THE *ALPHA* BET:
REQUIEM FOR A MISLEADING METRIC

It's not particularly provocative to suggest that evaluating an investment fund has little in common with analyzing an individual investment. As a practice, fund investors rarely venture beyond the aggregate historical price data to analyze the underlying individual assets. Which is another way of saying that the vast majority don't *really* comprehend how returns are ultimately generated. For every investor who can describe a fund's top ten positions as well as explain specifically why they were profitable (or not), there are probably five thousand who would struggle to summarize the basic investment strategy. This is arguably the defining distinction between investors and those more aptly described as "allocators."

Most allocators operate on the default assumption that financial statistics provide a trustworthy surrogate for position-specific, investment-level analysis. The nexus of this data-dependent pursuit of profit is the statistic known as "Alpha" (α). For those unfamiliar, Alpha is a relative measure denoting the additional return above the expected return of a given benchmark. The investment return of the most common benchmark, the market overall, is represented by "Beta" (β). Beta is also known as the "passive return" because an investor can capture the returns of the market overall by simply buying an instrument designed to mimic the market – such as a low-cost ETF that tracks the S&P 500. It logically follows that if Beta is both easy and cheap to obtain, the only Alpha worth paying for is Alpha that significantly and consistently exceeds Beta without entailing a commensurate increase in risk and cost.

As a relative measure, Alpha moves independently of Beta, but not necessarily inversely with it (i.e., in the opposite direction). This last point is a distinction with an important difference because if Alpha is defined not as profits but as returns in excess of Beta, the market overall, then excess return includes *relatively smaller* losses than the market overall. In other words, if the market declines by 8% and the fund declines by 6%, the fund manager has provided Alpha because his losses were smaller than the market overall. Strictly speaking, losses can be a form of outperformance, and thus Alpha and profit are not technically synonymous. This leads us to the seminal problem with Alpha as an investment metric:
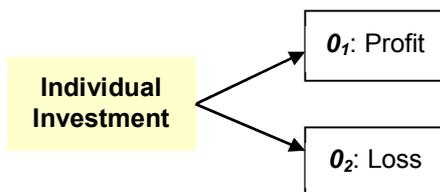
The Alpha that is only *non-Beta* is not the Alpha that fund investors should be seeking.

If the preceding statement seems vaguely circular (or overtly confusing), consider what comprises the optimal fund return to begin with. Fund returns should be:
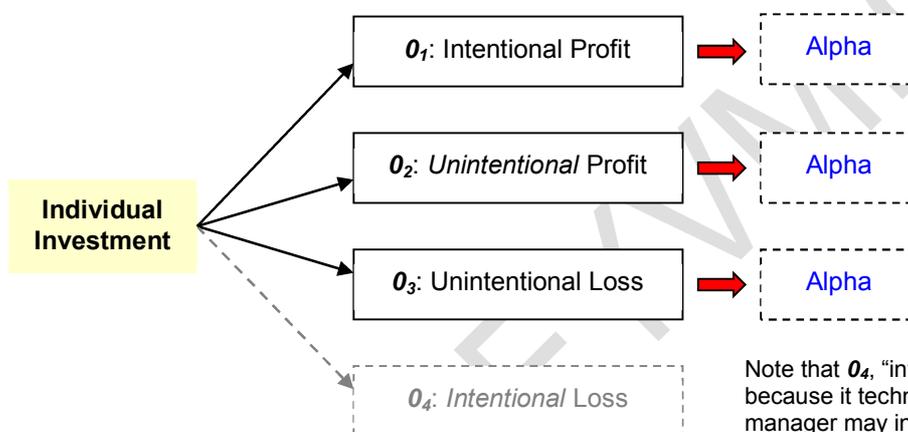
1. Independent of the relevant benchmark or broader market (i.e., β),
2. An attractive risk/reward balance,
3. Predictable (i.e., the strategy should perform as described),
4. Persistent (i.e., the returns should persist or continue over time), and
5. Profitable over the long term.

Although fund investors may be satisfied over the short-term with fund losses that are relatively smaller than the market overall, over the long term they naturally insist upon profits. They're not investing to reduce their capital, and any fund that achieves 10 years of *relatively-smaller* losses has still incurred a decade of losses. That being the case, Alpha's relevance to fund investors is ultimately subject to the fundamental goal of generating attractive risk-adjusted profits.

