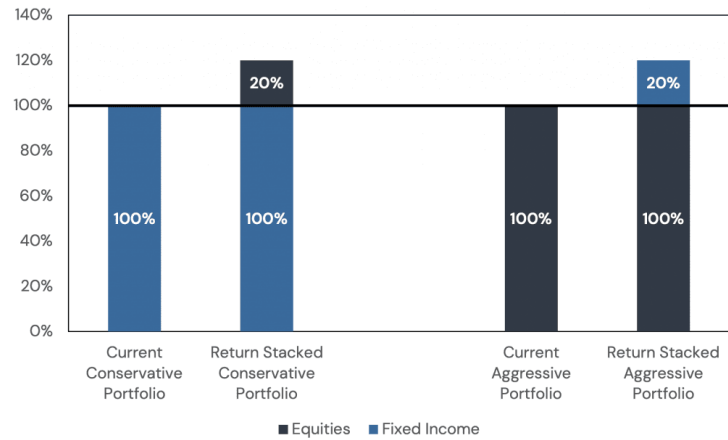
- The conservative investor would sell 20% of their bonds to buy 20% of Strategy 1.
- The aggressive investor would sell 20% of their stocks to buy 20% of Strategy 1.

Figure 4: Adding Stock and Bond Diversification to a Portfolio – Portfolio Allocation



Source: Newfound Research. For illustrative purposes only.

Figure 5: Adding Stock and Bond Diversification to a Portfolio – Notional Allocation



Source: Newfound Research. For illustrative purposes only.

Case Study 3: Including Alternative Assets

In this section, we show two sub-case studies with two different methods of including alternative or diversifying assets.

In many cases, an investor may want to add diversifying assets but is reluctant to [sell down existing core exposures](#) to do so. By implementing return stacking techniques, we can include diversifying assets without sacrificing our existing exposures.

Case Study 3A: Adding a Capital Efficient Fund with Alternatives Exposure

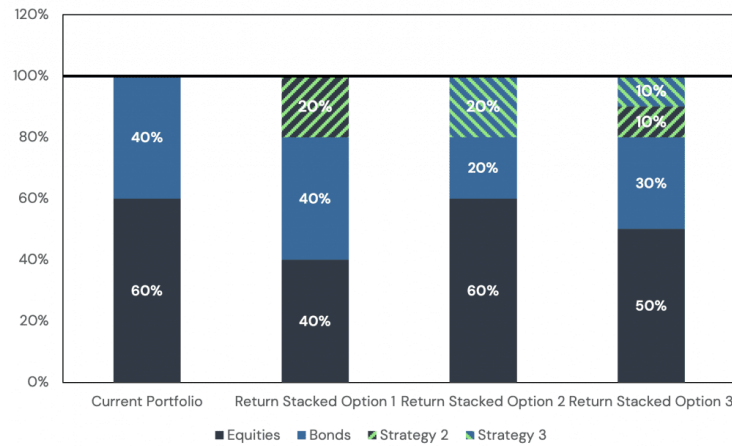
One straightforward way to include certain alternatives is to utilize strategies that pre-package capital efficient alternatives on top of core stock or bond exposures, such as Strategy 2 (100% Equities / 100% Alternatives), Strategy 3 (100% Fixed Income / 100% Alternatives), or a combination thereof. These strategies embody the portable alpha concept by overlaying alternative investments onto beta exposures, enhancing portfolio efficiency.

If a portfolio begins with a 60/40 equity/bond exposure and wants to add an additional 20% to alternatives, there are three options to accomplish this:

1. Sell 20% stocks to purchase 20% of Strategy 2 (100% Equities / 100% Alternatives).
2. Sell 20% bonds to purchase 20% of Strategy 3 (100% Fixed Income / 100% Alternatives).
3. Sell 10% of stocks and 10% of bonds to purchase 10% in Strategy 2 and 10% in Strategy 3.

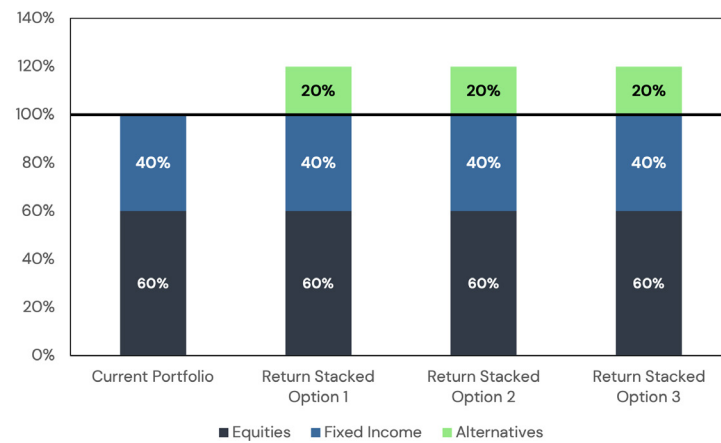
As we can see from Figure 7, in all cases the resulting asset allocations are all the same; however, the underlying strategies held in the portfolio differ, as shown in Figure 6.

