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ISSUE

A look at alpha and beta decisions in investment strategies.

MEASURING UP

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The Pursuit of Alpha

The prospect of a “low-return” environment is fueling a renaissance in the field of investment management as investors search for additional sources of return.

A basic portfolio consisting of only stocks and bonds may be moving toward obsolescence as institutions begin to mimic the industry’s thought leaders from Wall Street to academia. Alternative asset classes such as hedge funds and private equity are becoming more commonplace as investors strive to improve the efficiency of their portfolios as well as expand the investment opportunity set. Once taboo topics such as short sales, leverage, and derivatives are being revisited as investors strive to increase their alpha opportunity. Portfolio strategy is evolving, placing greater emphasis on isolating the alpha and beta decisions.

For many, the concepts of alpha and beta might seem foreign. While more technical definitions certainly exist, we will try to simplify the discussion. Essentially, beta can be described as market exposure. Beta returns represent compensation to investors for assuming market risks such as large cap stocks (S&P 500 Index) and fixed income (Lehman Brothers Aggregate Index). When an investor’s return exceeds the market return (beta), without incurring additional market risk, the result is alpha. For example, suppose a large cap manager earns a return of 12% versus 10% for the S&P 500 Index. The S&P return of 10% represents the beta return, the remaining 2% is alpha.

A variety of innovative strategies designed to target alpha more directly have garnered significant interest from institutional investors. Strategies such as unconstrained equity, long-short extension, and portable alpha have all gained significant momentum. One downside of such innovation is the dearth of empirical data necessary to assess potential returns relative to the risks of such strategies. Given that many new products have limited track records, significant judgment is necessary as we endeavor to construct more advanced portfolios. In order to facilitate sound judgment, investors and fiduciaries should begin with the fundamentals of financial theory.

The Importance of Beta

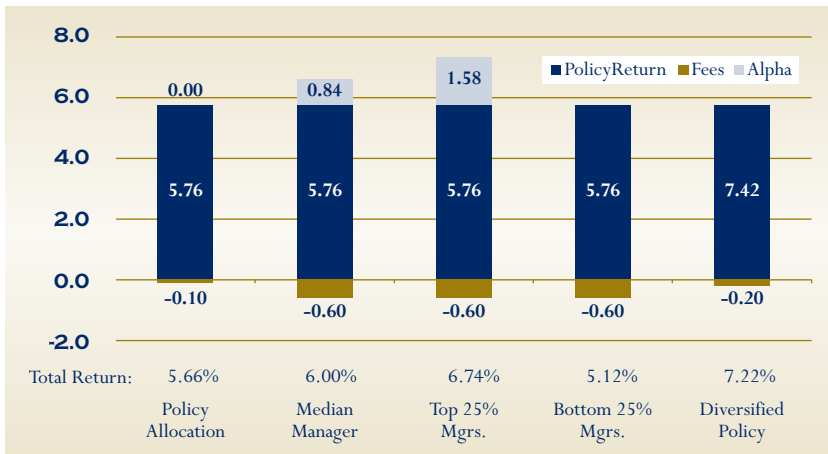
“From my perspective, investment managers have relegated beta to the dustbin of finance. Alpha, they seem to think, is the only good. This is not a healthy development.”

Brian D. Singer, CFA (UBS Global Asset Management)¹

It is important for investors to appreciate beta. As previously mentioned, beta returns represent the systematic compensation to investors for assuming market risk. Such returns can easily be obtained at minimal expense through index funds. More importantly, beta returns represent the primary building block in asset allocation work. Investors

¹ Brian D. Singer, *Risk Capital Allocation: Beyond Traditional Asset Allocation Approaches*, UBS Global Asset Management, 2006, 1-12.

FIGURE ONE
Contribution to Total Return - Dec. 2001 through Dec. 2006



seek to maximize their expected return for a given level of risk by combining multiple beta exposures with low correlations. This objective represents the foundation of modern portfolio theory and drives the investment philosophy of Gianni Partners.