Arithmetically speaking, fund profits (or losses) are the net result of multiple individual investments, each of which is framed in binary terms.[1]

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                                    ┌─────────────────┐
                                    │ 0₁: Profit      │
                                    └─────────────────┘
        ┌──────────────┐          ↗
        │ Individual   │
        │ Investment   │
        └──────────────┘          ↘
                                    ┌─────────────────┐
                                    │ 0₂: Loss        │
                                    └─────────────────┘
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However, that purely quantitative, either/or binomial framework only distinguishes the *extent to which* profits or losses are generated, not *how*. And as a result, it ultimately fails to capture all of the actual possible outcomes. If the phenomenon is correctly schematized, although the final *quantitative outcome* may be a profit or loss, each individual investment ultimately results in twice that number of *qualitatively distinct outcomes*:
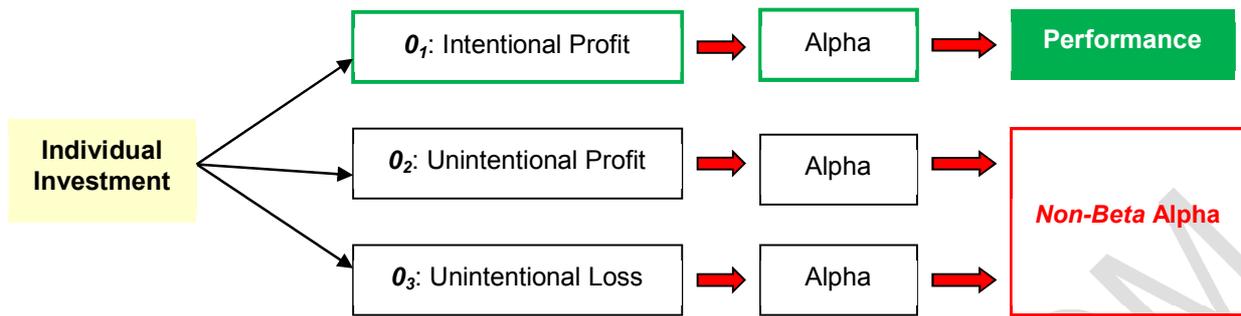
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                    ┌──────────────────────────┐        ┌──────────┐
                    │ 0₁: Intentional Profit    │  ──▶   │  Alpha   │
                    └──────────────────────────┘        └──────────┘

                    ┌──────────────────────────┐        ┌──────────┐
                    │ 0₂: Unintentional Profit  │  ──▶   │  Alpha   │
    ┌──────────┐    └──────────────────────────┘        └──────────┘
    │Individual│
    │Investment│    ┌──────────────────────────┐        ┌──────────┐
    └──────────┘    │ 0₃: Unintentional Loss    │  ──▶   │  Alpha   │
                    └──────────────────────────┘        └──────────┘

                    ┌──────────────────────────┐
                    │ 0₄: Intentional Loss      │
                    └──────────────────────────┘
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Note that 0_4, "intentional loss," is shown only because it technically exists. Although a fund manager may incur occasional intentional losses as a result of hedging, etc., no fund would ever deliberately incur net total losses.

The above diagram illustrates the nature of the overlap among Alpha, intent, and profits and losses. As shown, Alpha includes not only losses, but unintentional profits as well. If over the long term persistent profits are the only kind of investment performance worth pursuing,

Common sense dictates that intent is what fund investors should be trying to isolate, not just relative outperformance or even positive returns.

The problem for the allocators is that because intent is not statistically identifiable over the short term, the quantitative Alpha fund investors capture is in reality only *non*-Beta, comprised of both intentional and unintentional profits. Recall that the end purpose of Alpha is to measure the added value brought by a manager to the investment portfolio over the returns of a passive index. But the fact that a manager exceeds the return of an index doesn't mean that his performance was by design, and not in part or whole an accident. Alpha, in short, includes all manner of accidents. Individuals allocate to specific strategies only because they hope to generate attractive returns over the extended holding period. As such, they require more than positive Alpha; they need positive Alpha *that persists.*

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[1] Note that we assume a dynamic price environment, and thus intentionally ignore the statistically insignificant outcome of absolutely no change.

