

Separating Alpha from Beta in Investment Products

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A Brief Outline

- Strategic vs. Tactical Asset Allocation: Beta Drivers vs. Alpha Drivers.
- Asset Management Business Models and Innovation
- Separating Alpha from Beta
- Conclusions and Observations.

Strategic Asset Allocation: An Overview

- Target allocation among the major asset classes.
 - Best to use broad asset classes—sub-asset classes and styles should be left to tactics.
- The translation of investment policy.
 - Should reflect the Risk Tolerance of the Board
- Designed to meet the goals of the organization over a full market cycle—anything less is an attempt at market timing.
- Strategic Asset Allocation is not designed to “Beat the Market.”
- Establishes the Policy or Beta Risk for an Investor.

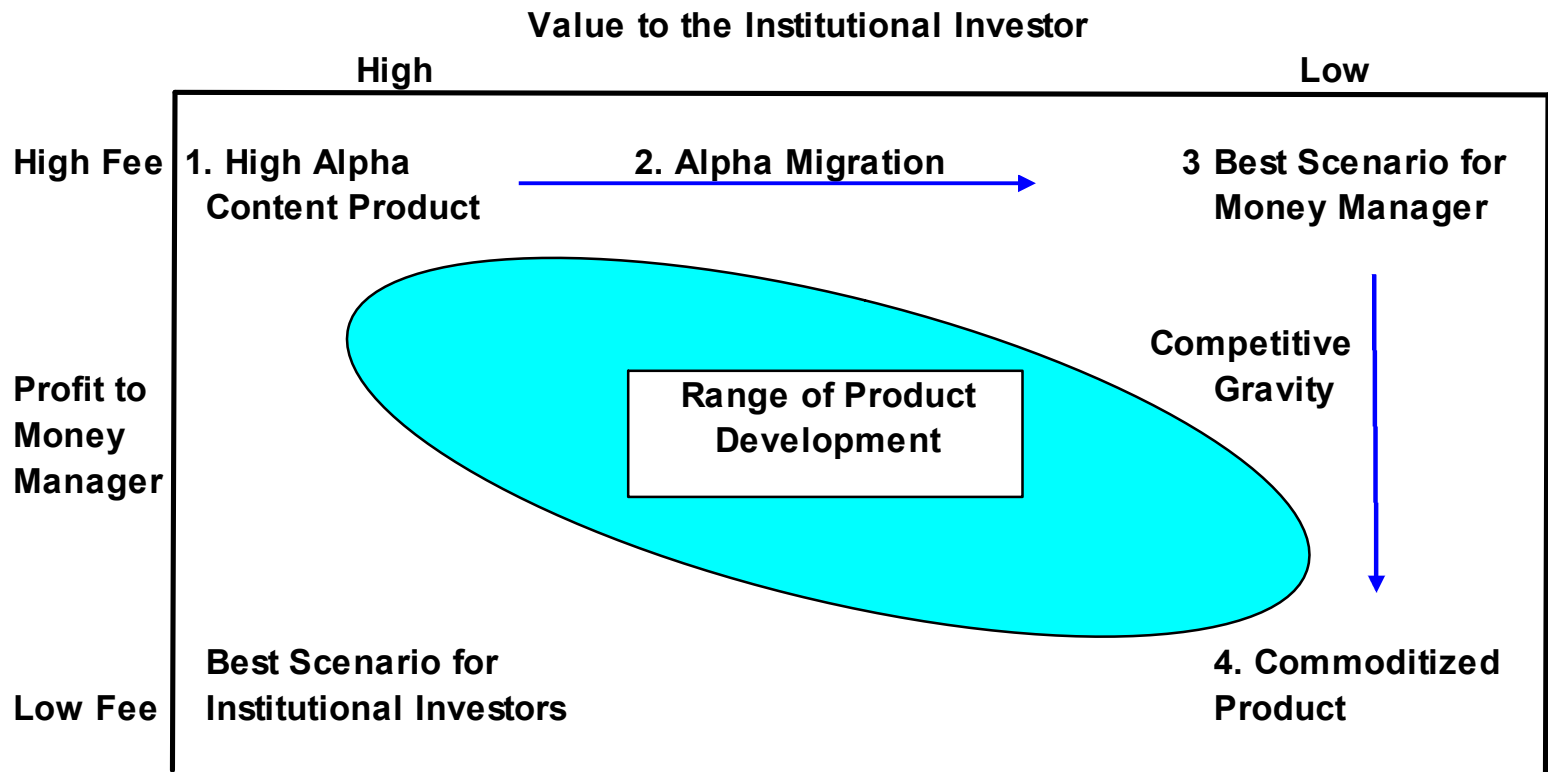
Tactical Asset Allocation: An Overview

- Intended to take advantage of opportunities in the financial markets.
 - Attempts to “beat the market.”
 - Facilitate a fund’s long term funding goals by seeking added value.
 - The goal is to generate alpha.
- Timing is a key distinction between Tactical and Strategic Asset Allocation.
 - Tactical allocation is performed more frequently.
 - Any adjustment to a portfolio that is not part of Strategic Asset Allocation is a tactical attempt to add value.

Asset Allocation Made Simple: Alpha Drivers vs. Beta Drivers

- Pension fund Boards of Trustees engage in Strategic Asset Allocation where fund assets are allocated across major asset classes.
 - This process identifies strategic benchmarks which, in turn, establish the Policy Risk for the Fund.
 - This is also known as the **Beta** or market risk of the fund.
 - Pension funds often attempt to extract **Alpha** (excess returns) from their strategic benchmarks.
 - That is, the alpha and beta returns are not pursued independently.
 - This can lead to **Linear Beta Drivers** masquerading as **Alpha Drivers**

