

Alpha and Beta Separation: Advantages and Limitations of Applying Alpha-Only Strategies

Russell Read, Ph.D., C.F.A.
Deputy Chief Investment Officer
Deutsche Asset Management, Americas



Best Practice for Asset Allocation has become Increasingly Dynamic

- **Traditional Questions**
 - How should I allocate among traditional asset classes to identify my best strategic mix?
 - Efficient Investment Frontiers: Find the best expected ROA or ROE for a given volatility
- **New Questions**
 - How much alpha-only product should I own?
 - How much should I allocate tactically?



Why is Best Practice Dynamic?

- Realization that plan sponsors can gain some Beta market exposures cheaply
- Emergence of a vibrant industry providing alpha-only products
- Allocation to a wider range of asset classes including private equity, real estate, and physical commodities each with its own return, risk, and liquidity considerations



The Basic Opportunity Set

- $E[R] = \sum \omega(i)E[\alpha(i)] + \sum \omega(i)\beta(i)E[r(\text{markets})]$
- Key Insights
 - For each investment (i), plan sponsor can take α -only, $\alpha + \beta$, or β -only risk
 - Regarding expected returns, the key decision for employing α -only strategies involves comparing $E[\alpha(i)]$ with $E[r(\text{markets})]$
 - This comparison is inherently dynamic (i.e., history is an especially poor indicator of future comparative returns)



Prominent α -Only Alternatives

- Hedge Funds
- Hedged Long-Only Investment Products
- Asset Allocation Overlays



General Benefit Potential for Using Alpha-Only/Portable α Strategies

- No disruption to underlying managers
- No disruption to strategic asset allocation
- Capital efficient
- Often low correlation to other asset classes and traditional active managers
- Only pay for active returns (alpha, not beta)
- Allocate effectively to market risk and active risk
- Efficiently capture TAA opportunities



Limitations of α -Only Strategies

- α -only products are not available to capture the opportunities in many markets (e.g., relative value in emerging markets equities)
- Several popular α -only strategies have proved reliant on trending markets and market liquidity (i.e., not β -neutral)
- Canadian foreign content limitations crowd out many non-Canadian α -only products



Specific Benefits to Canadian Plan Sponsors of α -Only Products

- α -only/portable α overlay products could use futures, forward, and swap contracts using Canadian collateral to capture the relative value opportunities among major stock, bond, and currency markets worldwide
- Many of these strategies could be put in place without compromising Canadian foreign content rule limitations



Conclusions

- Alpha-only/portable α strategies have become increasingly critical to plan sponsors in recent years
- Use of alpha-only strategies has made Tactical Asset Allocation (TAA) increasingly important to plan sponsors
- α -only strategies have emerged as efficient vehicles to achieve value-added TAA

