Ideas and Insights for Wealth Managers

onwallstreet

September 2009

PEAK PERFORMANCE | THE ASSET CLASS

Alternative Medicine: Separating Beta from Alpha

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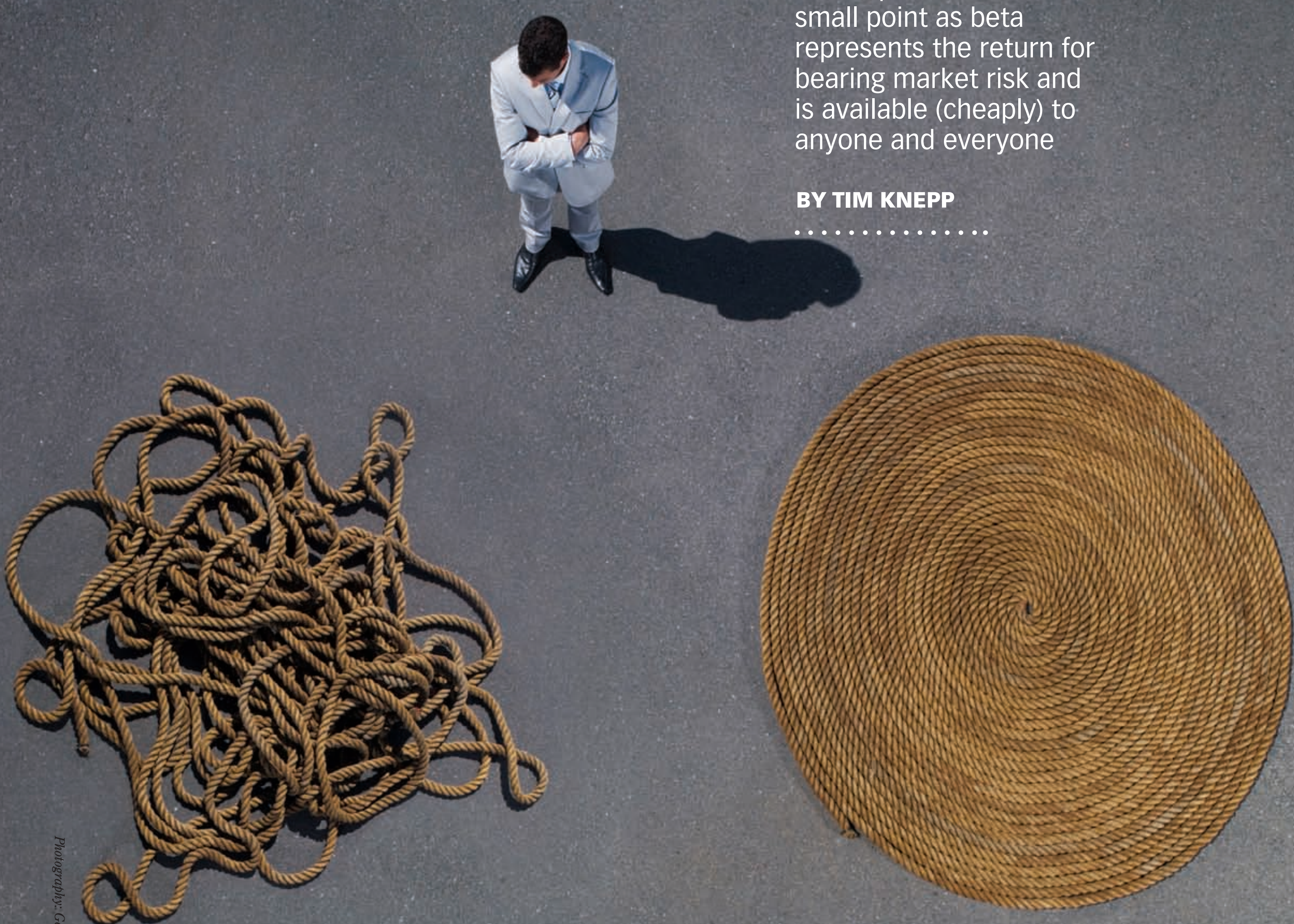

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Retirement portfolios have been subject to significant stress and this, combined with a daunting global economic outlook, has many investors considering alternative strategies in an effort to shore up their traditional investment allocations.

But alternatives have not been unscathed by the current turmoil, showing vulnerabilities common to traditional asset classes. A better understanding of these shared risks should promote more grounded expectations and ultimately a better implementation of alternative strategies.

Alternative strategies may generally be defined as products able to utilize leverage, less liquid assets, flexible trading and inverse directional positions. And they may be invested across both capital and physical markets.

The appeal of alternative investment strategies is the notion that, deployed with unique skill and fewer constraints, they are better able to deliver alpha, which is the ability to achieve consistent returns independent of more general market risk. As an added bonus, the potential alpha will have a low correlation to traditional asset classes.

Alpha, by definition, requires segregation from beta. This is no small point as beta represents the return for bearing market risk, and is available (cheaply) to anyone and everyone. Beta is a risk premium that is guaranteed to pay, good or bad, and no skill is needed to obtain it.

Being easily obtained may also mean beta can be maddeningly difficult to avoid, a fact not lost on managers of alternative strategies, who are frequently criticized for packaging beta rather than delivering the promised alpha. How does this sleight-of-hand come about?

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For example, consider illiquidity. Illiquidity premiums are paid to anyone willing to hold marketable but less liquid assets. It is also possible to add value through selectivity, but selection skill may be less important than having the time horizon and ability to hold illiquid assets.

This distinction between broad risk premium and true alpha should not be lost on investors asked to pay healthy skill-based fee structures.

Other betas include the risk premiums paid for asset classes such as emerging market debt and the aforementioned S&P 500.

The concept of passive risk premiums—that is, getting a return for "just showing up" rather than skill—is important for both investor expectations and portfolio positioning.

To be sure, allocating and managing beta exposures can add value, but that is a different proposition from delivering alpha presumed to be uncorrelated with traditional assets.

The challenge with managing beta exposures is that the underlying market exposures understood to exist in a more traditional portfolio may also heavily influence what are presumed to be unrelated hedge fund strategies. History has shown that powerful market influences, such as the recent flight to quality, can push beta exposures to convergence on the downside.

The addition of leverage to the equation further muddles the evaluation of alternative investment performance. Leverage is a cyclical phenomenon tied to both credit conditions and the relative need to magnify available return opportunities. As with underlying beta exposures, portfolio leverage must be understood in the context of systemic influences on both credit availability and the liquidity of portfolio investments.

In other words, is the leverage and liquidity associated with historical results consistent with current and potential conditions?

Alternative investment strategies have the potential to complement more traditional investment allocations. Investors cannot assume, however, that all strategies will deliver the advertised benefits of uncorrelated skill-based performance. Expectations and implementation need to be grounded by an understanding of the many sources of past performance as well as current shared risk exposures.

This insight will allow you to better gauge whether a given alternative strategy has the potential to deliver alpha, and help you to perhaps avoid an unexpected increase in overall portfolio risk. **OWS**

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