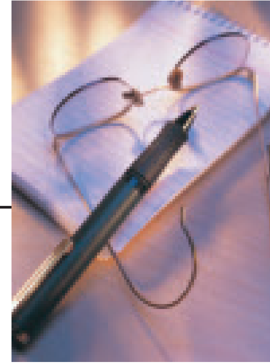
Winners and Losers

It takes all kinds to make the alpha game work.



FIELD NOTES

BY TRISTRAM S. LETT

I recently had the good fortune to uncover a very informative piece called the "Tao of Alpha." I thought it timely because of the nature of the discussion carried on in the financial media about alpha. The authors suggest the pursuit of alpha has now reached cult status and yet few actually understand it well enough to talk about it intelligently. I invite readers of this piece to circle back and read the "Tao of Alpha" because, between these two articles, one will be better educated on the topic.

I often ask groups I meet how much total alpha is out there. After a few hints the correct answer usually comes out: zero, nada, zip, none, nil… after all, it is a zero sum game. Well, zero until you deduct the cost of looking for it (I will deal with the idea of net alpha shortly). The notion of alpha hunting is quite remarkable since there is a class of investors who do nothing but seek something, which, in aggregate, does not exist! But the essence of the zero sum game is that any winnings must be matched with losses, so winners can exist. They do find alpha and therefore, the losers transfer it to them and, as a result, experience negative alpha.

A general theme in the financial media today is that the large influx of investments flowing to hedge funds and the number of new firms servicing these investments is diluting alpha and, therefore, returns are falling and will continue to fall. I find that this theme tests credibility.

TAKING BACK ALPHA

Earning alpha is not like buying an index fund—a source of pure beta return. Beta return is available to anyone by right. Investors don't need to know anything to earn it. Alpha is earned by taking it from someone else, literally. It occurs in an anonymous contest: it's the only way winning and losing can happen because no one would do it willingly. This occurs in three ways. First, you are smarter or better informed than your unseen competitors. Second, the faceless party on the other side of the transaction may have a different utility function that constrains him from taking advantage of an alpha-earning opportunity and, third, you are simply lucky.

The fallacy of declining alpha is centred on the notion that all these new entrants are superior investors, with superior insights and a significant dose of good luck to top it all off. While I am sure that every budding new hedge fund manager feels they have a constructive and consistent way to extract alpha, the fact is there will always be a substantial number of losers who will, in fact, give up alpha. Since the game is a zero sum one, there will always be ample alpha-generating opportunities. Every new set of entrants will bring with it its "greater fools."

As an instructive experiment, we can postulate a world in which no alpha is earned by anyone. If all investors were equally skilled, equally informed, equally lucky with similar constraints, it would be impossible to take alpha from one another. Obviously this is a rather ridiculous assumption because we know the chance of these conditions existing in reality is nil. Therefore, alpha will always be available for the taking by the skilled.

DIRTY UNDERSIDE

One then must ask the question, why is there a view that alpha is declining and that it will continue to do so? This is the dirty underside of the absolute return

Tristram S. Lett is managing director, absolute return strategies, Integra Capital Management Corporation

> "There will always be a substantial number of losers who will, in fact, give up alpha."

business. Many practitioners in this business are either not providing alpha at all or they are providing very little of it. Their returns mainly derive from beta exposure. Indeed, one only has to look at the correlation of aggregate hedge fund returns with S&P 500 returns to see this.

But the question is more complicated than simple betas based on well-known market benchmarks. Higher-order betas come into play, which are better explained by passive option strategies. There is a growing body of literature developing in this area with major contributions coming from Bill Fung and David Hseih, Andrew Lo, Harry Kat and recently in Canada by Steve Foerster. The point made by all of them is that many absolute return strategies are more accurately described as relative return strategies and, as such, they should be charged out at the fees associated with the latter.

The 2006 Alternative Investment Conference will be exploring these issues and proceedings will be published in the Spring 2007 issue of *Canadian Investment Review.* Participants will no doubt enjoy some interesting presentations in this regard.

Why is alpha enjoying its so-called cult status? Why does everyone seek it and hold it so dear? No mystery here—its qualities are positive in every regard. Absolute returns by definition mean a very high incidence of positive outcomes over short measurement periods. The processes involved in extracting alpha from other investors attract little risk and that which it does incur is readily diversifiable. Most appealing of all is the lack of correlation with everything else. This makes it the ideal portfolio candidate. With all these positive virtues, it is no surprise that the demand for alpha is growing astronomically.

But what makes it so special? If alpha were positive in aggregate, then you could invest passively in it. And, if you could invest passively in it, it would not be that special—and fees would be beta-like. In other words, alpha needs to be zero-sum or it's not special.

ALPHA FUTURE

The final question is, where is the alpha production business going and what is it going to look like with large sums being allocated to it? A new trend is emerging which has everything to do with the arrival of the mainstream institutional investor on the scene. As I noted earlier, while total alpha is zero, net total alpha is negative. The difference between the gross and net is accounted for by management fees and transaction costs. These are not inconsequential and they feed two important elements of the hedge fund food chain—managers and prime brokers.

We are now witnessing the arrival of process-driven, long-only, institutional managers offering absolute return strategies with a high degree of success. Barclays Global Investors, for example, went from a dead start in 2000 to $17 billion under management (unleveraged) in less than five years. These managers offer strategies with significant differences from mainstream hedge fund managers. Five characteristics distinguish them—lower fees, lower transaction costs, purer alpha, full transparency (risk or position) and monthly liquidity. The first two characteristics help increase the net alpha production for their clients. Purer alpha is a major bonus when combined with lower fees and also in portfolio construction. The final two characteristics give fiduciaries a great deal of comfort.

These managers have long histories of successfully serving institutional investors and know exactly what they want and need. They also seem to have discovered the net alpha concept at a timely moment in the evolution of the hedge fund industry. Because of this, their success is likely assured. ∎

ENDNOTES

1. "The Tao of Alpha" can be found on the website www.ilukacg.com