Figure 6: Adding Alternative Exposure Through Pre-Packaged Return Stack – Portfolio Allocation



Source: Newfound Research. For illustrative purposes only.

Figure 7: Adding Alternative Exposure Through Pre-Packaged Return Stack – Notional Allocation



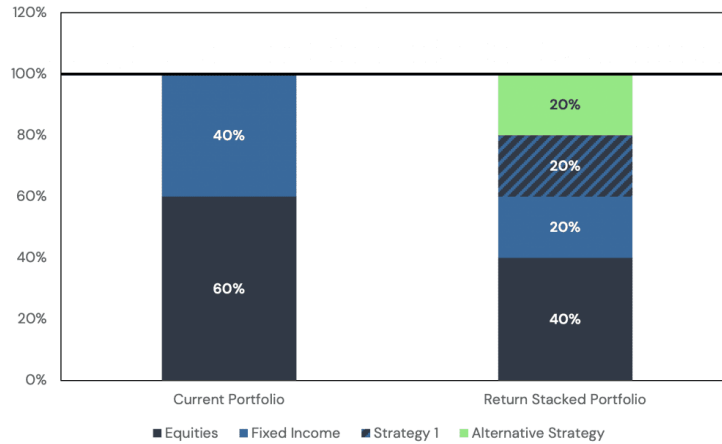
Source: Newfound Research. For illustrative purposes only.

Case Study 3B: Freeing-Up Space for Alternative (or Diversifying) Assets

In this case study, we use the term “alternatives” loosely. This freed-up space could be allocated to almost any additional asset class that you could think of, such as [alternative funds](#) or real assets. This is very much a “choose your own adventure” style of return stacking. Similar to portable alpha strategies, the investor could choose any combination of funds, asset classes, or styles to allocate to with the freed-up capital (though, we would still recommend that these additions diversify the existing portfolio).

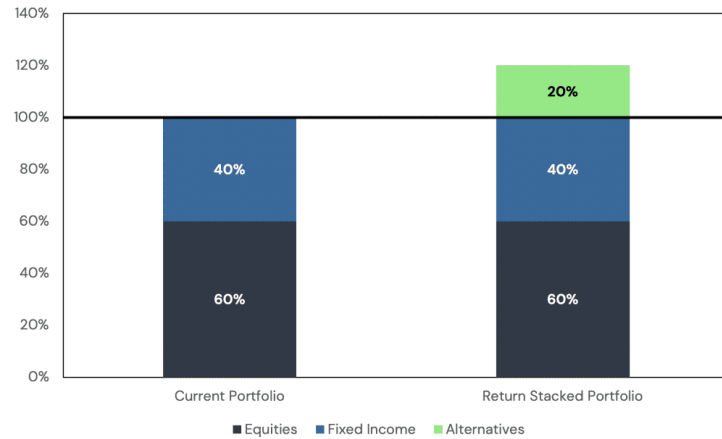
To accomplish this, using a 60/40 portfolio as a starting point with the desire to add 20% alternatives exposure, we could once again utilize Strategy 1. By selling 20% equities and 20% bonds to buy 20% of Strategy 1 (100% Equities / 100% Fixed Income), the portfolio now has 20% of available capital to allocate to alternatives, or whatever asset class the investor may desire.

Figure 8: Choose Your Own Adventure – Portfolio Allocation



Source: Newfound Research. For illustrative purposes only.

Figure 9: Choose Your Own Adventure – Notional Allocation



Source: Newfound Research. For illustrative purposes only.

Conclusion

Return stacking is a very powerful concept that has many potential applications in portfolio design. In this post, we have demonstrated that return stacking may resolve three potential challenges for advisors. In each case, the current asset allocation remains intact and does not materially affect the composition of the funds held within the portfolio. In essence, the return stacking strategies we've explored not only preserve existing asset allocations but also embody the core principles of portable alpha, enhancing portfolio efficiency and diversification.

While there are certainly many additional cases where return stacking can be a solution, the case studies highlighted in this article reflect the most common concerns that we hear from advisors, with the most straightforward implementations.

The Return Stacking Checklist

We believe return stacking is a portfolio concept that can revolutionize the way you think about building portfolios. There are a number of things to consider, however, when building a return stacked portfolio, which is why we built this checklist: to help get you started on your return stacking journey.

1. Figure out what you want to stack

First and foremost, we need to choose what we want to stack on our portfolio. In theory, we can stack just about anything. In practice, however, we want to consider at least two important points.

