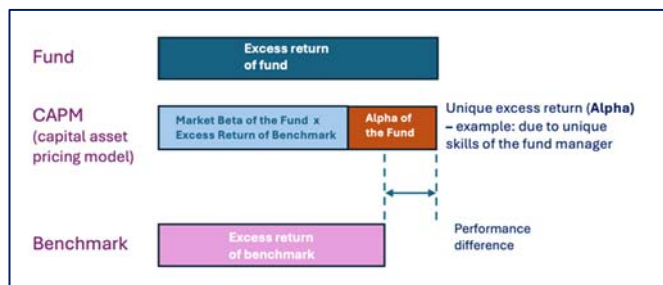


Under the Bonnet – We all love Alpha ...

Origin of Alpha

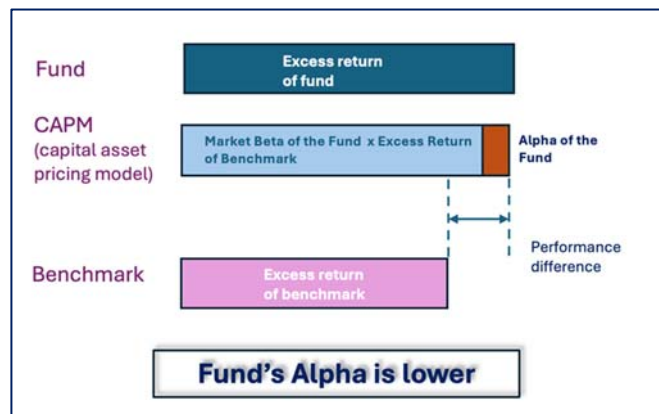
In the 1960s, a few economists including Jack Treynor, William Sharpe and John Litner, developed a model for pricing securities. Known as the capital asset pricing model (CAPM), it tried to explain how the return of the broad market affects the expected return of a security, via a sensitivity known as 'Market Beta'. This was extended by Jensen in 1968 to the expected returns of mutual funds. Specifically, the fund manager's skills should improve the expected return of a fund above that of the broad market, or Market Beta. As illustrated in the diagram below, this difference is called Alpha.



Alpha is a buzzword that we hear frequently in the investment industry. Funds which produce most of their returns linked to the market returns will have a Market Beta close to 1 and a very low Alpha (also known as closet index trackers). We all prefer funds that have high, positive Alpha. This is the part of the performance that does not depend on the broad market. Therefore, the level of Alpha reflects the skills of a fund manager. Mathematically, the returns coming from Alpha should be completely unrelated (or statistically independent) from the returns driven by Market Beta.

Alpha is not outperformance

While Alpha is important and reflect the skills of a fund manager, it is **not** outperformance. As you can see from the diagram below, a fund can still perform well for a low Alpha – if the fund manager adjusts the Market Beta well in a positive market (>1, which can be done by tilting towards high Beta stocks or using some leverage). One can argue that adjusting Market Beta in a timely manner is also an important fund management skill.



Alpha is not constant

Consider how an active fund manager constructs a portfolio:

1. The fund has an investment objective, stating which market that the fund will invest in (which becomes the benchmark for the fund; for example, FTSE All-Share index). This forms the universe of securities.
2. The fund manager selects what securities from this universe to invest in the portfolio. That will depend on (a) the manager's view of the economy and broad market, (b) their outlook on different sectors and industries, and (c) their view on future performance of the securities they want to invest in.
3. Note that (a) drives decision in (b), and (b) drives decision in (c). And all these decisions affect the performance of the fund.

If Alpha represents the performance that is not related to Market Beta, then it should come from selecting the right securities based on (b) and (c). But not all managers can select the right securities in all stages of an economic cycle. For example, a manager may be very good in picking defensive stocks when interest rates are high. But when interest rates drop (which favour growth stocks), the manager's performance suffers. So their Alpha may deteriorate when the interest rate cycle reverses.

As one can see, understanding how the skills of a fund manager evolve with an economic cycle is important. We will be introducing tools to help advisers and fund selectors very soon.

James Chu CFA, Head of Investment Solutions

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