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At the Market's Mercy: Why?

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Make gains when the market goes up and then get crushed when it goes down – that is not a smart investment strategy. The key to changing this frustrating sequence relies on the Greek alphabet: getting more of your portfolio returns from alpha and having less exposure to beta.

In a nutshell, beta is the return you get from the market. Therefore, the return from an index fund, like one tracking the Standard & Poor's 500, would be pure beta. To achieve beta, an investor needs to take systematic equity risk. There can be large rewards for taking this risk (such as from 1995 to 1999), but there can also be large losses (in 2002 and 2008).

Alpha is excess return above the market's performance. This return can come from a number of different sources and the amount of beta attached to the alpha can vary. Depending from where you achieve it, alpha tends to be less volatile than beta.

Traditional portfolio construction usually takes one of two forms:

All-beta portfolio. This consists of only index mutual funds or index exchange-traded funds. Investors here believe active managers cannot consistently beat their benchmarks. So the best and cheapest approach is to just buy the index. Because all of the returns come from beta, the investor is completely at the mercy of the markets.

For example, if I want the returns of the S&P 500, I might choose the **SPDR S&P 500** (SPY [1]). According to Morningstar, as of June 18, this ETF has a five-year average annual return of minus 0.55%. In the 2008 fiscal crisis year, it was down 36.7%.

Mostly beta portfolio with a little bit of alpha attached. This is a collection of actively managed mutual funds or ETFs or individual stocks. Most of the returns still come from beta, but active management tries to add excess return above the index. Say you decide there are good prospects with large-capitalization U.S. stocks. Instead of buying an index vehicle, you use an actively managed fund, which typically over-weights and under-weights different sectors to try to add alpha.

On the surface, this sounds like a better approach, but it really isn't. You basically still have the same beta risk of the markets. You can have the best stock pickers in the world, but it is hard to pick good stocks when most of them are going down. If I chose a diversified stock fund like

Legg Mason Capital Value Management (LMVTX [2]), my five-year returns averaged minus 9.8%, for worse than the S&P 500's showing. And in 2008, the Legg Mason fund lost 55%, also more than the index.

A Better Approach

A better approach is to have a greater percentage of your returns coming from uncorrelated sources of alpha, meaning they behave differently in market advances and declines, while being much less dependent on beta.

If beta exposure causes losses, why not get rid of beta entirely? Two reasons: First, it is hard to do – just about any strategy or methodology will have some beta exposure. Second, under the right market conditions, beta can provide solid returns.

Designing a better portfolio means combining substantially different methodologies and different time frames. Example: Combine a long-term trend-following strategy on the S&P 500 with a short-term counter-trend strategy on the same index. The portfolio carries varying beta risk. When fully invested, it is completely at risk; when partially invested, it is partially at risk; when 100% in cash, there is no beta risk.

The alpha from the long-term trend-following strategy rests on its ability to get out of the market before a small loss turned into a big loss. The alpha from the short-term counter-trend strategy stems from getting in on short-term market lows and out on short-term highs. Any correlation between those two sources of alpha is pure coincidence.

Furthermore, even though each strategy is investing in the same market, they are doing so at different times. So they seldom are correlated.

If I put 50% of my money into the trend-following strategy and 50% into the-counter trend alternative, both using SPY and not counting fees, the five-year return is 15.17% and in 2008, 14.29%.

Improving the Portfolio

We could further improve this simple model by adding other non-correlated methodologies such as momentum and inter-market analysis. We could also expand our investment basket to include bonds, real estate investment trusts, commodities and currencies.

Traditional portfolio construction puts investors at the mercy of the markets with beta far too much. Staking your financial future on whether the market goes up or not is not a wise investment strategy. A better approach involves combining non-correlated sources of alpha, and sources of beta that are more heavily weighted to alpha.

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