Business Models in Asset Management: Fees vs. Value



What is the best business model in the Asset Management Industry?

Sustainable Business Models Require Either Innovation or Economies of Scale

- Innovative Products command a fee premium
 - New products that generate new demand
 - New application of an existing product
 - New distribution channels
- Economies of Scale for Less Innovative Products
 - Increase scale to provide these products as cost effectively as possible.
 - Market share is the key.
 - Increase Marketing Effort: Good product positioning can give the impression of a premium product.
 - But consider: TV commercials for mutual fund companies right alongside beer ads—marketed like a commodity.
 - Good marketing, good product design, good distribution, good cost control.
 - But what is not necessary for less innovative products? Good Performance.

Product Type #1: An Innovative, High Fee Product--A Business Development Company



What, exactly, is a BDC?

Business Development Companies: Two Types of Innovation

- BDCs were created by the Small Business Investment Company Act of 1980.
 - Amended the Investment Company Act of 1940 to create a new type of mutual fund—a fund meant to encourage investment in small, start up companies.
 - Essentially, the BDC idea remained dormant for over 20 years until Apollo Investment Management dusted it off and applied it in a new format.
- The Apollo BDC charges 2 & 20 for a mutual fund product.
 - Innovation #1: New application of an existing product—using BDCs to invest in mezzanine debt—the Apollo BDC buys the mezz debt tranche from LBOs of other buyout firms.
 - Innovation #2: A new distribution channel for mezzanine debt—Apollo brought mezzanine debt investing to retail investors.
 - For this, Apollo collects significant economic rents: a \$20 million a year annuity of management fees—NPV value of \$200 million—and gets to collect profit sharing fees to boot. Not a bad deal.