First, how similar is what we're stacking to what we already own? Ideally, stacking allows us to introduce new, diversifying sources of return. Here we want to consider not just how the exposures behave on average, but in the tails as well.

Second, we want to think about liquidity. Stacking highly illiquid assets (or even just funds with a higher probability of gating redemptions in a stressed market environment) can prevent you from rebalancing during periods of market stress, potentially causing significant misalignments with intended risk profiles.

2. Measure your hurdle rate

When stacking, it's important to remember that we're implicitly borrowing money, [which means there is a financing rate](#). Fortunately, the embedded financing rate in derivatives like equity and bond futures is usually quite low; historically, they have been in the range of 1-3 month T-Bills and/or the SOFR rate. Other derivatives that can enable stacking, like swaps, may have different embedded costs. We also need to consider the fees of any fund wrapper as well as the potential tax implications of how we're implementing return stacking (see checklist item #8).

Taken together – financing rate, fees, and taxes – we create an embedded hurdle rate that our stacked exposure has to overcome before it can [add any excess returns](#) to our portfolio. Understanding this hurdle rate is critical for setting expectations as to the potential value a given exposure can contribute.

3. Determine how big a stack you want

The size of the stack is a critical component in defining the potential portfolio impact, including both the contribution to return and risk. As a simple rule, the size of the stack times the exposure's volatility will tell you, in the worst case scenario, how much more volatility and [tracking error](#) you're adding to your portfolio.

For example, if you want to stack a 10% exposure to a [managed futures program](#) with a volatility of 15%, you'd multiply 10% by 15% and find that you'd be adding 1.5% to portfolio volatility and tracking error. On the other hand, if you're looking to stack short-term, high-quality corporate bonds that have a volatility of 3%, a 10% position would just add up to 0.3% to the risk and tracking error profile.

As we can see, what you're stacking can heavily influence the appropriate size of the stack. Stacking equity on top of an equity heavy portfolio will just add risk. Stacking an uncorrelated asset or strategy might actually *reduce* risk. For example, stacking managed futures on a 60% stock / 40% bond portfolio has historically reduced drawdowns.

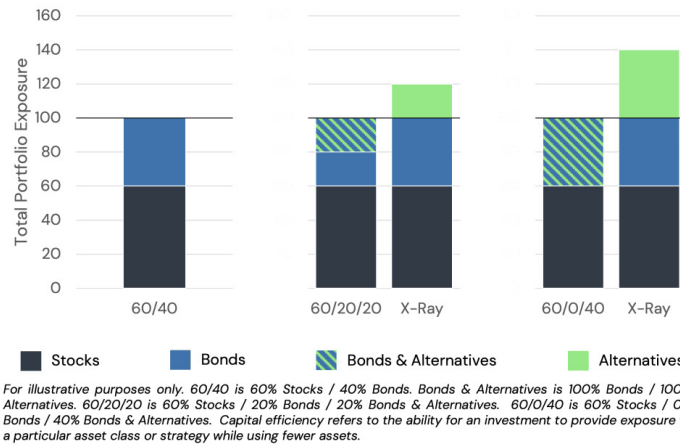
You can explore how different assets and stack sizes have historically impacted returns and risk with our [return stacking visualizer tool](#).

4. Determine if the exposure you want exists in a stacked fund

Once you have figured out what you want to stack and the size of the stack, you need to figure out how you're going to implement the stack. In some cases, the exposure may already exist pre-stacked in a fund.

For example, if you want to stack an alternative strategy, funds may already exist that simultaneously provide that [alternative strategy and either stock or bond](#) exposure. This can make implementation much easier, as you simply need to replace the appropriate amount of stocks (or bonds) with the pre-stacked fund. In the figure below, we show an example of how a 100% Bond / 100% Alternatives fund could be used to stack either 20% or 40% alternatives exposure on top of a 60% stock / 40% bond portfolio.

Figure 1: An illustrative example where return stacking is achieved through the use of a fund that internally implements return stacking



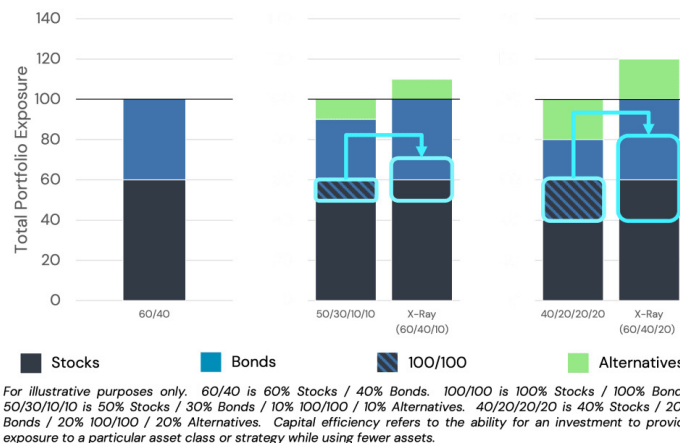
However, not all exposures exist in stacked formats. Or, perhaps, a strategy does exist in a stacked format, but you have a preferred manager for that strategy and they do not offer a stacked version. In this case, you need to figure out how to free up room in your portfolio in other ways.

