



Don't Pay Alpha Fees for Beta Performance

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Understanding whether returns are derived from alpha or beta is central to portfolio construction. Returns from beta are easily available at very low cost, but returns from alpha are much harder to obtain and, if delivered persistently, result in significant management fees. Larry Siegel is Director of Research for the Ford Foundation where he is part of a team managing a \$13 billion fund. We have written [previously](#) about Larry's research into the distinction between alpha and beta, performed in collaboration with Barton Waring and Matt Scanlan of Barclays Global Investors, scheduled to appear in a forthcoming article by the three authors. Drawing on a draft of their article, we look more closely at the subtle and complex issues facing advisors as they select from the realm of asset classes with vastly different performance characteristics.

You can separate alpha from beta

In theory, the return on any asset, no matter how exotic or hard to evaluate, consists of a part that is correlated to some market or set of common factors (beta) and a part that is uncorrelated (alpha). With a suitable benchmark, a statistical regression will determine these parameters for most publicly traded liquid assets. However, for illiquid assets (private equity, venture capital, real estate, and most hedge funds) this calculation is much more difficult, due to the lack of fund transparency and an appropriate benchmark.

In asset classes where index funds are available, alpha and beta quite can be measured accurately and invested in separately. In theory, index funds could be used to obtain the desired beta exposure, and specialized investment vehicles (e.g., market-neutral hedge funds) could be employed to add (or subtract!) alpha. Siegel, Waring, and Scanlan note that this structure has come to be known as "portable alpha" although, he says it would be better named "portable beta" since close to 100% of available capital is invested in the alpha sources and index contracts, which require almost no capital, are used to salt and pepper the portfolio to taste with beta exposures.

Siegel and his co-authors advocate against such extreme structures. Some traditional long-only active managers, who blend alpha and beta, have the kind of exceptional skill required for successfully implementing an active strategy, and those who do should be part of an investor's portfolio. The authors note that "skill can be found in many places and the investor should take advantage of it wherever he or she finds it," adding, "But at the same time, the investor should be cognizant of the aggregate of all the beta positions across their asset



allocation, and make sure this aggregate is consistent with the intended strategic asset allocation policy.”

Alpha and beta for illiquid alternative investments

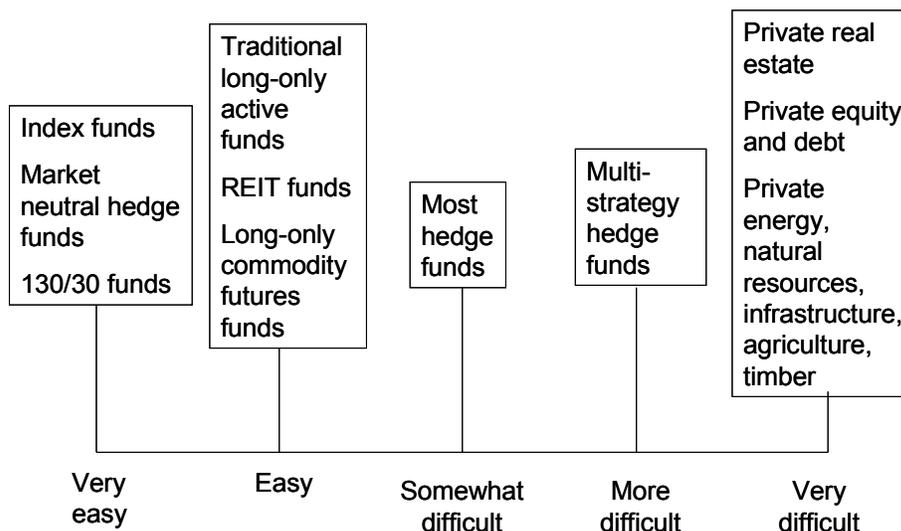
Many of the most interesting investments are in alternative asset classes where it is difficult and occasionally impossible to accurately distinguish alpha from beta. These include private equity, real estate, some hedge funds, and partnerships that invest in energy, other natural resources, infrastructure, agriculture, and timber. As Siegel notes, “it is more productive to analyze these exceptions than to keep repeating the mantra that alpha and beta are separable.”

Investment in an illiquid alternative asset resembles a stake in a private company, moreso than it does an investment in a public equity. Investors must confront the lack of a continually updated market price, tolerate the accounting provided by the alternative investment manager, and wait ten or more years to get a full payout of cash and/or marketable securities. At that point it is possible to look back and calculate the performance, but *not* the correlations with asset class benchmarks that would make it possible to calculate alphas and betas.

A continuum from “easy to separate alpha and beta” to “very difficult”

Siegel and his co-authors provide the following illustration, showing asset classes and the ability to separate alpha from beta:

Exhibit 1
Continuum of difficulty in separating alpha and beta





A market-neutral, style-neutral, and everything-else-neutral hedge fund consisting of liquid securities is at the “very easy” end of the continuum, although in practice such funds rarely exist in this pure a form. The proper benchmark is cash, and the return in excess of cash is all alpha. One can debate about whether a given alpha produced in such a manner is due to skill or luck, but it is alpha nonetheless.