An Example of Product Type #2: Alpha Migration--Convertible Bond Arbitrage

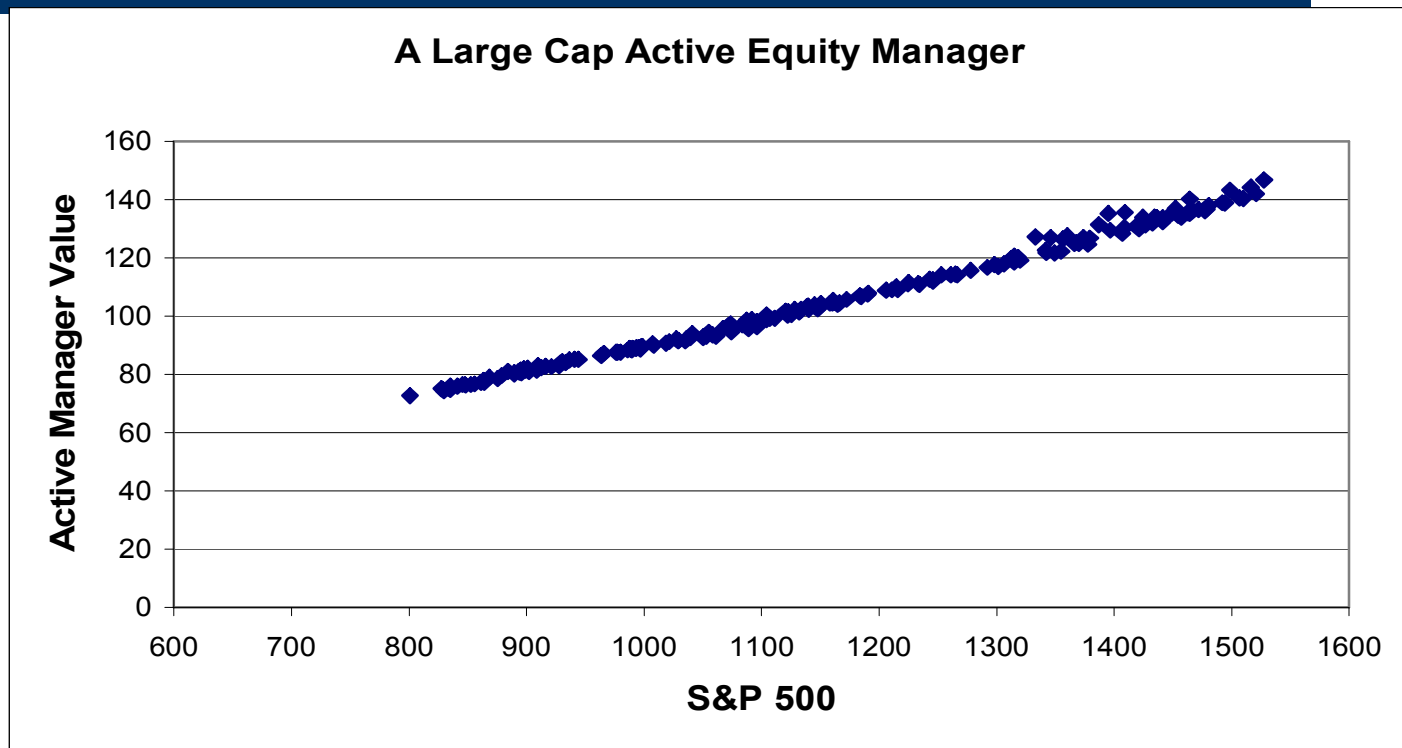
- Four fundamental economic drivers of convertible bond returns:
 - Interest rate exposure: bond duration.
 - Stock market risk: convertible into company stock.
 - Credit spreads: convertibles are typically issued by below investment grade companies.
 - Volatility: the embedded equity option
- Convertible bonds offer non-linear payouts by virtue of the embedded option attached to the bond.

Economic Analysis of the Convertible Bond Arbitrage Industry

Fund Return	Alpha	T Bond	S&P 500	SBHY Cash Pay	VIX	R ²
Value (t-stat)	-0.07% (-1.75)	0.001 (0.028)	-0.018 (-0.55)	0.16 (3.41)	0.057 (3.10)	0.37

- Interest rate exposure hedged away & a Delta-neutral equity hedge.
- With duration and stock market risk hedged, the R-square of 0.37 applies to the two remaining variables: credit exposure and gamma (volatility) risk.
- Security selection (alpha) does not indicate any value added—only the **Beta** exposures are statistically significant.
- Convertible arbitrage is now about finding cheap **Beta**, not **Alpha**.

