



# RECOGNIZE ALPHA WHEN YOU SEE IT

*Quest for skill in markets is centuries old.*

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“Portable alpha” is just a catchy phrase for an ancient innovation—rice futures were traded in 17th century Japan. But our dilemma is the same: finding who has what kind of sustainable alpha. Regrettably, for the majority of investors alpha is scarce and capricious, morphing with asset growth and surfing market cycles. Its true sources are often not transparent. The byword in the new, round investment world will become “no transparency, no transport.”

Pinpointing the true source of alpha and having the toolkit to document it will become essential to sustaining total plan return/risk targets. Thankfully, this toolkit exists.

## A New Image for Investing

Tomorrow’s active manager will need not only to articulate an intriguing process but also quantify the nature of its alpha signature, thereby, among other things, grasping its correlation properties. The following six “rules of the game,” followed by their respective established quantitative yardsticks, will gain growing acceptance in identifying the quantity and footprint of alpha:

- Play well (skill): Selection hit rate and optimal weightings;
- Play often (breadth): Number of complementary bets;
- Play the right game (dispersion): Cross-sectional range of returns;
- Play on the field (risk budget): Tracking error;
- Play efficiently (slippage): Factors that reduce the hit ratio due to constraints, and;
- Play with a referee (attribution): Multifactor regression (rough translation: we made money, and we know exactly how).

Nirvana in active management is maximizing the information ratio. We can measure success by finding the theoretical optimal weights of all alpha factors, then comparing the actual returns and attributing them to the managed exposures of the explicit alpha factors. The manager will be accountable not just for active per-

formance, but also for historic and forecasted answers to these committee curiosities:

- What are your alpha sources, and how are they calibrated?
- What is the historical information coefficient of the individual factors and the overall composite ranking system?
- Where are the current exposures versus the benchmark?
- What performance within the portfolio has been derived from these exposures?

## Engineering Diversification

It can be revealing to array asset strategies against a prism of market dynamics in order to better pinpoint their real drivers and achieve non-correlation. These strategies can include liquidity sourcing, volatility exposing, and duration adjusting. For example, value strategies supply liquidity and add value through mean reversion, or rational pricing. They may also be thought of as short-duration. Momentum strategies are liquidity takers and add value through market hype or the “greater fool” theory as high prices lock the asset in someone else’s hands. Strategies such as high beta may be short volatility, causing them to get trounced in a market down-spike. In contrast, high dividend or cash flow yield holds up better in such a spike.

New levels of attribution now enable us to “look through” traditional asset allocations or measure non-traditional investment structures in order to decipher the true sources of alpha and risk and manage them.

These tools should enable the manager of the future to avoid embarrassing characterizations such as “alpha imposter,” “beta fudger,” or “style sneaker.” Full deployment of the modern portfolio theory toolkit should equip us to engineer vastly more efficient portfolios and make better plan-level decisions. It’s all about identifying real skill, memorializing it beforehand, managing to it, and attributing it afterward. ■