Across the investment industry, the term alpha is often used to label the returns generated by skilled active managers. Despite its wide use, the term is understood by very few. One common definition of alpha is the excess returns above a predetermined benchmark. Others say alpha is the fraction of returns not explained by beta. While these definitions are fine, they are not comprehensive and fail to uncover the true nature of alpha. A more nuanced definition, one that fully describes the characteristics of alpha, can help asset owners evaluate their portfolio allocations, and make more informed decisions regarding risk and return.

**Beta Before Alpha**

Before defining alpha, it is important to have an understanding of the other sources of risk in institutional portfolios. The first of these, beta, is the systematic risk that investors assume for holding a security or an index. Often times the term is used to refer to broad-based equity indices, but it can also be applied to fixed income, currencies, and commodities as well. Over time, investors expect to be compensated for incurring this risk and should be rewarded with a positive expected return, or “risk premium”. Often times, beta is the dominant form of risk in institutional portfolios, due to the fact that it requires little skill, is highly scalable, and can be implemented at very low cost.

**What is Smart Beta?**

While beta is the dominant form of risk in most institutional portfolios, it is not the only one. The second form of risk has garnered plenty of attention recently, and when combined with beta may contribute over 90% of a portfolio’s variance. Whether it is called “smart beta”, “factor beta”, “alternative beta” or “exotic beta”, this type of risk differs from market beta in several key ways. Like market beta, alternative beta has a positive expected return, but is not immune to economic and market conditions. Harvesting it requires trading through a naïve, systematic strategy. Common examples of this include alternatively weighted indices and risk factors, such as momentum, value, size, and carry. Strategies offering exposure to risk factors were once the exclusive domain of hedge funds, but are now widely recognized by the investment community and available at relatively low cost. They require a moderate amount of skill to implement, are somewhat scalable, and...

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1 https://www.portfoliovisualizer.com/factor-performance-attribution
2 Examples include fundamentally weighted indices and risk-weighted indices (e.g., Minimum Volatility and Equal Risk Contribution portfolios).
transparent and liquid, and can therefore be found in many investment portfolios. In addition, their semi-active nature also means they have lower correlations to broad market indices, and may complement a portfolio of market betas.

**True Alpha**

While smart beta may be a valuable tool for an investor looking to improve the efficiency of a portfolio, the addition of another type of risk, alpha, may further augment a portfolio’s risk/return profile. **Alpha is positive excess return that cannot be explained by systemic market exposure or known risk factors.** The discovery and inclusion of alternative betas in factor models has, and will continue to, erode measured alpha. As a result, positive alpha is scarce, transitory, and often not scalable. Once found however, positive alpha may yield substantial portfolio benefits due to its potential to deliver returns in all market environments.

1. **Low Correlation.** The true benefits of alpha stem from its low correlation with market and alternative factors. It is therefore extremely valuable for the investor looking to construct a portfolio that delivers superior risk-adjusted returns.

2. **Consistency.** Finding true alpha is difficult. Short term outperformance is not necessarily an indication of alpha. It could signal that a manager has a bias for a market or factor that has been compensated recently. An alpha manager, in contrast, may demonstrate a willingness to rotate in and out of markets and factors, thus outperforming over several market cycles. Alternatively, alpha managers may limit factor exposures in order to neutralize the effects of market cycles.

3. **Risk & Leverage Management.** All alpha strategies require rigorous risk management practices in order to preserve capital when faced with adverse conditions. Alpha managers must also control leverage, and deploy it when market conditions are more favorable to their strategy.

4. **Market and Factor Neutrality.** Alpha achieves positive expected returns and low correlations through active management, rather than a systematic bias towards other forms of risk. As a result, true alpha is both market and factor neutral over time. At a given point, alpha may have a bias, but it is not persistent over time. As a result alpha has the chance to perform well when other assets suffer.

Given that we are in the midst of a low expected return environment for beta, allocating a portion of portfolio risk to alpha may be especially important. Alpha’s low
correlation to market and alternative betas offers the potential to deliver returns when other assets struggle. This, coupled with alpha's persistency, risk management and leverage control has the potential to make it a valuable addition to any investor’s strategic asset allocation.

For additional information, please contact us.