Product Type #3: A beta driver pretending to be an alpha driver



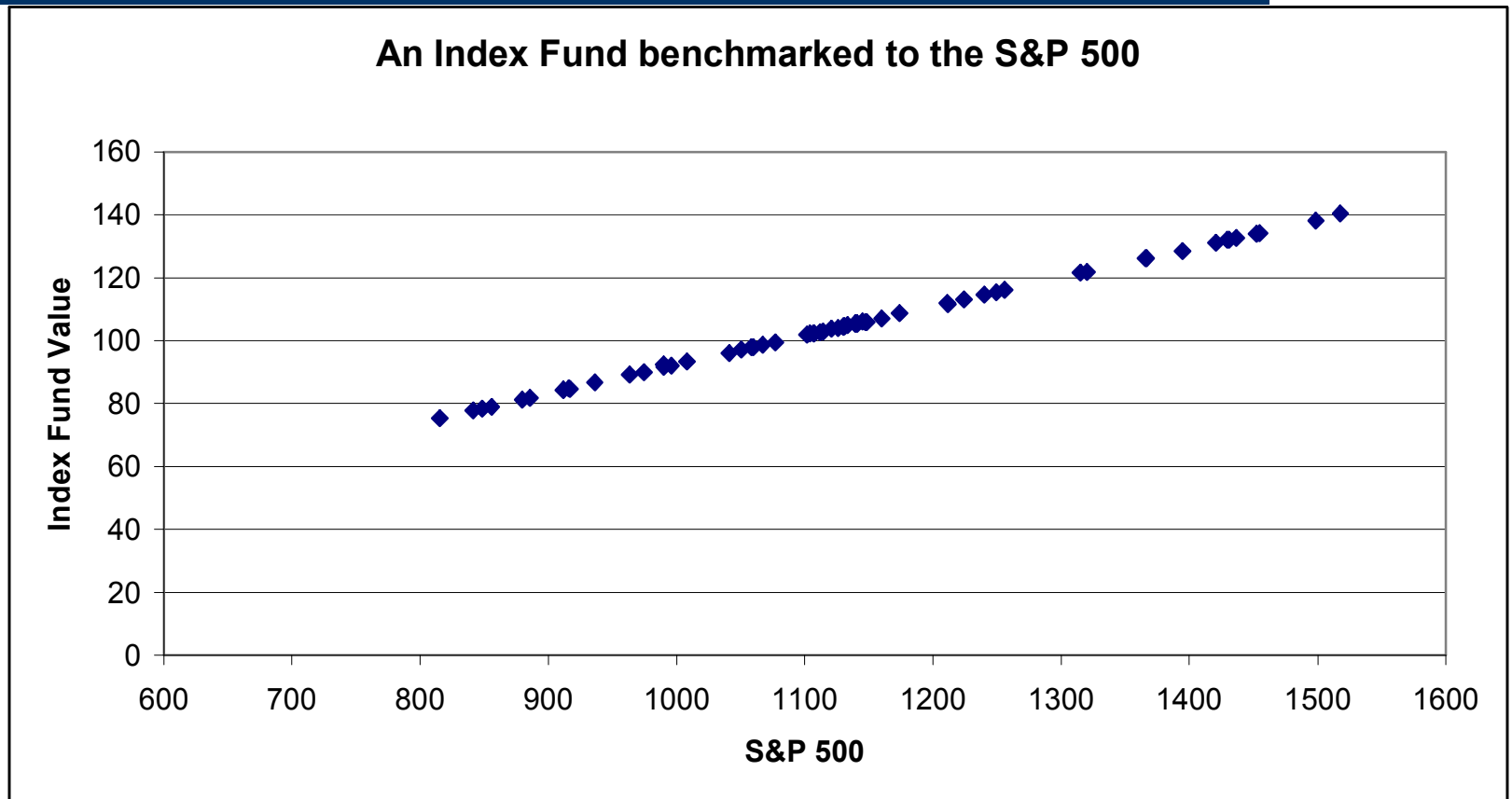
Beta 1.000 R-Square 0.994

This is Product #3—A High Fee (to manager) but Low Value (to client) Product

Observations about the Linear Beta Drivers

- This is why the asset management industry is a great industry to be in—when you can charge over 70 basis points to deliver a straight line!
 - This asset manager has several billion \$ of assets under management in this product.
 - Furthermore, this product has underperformed the S&P 500 on average by 0.75% per year for the last 4 years (Coincidence?).
 - This product is inappropriate as both a beta driver and an alpha driver.
- Bottom line: Investors should not attempt to extract Alpha (excess returns) from Beta Drivers.
 - Alpha must be unbundled from beta drivers.
 - Suspend the notion that alpha is captive to beta.