An index fund is also at the “very easy” end. The whole return is beta, with no alpha.

Traditional portfolios (including long-only and long-short funds) are usually amenable to regression on a benchmark or mix of benchmarks, and thus easy to analyze in terms of alpha and beta. There may be some debate about which benchmark or mix of benchmarks is the right one to use, but the analysis can still be satisfactorily performed.

Hedge funds, particularly if they employ a multi-strategy architecture or lack transparency, are harder to analyze in terms of alpha and beta exposures. One must rely on a mix of the description of the strategy offered by the manager, and regression on various benchmarks, and subjective analysis, and it may not be possible to achieve estimates in which one has confidence.

The menagerie of private investments in the rightmost column of Exhibit 1 has betas (and thus alphas) that are conceptually *there*, but we have no data with which to estimate them. However, empirical estimation is not the only tool we can use. We can also use subjective judgment, asserting that, for example, a given private real estate partnership has a beta that is closer to one – relative to a hypothetical private real estate benchmark – than to zero. (A zero beta would imply that the real estate partnership is an absolute return investment, a claim we can easily dismiss by noting the fluctuations of the real estate market and recognizing that just about any investment in that market is affected by these fluctuations.)

The order of the asset classes in the diagram is not clear cut; many hedge funds are harder to analyze, in terms of their beta and alpha exposures, than many private investments. But, as the authors note, “we are sure that the betas – and hence the alphas – are “there,” whether or not we have data (or subjective analysis) that we can use to put a number on them.”

On hot dog stands and carbon credits

Ronald Coase won the Nobel Prize in 1937 for his theory of the firm, which essentially stated that companies exist because they can produce goods and services more efficiently than individuals on their own. But, isn’t that exactly what



some exotic hedge funds and limited partnerships are doing? Let's consider some examples, one silly, one serious.

Some time ago, about 1964, there was a craze for hot dog stands in Istanbul, Turkey. At first this foreign influence was opposed, and teenagers had to sneak out of their parents' sight for this tasty new treat. After a while, even the parents were eating hot dogs. This new business made a high return on capital for a while. Is this high return alpha or beta? Siegel and his co-authors argue that it is clearly beta, since all hot dog stands were roughly equal all you had to do was "be there." We don't know of any funds that were organized to participate in these lofty returns, but investors should have been willing to pay quite a high fee to get into such a fund, properly viewing the fee as an "assembly charge" for making hot dog stands in Turkey into an investable asset.

More recently, a prominent hedge fund manager has made a business by buying carbon credits earned by free tillers in India and selling them to industrial polluters in Belgium. The fund charges a 2-and-20 fee for what obviously would be considered beta, since anyone can enter this business and earn roughly the same return. So why don't others compete and eliminate the "exorbitant" fee? For one thing, competitors would need to understand the dynamics of free tillers in India, and would have a tough time negotiating a good deal on carbon credits. A 2-and-20 fee is a low price for the convenience of not having to learn this new trade while still being allowed to keep most of the return from it. This is the same reason plumbers and car mechanics charge, and more importantly receive, high prices.

Siegel, Waring, and Scanlan argue that most of the return from these activities, where all you have to do is "be there," is beta. There is an assembly process that needs to be undertaken to make these cottage industries into investable assets. However, the assembly process, while requiring skill, does not require alpha generation. It does not require the way-above-average skill it takes to beat other managers, and thus earn alpha. Yet it is worth a high fee.

A beta return can therefore be worth an alpha-like fee, typically when circumstances discourage performing the required assembly steps. As the authors say, "few people want to move to Turkey to invest in hot dog stands or negotiate with Indian farmers for the carbon credits they've earned."

William Sharpe observation that the return on *any* portfolio consists of a market (beta) part and a non-market (alpha) part is "perhaps the most profound insight in modern finance." All investments, including illiquid and non-transparent alternatives, have betas and alpha, even if they are not readily apparent to the naked eye. If all you have to do is "be there" (as in the case of Turkish hot dog stands), it is beta. But if you need to identify a manager with superior skill to



justify making a superior investment, then that's a combined beta and alpha decision.

Is timing among beta exposures alpha or beta?

Should attempts to earn a return by timing beta exposures be credited to beta or alpha? Siegel and his colleagues believe it's understandable that investors are confused on this point, since the question contains a surprisingly large number of moving parts.

At first blush it would seem that such bets should always be credited to alpha. If an investor held the S&P 500 from January 1995 to March 2000, then Treasury bonds from April 2000 to February 2003, then the S&P 500 thereafter, they would have been a genius (or extremely lucky) at market timing and would have earned a huge alpha, regardless of the benchmark against which their performance was measured.

But let's dig a little deeper. Many international (EAFE) managers beat their benchmark in the 1990s by underweighting Japan, which, at its peak, represented almost 60% of EAFE. Siegel, Waring, and Scanlan argue that whether the return from underweighting Japan is alpha or beta depends on the manager's *intent*. If the manager underweighted Japan because they thought that Japanese stocks were overpriced, then it's alpha. If the manager underweighted Japan for risk control reasons (say, to avoid putting 60% of a portfolio in one country), or because their peers were also underweighting Japan, then the return is arguably beta – that is, it should not be regarded as evidence of manager skill. Unfortunately, it's essentially impossible to discern manager intent looking backward over time; managers will say they intended to make the bets that had favorable payoffs. To get the information needed to distinguish alpha from beta in the current example, one would have had to keep track of the manager's stated intentions in "live action."

