

PARTNER'S MESSAGE

Alpha Shop

By Max Darnell

We at First Quadrant have used the term “alpha shop” to describe our business for many years now. Given the now-widespread talk about the separation of alpha and beta, and to a lesser extent, about a possible redefinition of what alpha and beta are, it seems incumbent upon us to be more specific about what that means exactly – being an “alpha shop,” that is.

The easy answer (too easy?) would be to point to our history of running alpha products. We’ve been delivering alpha separated from beta to the market since the early 1990’s. In 1991, we launched equity market neutral which delivers equity alpha separated

FQ has been providing alpha-only strategies to the marketplace since the early 1990’s.

from the equity market return. In 1993, we began running our first long/short futures product. The goal of such a product is to deliver excess return above a cash benchmark without exposing the product to the market on average over time. Currency was introduced outside the overlay context as a pure source of alpha in 1995, at the same time that we introduced a market-neutral options strategy which again, delivered only alpha, no beta.

We could also point to the message we’ve sought to deliver to our clients and the marketplace at large over the years as being “alpha focused.” In the mid-1990’s we were known for dragging our clients through presentations on how to combine market neutral or long-short strategies with equity or bond futures to port alpha onto whichever of those two betas might be wanted. Admittedly, we timed our message poorly. In the context of a roaring bull market there was

understandably very little interest in how clever one could be in porting alpha when beta alone was delivering double-digit returns. Who needs alpha, much less alpha porting in that context? (Still would have been a good idea... but we did eventually figure out that interest was low and moved on to other subjects.) At our 1997 Client Conference, no less than Alpha Man himself, Marv Damsma (Amoco), came and performed his one-man Alpha Man “stage show,” clad in Superman tights and red undies, complete with backup singers (on tape), and Alpha Man tee-shirts for all (where is mine?).

What is Alpha Really?

All that sounds like the good beginnings of an answer to what it means to be an alpha shop, but it remains too vague. What is this alpha really? Is it value added relative to a benchmark? If I build a high beta portfolio of stocks from the S&P 500 and beat the S&P 500 over the course of a bull market, have I delivered alpha? I’ve certainly beaten the benchmark. What if I build a portfolio of smaller cap stocks from the Russell 1000 and beat the total return on the same during a

Value added, properly defined, is more than just the return in excess of the benchmark.

market that favors small cap? Value added? Once more, what if I screen stocks for earnings quality by identifying and investing in those stocks with lower than average use of discretionary accounts receivables? Each of these might deliver a performance result that is better than the benchmark, but does that mean that we’ve delivered alpha in each or any of these cases?

The answer probably comes to all of us more readily in the case where we've chose high beta stocks. We, and our readers, will quickly reject the notion that such an approach is a value adding strategy because it's a "beta bet" rather than an "alpha bet." That doesn't mean that it will work all of the time. Low beta strategies like valuation will outperform the market at times, particularly when stock prices are falling. Nevertheless, in our definition of alpha, we rightly reject the notion that a permanent, or static beta tilt is alpha.

Less immediately obvious are the other two examples. Most would agree that the small cap bet is a "bias," which somehow means that it isn't alpha either.

There are a wide range of systematic risks that should be viewed to be a form of systematic risk rather than alpha.

So what's the difference between screening on market capitalization - or price/book for that matter - and screening on discretionary accruals? Nothing other than the fact that small cap stocks have been identified in the literature as a "style" that has had a long-term payoff and therefore has been "officially recognized." We would say that there isn't a difference between them. They both represent a systematic risk that can be easily produced by screening the stock universe for some objective characteristics of stocks.

A logical extension of this argument might be to say that pretty much any objective, systematic approach to selecting assets might never amount to anything we'd call true alpha. Such approaches might be accused of doing nothing more than bundling together a set of what are ultimately some form of systematic risks. We can imagine the traditional fundamental stock pickers saying that it's the subjective decisions that come after their stock screens that are the real alpha. If these decisions are disciplined (read: systematic), however, then they may boil down to just another screening process, even if the judgments are based less on objective facts. And what if the judgments aren't

systematic, what are they then? In the spirit of Bill Clinton, we might then ask, "Is it an it?" At any rate, we'll leave the matter of traditional, subjective approaches and their relation to alpha to others to meditate on. This is not our area of expertise.

Craftsmanship

Let's get back to this notion of bundling together a set of systematic risks. Here in Pasadena, there are a number of new buildings going up. Pretty much the same materials are being used in all of them, and you can be sure that the same materials were at least available to each of the different builders. Yet the final products - the buildings - will be very different from each other, and different values will be attached to each.