Product Type #4: A Beta Driver used to Implement Strategic Asset Allocation

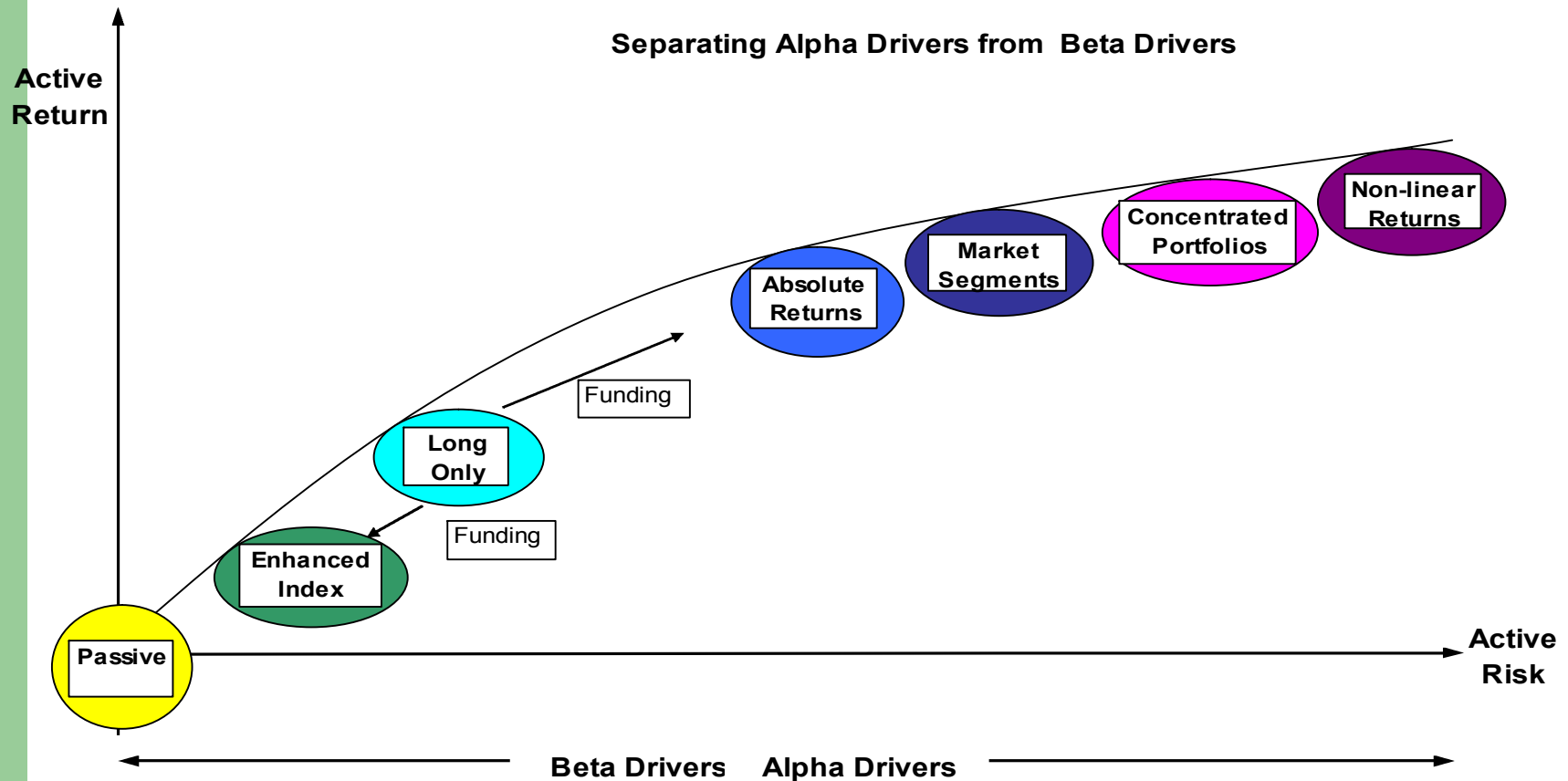


Beta = 1.00 R-Square = 1.00

Re-Thinking Asset Allocation

- Institutional Investors must break away from the traditional asset allocation model of trying to extract alpha from beta drivers.
 - Beta drivers are not designed to outperform the market—they provide efficient exposure to broad asset classes.
 - Alpha drivers are designed to outperform the market, often without regard to “benchmark boxes.”
