



Letter to the Editor: Alpha during Market Cycles

September 2, 2008

The following letter is in response to our article [Luck versus Skill in Active Mutual Funds](#), and the ensuing letters on this topic, the most recent of which was [When Will Objectivity Enter the Active versus Passive Debate?](#).

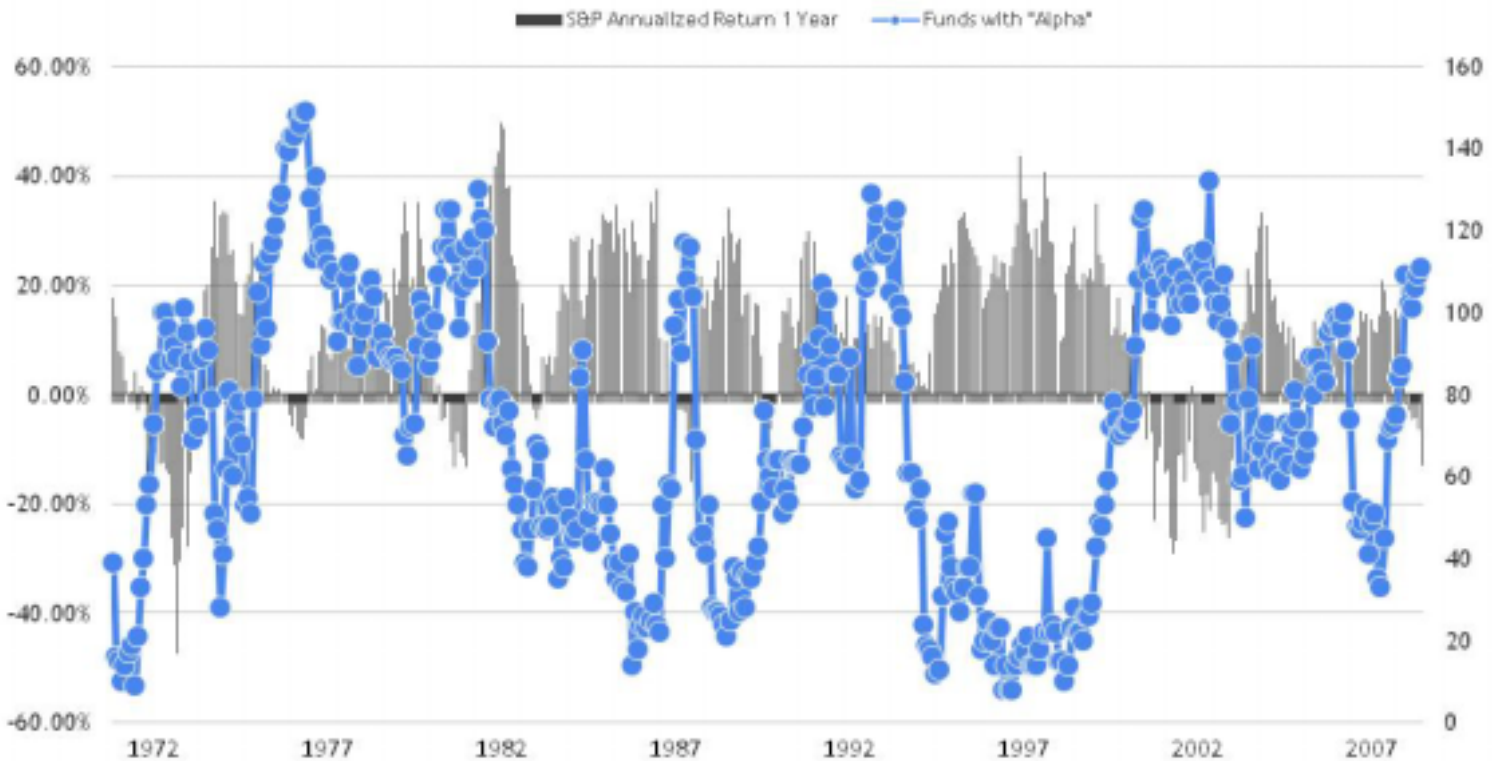
Dear Editor,

I enjoy the ongoing debate over whether skill can be found, and if so, whether it means active management is superior to passive management.

I believe the manner by which advisors, funds, and vendors equate alpha to skill is flawed. Alpha is not skill. It is a measure of return above a benchmark or index. As I show below, it is highly dependent upon the index's performance.

The data below show that alpha is inversely correlated to the performance of the S&P 500. Alpha surges when the S&P 500 does poorly, and recedes in bull markets.

S&P 500 Rolling Annual Returns v. "Alpha" of US Mutual Funds: 1972 - 2008



In this chart, the horizontal axis represents time, from 1972 to the current. The blue dots represent number of US mutual funds demonstrating alpha in each month, using the right vertical axis. Alpha was calculated monthly using Jensen's alpha based on the previous 12 months of returns. The grey bars represent the annual rolling returns of the S&P 500, using the left vertical axis.

Furthermore, this illustrates that the S&P 500 is not the proper benchmark for most funds, as Dave Loeper argues in his [article](#).

I am quite certain skill can be assessed and quantified. More importantly, the skill that should be measured is how well the advisor's investment policy (asset allocation) assists the client in obtaining the highest upside potential relative to their goals with the lowest downside deviation, rendering the active vs passive debate moot.



As a relative comparison, alpha cannot be equated to skill because it was never intended as such.

Yours truly,

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