Individual Investment

O_1: Intentional Profit → Alpha → **Performance**

O_2: Unintentional Profit → Alpha →

O_3: Unintentional Loss → Alpha → *Non-Beta* Alpha

Only what is *qualitatively superior* over the short run is in any way likely to *quantitatively persist* over the long-term. If luck is by definition inconsistent and uncontrollable, the only returns that persist over time are deliberate. We define these <u>intentional positive returns</u> – the (ahem) *non*-Non-Beta Alpha in the above diagram – as *performance* ("Performance").

Intentional Profit → **Intentional Alpha** → **Performance**

**The Alpha that fund investors should be pursuing we would call "Performance,"
defined as *intentional positive returns*.**

Evaluating fund Alpha through the lens of intent highlights another important but frequently overlooked issue: Intent isn't just what separates truly attractive returns from non-Beta;

Intent is what distinguishes pursuing Alpha from simply chasing fund returns.

Extrapolating past fund performance into the future is at best an inherently dodgy exercise. Relying on quantitative data in doing so is the definition of recklessness. There's no question that negative or very poor returns have a habit of persisting. But aside from those fund managers that self-select for exclusion due to consistently horrendous returns, quantitative information is all but useless in identifying managers who will in the future consistently outperform. In order to enjoy the compounding benefit of Warren Buffett's returns one had to invest early on, but the only way to distinguish Buffett in Year 3 from the 5,000 other seemingly talented "value" managers that subsequently went out of business was to recognize the genius of his process in application.

Intentional returns are returns *by design*, literally and figuratively. Historically speaking, performance that persists assumes one of two forms: talent-based and structure-based. Whereas the Buffetts of the world represent the talent contingent, structure-based performance derives from proprietary tactics and tools that enable the fund manager to exploit the structure of the market itself, often relying on technology or execution speed to generate returns, which they frequently amplify with leverage. It is the execution-based arbitrage of the market's architecture. Think of the "quant" fund manager who achieves returns by darting in and out of the market, utilizing bespoke algorithms grafted onto trading platforms to exploit fractional price disparities or momentary anomalies with lightning speed.

The "performance" of the structure-based fund manager will persist only as long as his trading edge does. This includes whatever unique market access he is exploiting, such as "flash trading," "dark pools," and any other types of arguably privileged trade execution that enable him to take advantage of split-second trading opportunities. Note that the persistence of those critical structural features is much less a question of historical returns than it is evolving market architecture, exchange competition, and regulatory change. Past results of the "algo" fund may not be irrelevant, but if the access it relies on is somehow impaired by the SEC, snatching those pennies might get a whole lot harder.

To paraphrase Max Ernst, trying to evaluate an investment fund's results by looking at statistical data alone is like trying to understand an explosion by looking at a piece of shrapnel. The fact that the alternative – an authentically in-

depth, position-level analysis – requires considerable time and hands-on experience is not an excuse for using a methodology that is ill-suited and at best misleading. Relying on conventional *Alpha* to make fund investment decisions is the equivalent of using the butt of a loaded revolver to drive nails into a wall because there's no hammer within reach.

**Alpha has become a synthetic surrogate for authentic analysis,
utilized not because it provides prudent guidance but because it is easy to use.**

Any tool that enables the user to claim expertise without experience or knowledge is destined to be popular. But regardless of how pervasive, custom doesn't trump common sense. The investor who doesn't understand a fund's positions *doesn't understand the fund*, and there's no statistic or shortcut that will change that reality. Asserting otherwise is the equivalent of claiming to understand how a car functions while knowing nothing about engines or transmissions.

**If nothing is more important than the persistence of positive returns,
then nothing is more dangerous than something that creates the illusion thereof.**

In light of the behaviors it enables and encourages, Alpha might be seen as a uniquely malignant phenomenon. But its impact in application has been muted by the fact that its principal adherents, the funds-of-funds community, tend to rely heavily on dilutive diversification for protection from it. It's a damning, utterly transparent admission of doubt in their own methods. It's also painfully ironic – they're utilizing a metric designed to identify outperformance to assemble portfolios so diversified that they're *virtually guaranteed to not meaningfully outperform*. A more generous observer might credit them for implementing the measures necessary to protect the assets from their own questionable capabilities - which places Alpha precisely at the intersection of self-interest and ineptitude. *Quem deus vult perdere, dementat prius.*[2]

Steven R. Grey (2010)

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[2] "Whom the gods would destroy, they first make mad."