- Benchmark Boxes should be used when a pension fund believes that it has the least amount of talent or insight to add value.
 - Pension funds should reduce their reliance on beta drivers to generate excess returns.
 - This is the last place pension fund should look for alpha.
 - Pension funds should commit their internal staff resources to those sub asset classes where they can add value.
 - Look for the cracks in between benchmark boxes.

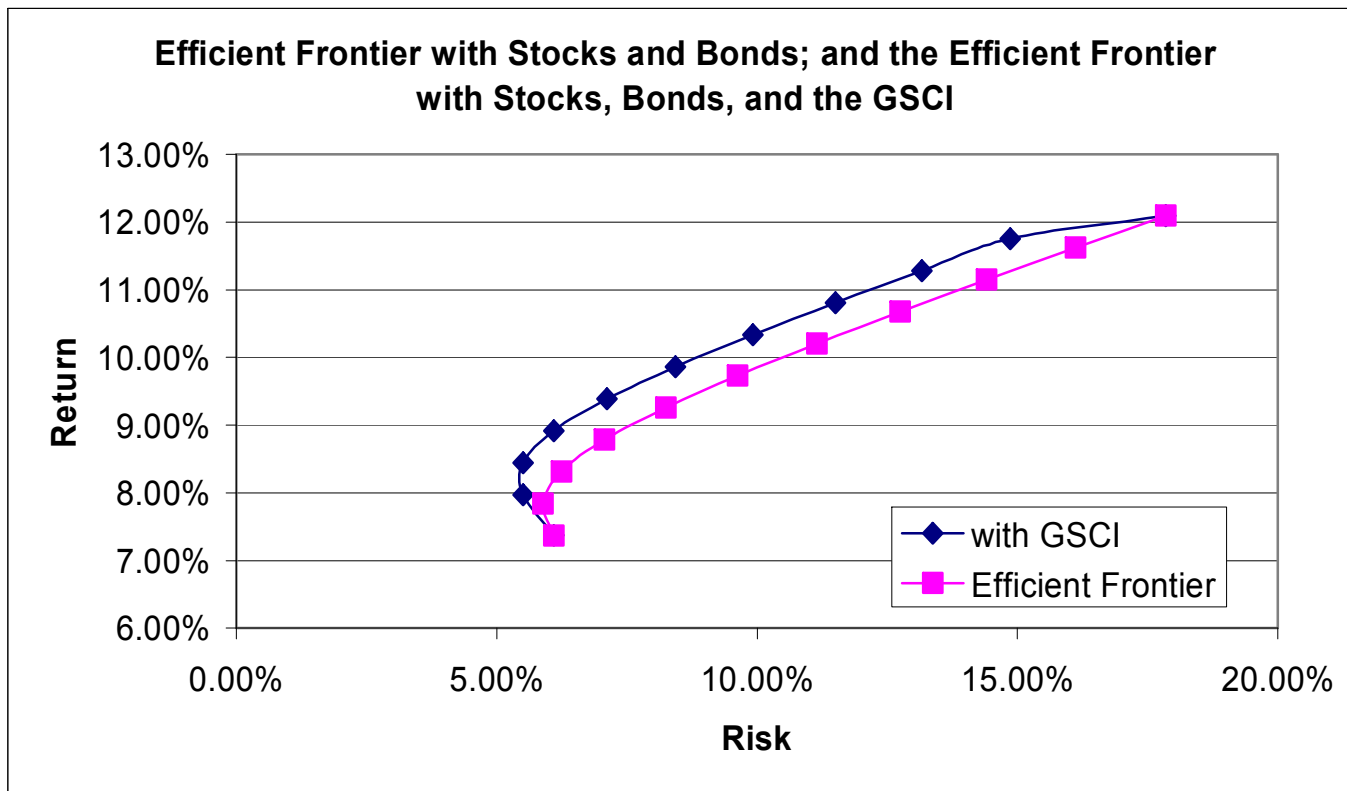
The Primary Strategy for Institutional Investors: Separating Alpha from Beta



