Where's the Alpha?

By Matthew Tuttle, CFP®

If the definition of insanity is doing the same thing over and over again while expecting different results, then Wall Street is insane. In my mind, making gains when the market goes up and then getting crushed when the market goes down is not a smart investment strategy. The key to changing this accepted ritual relies on the Greek alphabet: getting more of your portfolio returns from Alpha and having less exposure to Beta.

Beta and Alpha Definitions

In a nutshell, Beta is the return you get from the market. Therefore, the return from an index fund would be pure Beta. To achieve Beta, an investor needs to take systematic equity risk. There can be large rewards for taking this risk (i.e. 1995-1999) but there can also be large losses (i.e. 2002 and 2008).

Alpha is excess return. 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

Traditional portfolio construction usually takes one of two forms:

- the All-Beta Portfolio, or
- the Mostly-Beta Portfolio with a Little Bit of Alpha Attached

All-Beta Portfolio: The All-Beta Portfolio consists of only index mutual funds and / or index ETFs. Investors in these types of portfolios believe active managers cannot consistently beat their benchmarks (through achieving Alpha) so the best and cheapest approach is to just buy the index. Because all of the returns from this type of portfolio come from Beta, the investor is completely at the mercy of the markets.

Mostly-Beta Portfolio with a Little Bit of Alpha Attached: This is a collection of actively managed mutual funds and / or ETFs or individual stocks. Most of the returns still come from Beta, but active management is used to try to add some excess return over and above the relevant index. For example, you may decide to have exposure to large-cap U.S. stocks. Instead of using an index fund you use an actively managed fund. The actively managed fund typically over-weights and under-weights different sectors vs. their relative index to try to add Alpha. On the surface this might sound like a better approach, but it really isn't. You basically still have the same Beta risk of the markets. If the active managers can add Alpha it will be nearly 100% correlated. 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.

A Better Approach

A better approach is to have a greater percentage of your returns coming from uncorrelated sources of Alpha, while being much less dependent on Beta (which can also be made somewhat uncorrelated). 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. For example, I could 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 would have varying Beta risk, when it was fully invested it would be completely at risk, when it was partially invested it would be partially at risk; when 100% in cash there would be no Beta risk at all. The Alpha from the long-term trend-following strategy would derive from the 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 would come derive from the ability to get in on short-term market lows and out on short-term highs. Any correlation between those two sources of Alpha would be pure coincidence. Furthermore, even though each strategy is investing in the same market, they are doing so at different times. As a result, their Beta would also not be correlated (at times it would be correlated more than the Alpha, as there would be periods when they were both invested).

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, REITs, commodities, and / or currencies.

Conclusion

Traditional portfolio construction puts investors at the mercy of the markets (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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