Is rebalancing alpha or beta? In a market that is in a long uptrend or downtrend, rebalancing asset-class weights to the policy mix only after they have drifted appreciably away from the policy weights can add 5% a year compared to the policy mix (which assumes continuous rebalancing). If it is just a mechanical rule to avoid overly frequent trading, this extra return is beta. (By the way, in a trendless, mean-reverting market, the same rebalancing technique produces a negative return relative to the benchmark. This, too, is beta. As evidence that it's beta, note that the two effects cancel each other out; there is no preferred return, over both trending and mean-reverting markets, from the strategy. Stated another way, unless you know whether the markets are trending or not, in advance, the expected return of your rebalancing strategy is simply zero.)



The authors do not provide definitive guidance as to whether a beta-timing return is really beta or alpha. When viewed after the fact, excess returns result either from intended, skillful “beta bets” or from incidental, skill-free ones just as with any other active management decision. It’s similarly hard to distinguish one kind of bet from the other. Siegel and his co-authors do not suggest there is a “bright line,” but aim to raise awareness that returns from timing among beta exposures can produce returns that are fairly credited to either alpha or beta, depending on the circumstances. Looking “under the hood” is necessary to have any chance at telling the difference. But, as the authors say, one thing is sure, “if you intentionally make beta timing bets, it’s about the search for alpha, not for beta.”

Implications for Advisors

Distinguishing alpha from beta matters because fees for beta from well-established asset classes should be very low, while fees for alpha are very high. Furthermore, you should select alpha providers carefully so the fees are worth it! Separating alpha from beta (in a clearly defined measurement or evaluative sense, not necessarily by investing separately in them) insures you will pay high fees only for positive expected alpha, not for the delivery of a beta along with random, unskillful alpha production.

Siegel, Waring, and Scanlan note that “a world in which in which alpha and beta are *fully* separated and in which investors pay active fees *only* for alpha is a fantasy.” But the fantasy is at least theoretically available right now, by investing in index (pure beta) funds and market-neutral long-short (pure alpha) funds. Investors would then be literally paying active management fees only for true alpha along with radically lower index fund fee levels for beta exposure. Almost no institutional investor behaves this way, and for good reason. Why not?

First, there’s nothing wrong – even in principle – with buying beta packaged with alpha, as long as the investor believes the manager is skillful and the fees charged are an appropriate blend of the high alpha fees and low beta fees.

Second, to avoid buying beta bundled with alpha, you would have to completely avoid asset classes where the lines are blurred. These include private equity and debt, real estate, and many other alternative investments. At any given time, there are attractive opportunities in one or more of these asset classes, which should not be overlooked just because the benchmarks and index funds that would make it possible to separate alpha from beta in these investments do not exist.



Third, you would be ignoring portfolio designs that mix alpha and beta exposures. These include:

- Traditional long-only active managers
- Hedge funds or hedge-like funds that take some ordinary beta (stock market or bond market) exposure
- Hedge funds or hedge-like funds that expose you to nontraditional forms of beta (e.g., beta that is tied to alternative asset classes)

There is potential value—potential alpha—in all of these blended vehicles. Investors should not ignore these sources of alpha just because they will inevitably wind up paying some alpha fees for beta exposure.

A realistic strategy for implementing a full understanding of the difference between alpha bets and beta bets is:

- In most asset classes—in public markets with transparent benchmarks and liquid index funds and/or ETFs based on those benchmarks—separate alpha and beta as cleanly as possible. To accomplish this,
 - Use *more* index funds, enhanced index funds, and market-neutral long-short funds
 -
 - Use *less* traditional long-only active management, focusing on managers identified by the investor as having the skill necessary to deliver truly superior results after fees
- Nontraditional beta exposures, involving assembly charges to make the betas available to the investing public, may be worth a fee substantially higher than a traditional index fee. Try your best to negotiate such a fee in these asset classes.
- Finally, in some asset classes and types of funds, alpha and beta simply cannot be disentangled, and an alpha fee – beyond what can be justified by assembly costs – is charged on the entire return. Knowing that you will pay an alpha fee for the part of performance that is due to beta, invest in these only if the after-fee return you expect is more than sufficient to compensate for all of the risks taken and fees paid.

Such a structure moves the investor a long way toward the ideal of paying alpha fees only for true alpha, and index fund fees for beta. The ideal is not fully achieved but you are much closer than in current practice. Siegel, Waring, and Scanlan hope and expect to see investors adopting this structure in the future. Some of the current trends are in this direction, and the authors are



tremendously encouraged by them, but they also see investors paying very high fees for certain alpha sources. Investors will benefit from controlling fees and other investment costs while following the principles of alpha-beta separation as best as one can in a complex world.

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