Observations about Alpha vs. Beta

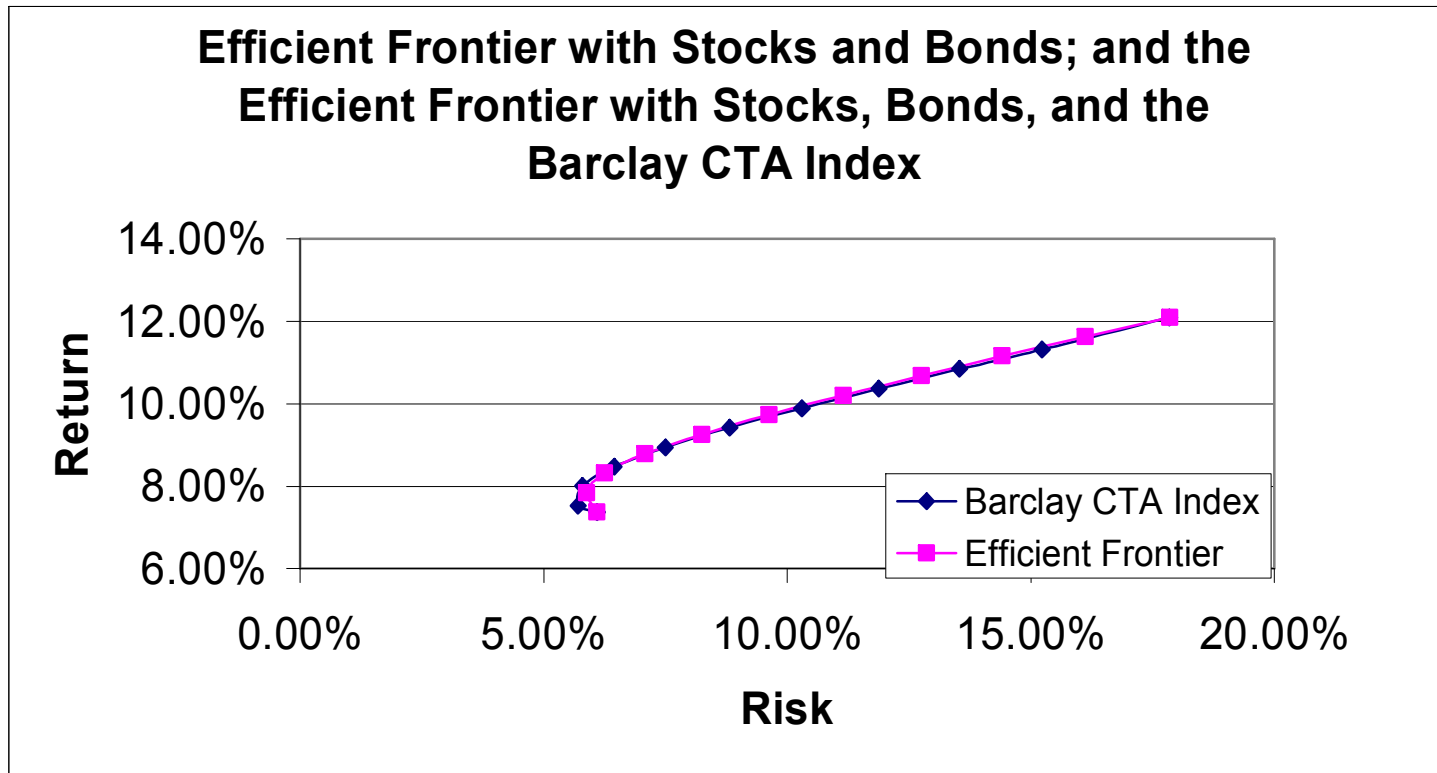
- Divide the task of the Investment Staff into two primary goals:
 - Implement Policy Risk as cost effectively as possible
 - Add value
- Divide the institutional portfolio into two sub-portfolios:
 - Beta Bets to establish the Policy Risk
 - Alpha Bets to generate added value.
- Alpha is a separate asset class from beta:
 - Find the most skillful managers regardless of asset class.
 - Form efficient portfolios of alpha and beta.