The same occurs in the kitchen. Put two chefs in the same kitchen - one who flips burgers at McDonalds and the other a sous chef from the best restaurant in town - and give them each the same ingredients to work with. When you compare the quality of what each of them produces with these ingredients, you'll likely taste a difference. The difference is the result of craftsmanship. The ingredients matter, but interesting buildings and tasty food depend upon the selection of the ingredients and the skill applied in putting those ingredients together. That's where the value added comes from.

Much like the way a chef might blend ingredients together in the kitchen to the pleasure of his diners, investment managers blend their ingredients into concoctions they refer to as portfolios designed to yield alpha. Just as two chefs will produce very different levels of satisfaction from their product with the very

Adding value through the use of systematic risks is a matter of craftsmanship.

same ingredients, investment managers will produce different streams of alpha from a common set of ingredients.

For investment managers, there can be no question that choosing the ingredients and choosing how much of each to include in the mix is one of the sources of true value added. You can't replicate that through some simple combination of exposures or some simple screening technique. Small cap managers will choose and mix their ingredients differently from large cap managers, as will value managers and growth managers, as will US, European and Asian equity managers.

Alpha Involves Timing

When making bread, you have to pay attention to both the level of humidity and the temperature when deciding which breads to make and how much yeast to include. Ever notice how much better sourdough is in San Francisco? The conditions are just right for sourdough. For investment managers, skill will also lie in how the ingredients and the amounts change *depending upon the market and economic environment*. The optimal mix of strategies will change through time. Valuation, for example, is a poor ingredient in certain market conditions. Furthermore, the degree of mispricing measured from a valuation perspective will vary across time as well. Therefore, valuation should play a greater role at times, and a lesser role at other times.

If the relative quantity of the ingredients is to time vary, aren't we talking about timing? There's no question about it. So, timing is another source of value added. Knowing when to favor valuation, when to focus on earnings quality, when to favor higher beta stocks,

Shifting the allocation of risk over time to different systematic risks is also an alpha generating activity.

when to favor growth over value – these are all timing decisions with respect to the relative share of each ingredient. Such timing does not have to come from taking a view about when these aspects will payoff. It

may simply derive from measuring the magnitude of opportunity associated with each and time-varying the magnitude of the risk associated. If differences in earnings quality, or valuation, for example, shrink and expand over time (they do!), then so should the magnitude of the risk taken in accordance with these strategies.

In a risk-constrained portfolio, allocations of risk are a matter of *relative* choice. To the extent to which that relative choice time-varies, the decision is as much a question of "When?" as "How much?"

Taking a step back, let's ask the question, what are we willing to time? Clearly, timing sub-market strategies is a practice that is more generally accepted, i.e., timing risk allocations *within* an equity strategy is widely accepted. We've established, however, that a clear distinction between a market beta and an "earnings quality beta" – between either of these equally systematic risks – is hard to draw. So, why not time

Timing risk allocations is commonplace at the sub-index level. It should be just as acceptable at the index level.

equity market beta, bond beta, and currency beta as well? Amongst many institutional investors, using beta to earn alpha through market timing or more refined strategies such as Tactical Asset Allocation and Currency Management gives them a queasy feeling. Varying away from the policy mix seems dangerous.

Keith Ambachtsheer has observed that in a typical pension fund, something on the order of only 2% risk

The asset-liability mismatch is the greatest source of risk in most pension funds.

is taken actively (tracking error relative to the benchmark, or policy mix). The policy mix, on the other

hand contributes something on the order of 10-11% risk (volatility of the benchmark return). Now here's the zinger. The policy mix tends to produce risk relative to the performance of the liabilities on the order of 16%! For anyone who fears deviating from the policy mix, these numbers must scare them to death... or at least they should. Peter Bernstein put clinging to the policy mix on the stand to face public scrutiny a little over a year ago, and many heads were turned.

In Short

Getting back to the point, what we're trying to do is to define what constitutes alpha. We've suggested that alpha is something more than just beating the benchmark. You can beat the benchmark by introducing an array of systematic risks ranging from what we'd more traditionally refer to as beta risk, to risks that are less commonly considered beta but are no less *systematic* than beta and therefore deserve to be thrown into the same bucket.

What's left after you've stripped the static systematic risks from the portfolio? Alpha can be defined as the time-varying selection of systematic risks, delivered without creating any average – over time - exposure to systematic risks. Alpha is about engineering or craftsmanship and timing. How you put investment strategies together, when you use them, and how much weight you give to each.

When we say that First Quadrant is an "alpha shop," we mean that First Quadrant is in the business of delivering alpha that isn't just beta disguised in a different form, and we mean that we add value through a careful engineering of the use of beta – defined in its broadest, most conceptual sense. This engineering includes a time variation in the allocation of risk to different sources of alpha.



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