5. If the exposure does not exist as a stacked fund, figure out how you're going to free up room in your portfolio

If a pre-stacked fund does not exist for the exposure you'd like to stack, you'll likely have to sell some combination of stocks and bonds and buy a capital-efficient stock/bond fund to make room in your portfolio.

For example, if we want to stack a 10% allocation to an alternative fund, we could sell 10% stocks / 10% bonds and buy 10% of a [100% stock / 100% bond fund](#). We can then invest the newly available 10% in the alternative fund. In the figure below, we show an example how a 100% stock / 100% bond fund can be used to stack either 10% or 20% of an alternative on top of a 60% stock / 40% bond portfolio.

Figure 2: An illustrative example where return stacking is achieved by making room in a portfolio through a capital efficient stock/bond fund



6. Make sure your betas match

Whether you're using a pre-stacked fund or selling stocks and bonds to make room via a capital efficient stock/bond fund, you want to make sure your betas match.

For example, if you're planning on buying a 100% Bond / 100% Alternatives fund to stack alternatives on top of your portfolio, you want to make sure the bonds (or bond funds) you sell in your portfolio are of the same nature of the bonds in the stacked fund.

Similarly, if you're selling both stocks and bonds to buy a capital efficient stock/bond fund, you want to make sure the stocks and bonds are of the same nature.

As an example, you probably wouldn't want to sell foreign developed stocks and short-term U.S. Treasuries to buy a 100% stock / 100% bond fund that gives exposure to the S&P 500 and broad U.S. Treasuries. Doing so would create a significant mismatch in your pre- and post-stacked portfolio profile.

**The Return Stacking landscape is ever evolving.
Go deeper by connecting with a team member.**

[Book a Time](#)

7. Estimate the worst-case scenario of your new stacked portfolio

While we advocate for trying to stack assets that will zig when our underlying portfolio zags, the phrase "return stacking" reminds us that we're just adding returns together. And if both of those returns are negative, we're going to be worse off than if we didn't stack.

Understanding the historical and expected return profiles for what we already own and what we're trying to stack is important for choosing the right stack size.

8. Consider the tax implications and asset location

Some forms of stacking can be more tax efficient than others. Consider the example of a 100/100 stock/bond fund. One way of creating this fund is by purchasing stocks and Treasury futures. Wrapped in an ETF, this may be highly tax efficient, especially since Treasury futures can be more tax efficient than Treasuries!

On the other hand, if the fund is implemented by buying bonds and S&P 500 futures, it will likely be very tax inefficient, regardless of whether it's in a mutual fund or ETF, especially since S&P 500 futures receive substantially worse tax treatment than passive S&P 500 exposure usually would.

When in doubt, you probably want to stack in qualified accounts. However, if you are looking to stack with taxable money, you'll want to consider the tax implications of how the stack is created.

9. Consider line-item risk

If you are managing money on behalf of others, line-item risk is a behavioral bias to thoughtfully consider. Not only does the individual need to be able to stick with the portfolio as a whole, but they need to be able to tolerate the volatility and relative performance of individual line items. This can change how you might consider implementing a given return stacking strategy.

As an example, let's say you want to stack a 10% allocation to managed futures, there are at least three ways you can do it. First, you could sell 10% of your bonds and buy a 100% Bond / 100% Managed Futures stacked fund. Second, you could sell 10% of your stocks and buy a

100% Stocks / 100% Managed Futures fund. Finally, you could sell 10% of your stocks and 10% of your bonds, buying 10% in a 100% stock / 100% bond fund and 10% in a managed futures fund.

All three approaches are, effectively, the same. But the performance of the line items in your portfolio will differ.

For example, the short-term performance of the 100% Bond / 100% Managed Futures fund will likely be dominated by the Managed Futures performance, as it is much more volatile than the bonds. The 100% Stock / 100% Managed Futures fund will be a significantly more volatile fund, and may have much more significant performance swings when stocks and managed futures are moving in the same direction. Similarly, the 100% Stock / 100% Bond fund might stand out in years like 2022 while the isolated managed futures fund might stand out in periods like 2010–2020 when managed futures largely went sideways.

While all of these approaches are identical at the aggregate portfolio level, understanding your – or your clients’ – tolerance for different forms of line-item risk is important.

If you want a quick recap here’s a video that might help!



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Easily backtest & explore different return stacking concepts

Model Portfolios:

Return stacked allocations, commentary and guidance designed for a range of client risk profiles and goals

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