Expanding the Efficient Frontier with a Strategic Beta Driver



Notice that a strategic beta driver expands the efficient frontier.

Expanding the Efficient Frontier with a Tactical Alpha Driver



Notice that tactical alpha drivers do not expand the efficient frontier.

The Old vs. the New

- The Old business model: Beta trumps Alpha.
 - Pension funds first make the strategic allocation to broad asset classes.
 - Then Staff is directed to squeeze alpha out of its strategic (efficient) benchmarks.
 - As a consequence, alpha risk budgets are typically spent in the most efficient markets, like our large cap equity friend.
- A new business model: Alpha is sought independently of beta:
 - Alpha should not be captive to beta.
 - Alpha risk budgets should be spent in the least efficient markets:
 - High Yield, Distressed Debt, Private Equity, Small Cap, Emerging Markets, Absolute Return, Real Estate, Corporate Governance.
 - These sub asset classes have the highest alpha content.

The Investment Business Model for Institutional Investors

- **Institutional investors are increasingly dividing their portfolios into alpha and beta building blocks.**
 - This allows them to target specific risk and return characteristics.
 - In the past there was a one-dimensional allocation process—managers were handed pieces of the asset allocation with both beta and alpha combined.
 - The asset allocation process will become two-dimensional—alpha managers will be an overlay to beta managers.
- **This means that asset class lines will become less important.**
 - Investment mandates will be driven more by risk and return attributes and less by asset categorizations.
 - Traditional benchmark constraints—such as no shorting—will erode.
 - In fact, there will be a convergence between alpha drivers on the one hand such as hedge funds looking for more capacity in net long mandates, and traditional asset managers on the other hand moving into the shorting space.

What will happen on the Retail Side?

- For the past 25 years, the retail investment model was all about savings/wealth accumulation.
 - Under this investment model, *market risk* was the primary risk.
 - But with aging Baby Boomers, new risks will dominate:
 - Longevity Risk
 - Inflation Risk/Principal Protection Risk
 - Healthcare cost risk
 - New products will be defined less by their investment style (e.g. large vs. small cap, style vs. growth) **and more by outcomes.**
 - For example, an inflation hedging product could contain commodities, real estate, and TIPS.
 - What is the implication for the retail market? **Asset Class lines will become less important**--the same conclusion as for Institutional Investors.

Recommendations

- Know your clients' benchmarks.
 - Knocking on a client's door without a knowledge of its benchmark is largely hit or miss—who knows, you might get lucky.
- Investment management business models should not be based on **“spaghetti thrown on the wall.”**
- Investment Companies should re-package their investment products into two broad product streams:
 - Cost effective beta drivers that help to implement strategic asset allocations in an efficient manner.
 - High content alpha drivers designed to outperform the strategic benchmarks.
- Do not offer high cost beta drivers disguised as alpha drivers.
 - We're catching on to this.

Parting Suggestions

- Remove asset class boundaries for Alpha Generation
 - Look in between the “benchmark boxes” for new product development.
 - Market partitioning is a great place to look for alpha generation.
 - Optimize alpha the same as you would beta.
- De-Emphasize organization structure along asset lines.
 - Most institutional investors and product providers build their investment teams along asset class lines.
 - Define your business model to reflect the separation of performance drivers.
- Looking forward, asset class lines will become less important—risk and return outcomes will drive product development.

Finally: What is your Competitive Advantage?

- For Investors: Spend your alpha budget where you have the greatest informational edge.
 - Example: UTIMCO has significant investments in Oil & Gas while Hermes has a successful Corporate Governance Program
- Be honest:
 - As markets become more efficient investors will begin to recognize they lack a competitive edge that can be translated into value.
 - If you have no competitive edge, cost control becomes the most important value added tool.
 - Focus on reducing costs through indexation.
 - Same applies for institutional money managers: If you have no informational advantage, then use economies of scale to offer cheap indexation.