Figure One illustrates the importance of beta within the context of the total portfolio's expected return. Assume an investor determined in December of 2001 that a portfolio of 60% stocks and 40% bonds would meet its long term risk and return objectives. The investor could easily obtain beta/market returns utilizing index funds for the stock and bond allocations at modest expense (we assume 0.10%). Alternatively, the investor could utilize active managers in an effort to obtain returns in excess of the passive beta portfolio, albeit at greater expense (we assume 0.60%).

Figure One highlights each portfolio's return attribution, taking into consideration the policy allocation (beta exposures), alpha experience, and investment fees. Even if the investor had the good fortune of selecting top quartile managers in each universe, beta's contribution to return is approximately 84%. Furthermore, had the investor broadened its asset allocation to a more diversified policy that included small cap and international

equity exposures, the pure beta return would have been 7.2% versus 5.7%. The diversified policy, absent the benefit of superior active management (alpha), outperformed both the passive and the top quartile portfolios.

This example is consistent with most academic studies, including the well known "Brinson Study" which concluded that over 90% of returns are derived from the portfolio's asset allocation². While some individuals within the investment community advance the pursuit of alpha, investors should fall back on the fundamentals and surmise that the asset allocation should be the priority of any portfolio strategy. In other words, the markets in which clients invest will provide the bulk of the returns.

The Alpha Endeavor

Now that the importance of beta has been established, we turn to the pursuit of alpha. Some investors might exhibit a greater capacity to bear risk and remain concerned by the modest returns currently being forecast for the capital markets. They are then likely to pursue additional returns in the form of alpha. Investors choosing this path must understand the potential risks of such an endeavor along with its potential rewards.

In contrast to beta returns which result from assuming market risk and can be obtained at minimal expense, alpha returns ultimately require skill and are inherently more expensive. In order to obtain alpha, an investor must consistently possess an information advantage relative to the broad market. Ultimately, alpha is considered to be a zero sum game in which 50% of alpha seekers succeed and 50% fail. This is before costs are factored into the equation. Realizing the task at hand, investors must then pursue alpha in a more strategic manner.

Market efficiency and costs represent natural impediments to alpha. Many financial theorists contend that a competitive marketplace of profit

² Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, *Determinants of Portfolio Performance*, Financial Analysts Journal, July-August, 1986, 39-44.

seeking investors is likely to compete away any consistent source of alpha. It is widely accepted that the more efficient the market, the more difficult it is to obtain alpha. Large cap core equity represents a more efficient marketplace compared to international equity markets. **Figure Two** below displays a distinct advantage for active management in the less efficient international markets. The median large cap core manager has lagged on average 1.8% annually, relative to its S&P 500 Index benchmark from 1993-2006. The median international equity manager has outperformed by 1.2% from 1993-2006.

Active management’s detractors also point to agency considerations, along with market efficiency, that have impacted the alpha track record of most managers. In his book *Pioneering Portfolio Management*³, David Swensen, Chief Investment Officer of Yale University, provides examples of such agency considerations. Swensen argues that asset based fees encourage managers to target asset growth. Such asset growth can impair a manager’s ability to trade in specific markets, thereby reducing the alpha opportunity. Further, as a manager develops a strong track record which tends to attract significant assets, the manager protects his or her track record in order to retain clients. Successful asset gatherers might equate active risk with business risk. In order to minimize business risk, the managers bring their portfolios more in line with the benchmark earning the moniker “closet-indexers.”

Finally, some portfolio constraints represent artificial impediments to the alpha endeavor. Investors and fiduciaries rely on such constraints in their investment policy documents as a passive form of risk management. Typical constraints include: portfolio construction constraints (maximum position size, number of holdings, sector/industry limitations, and investment style), the long only constraint (which prohibits short sales of securities), and the prohibition of the use of derivatives and

leverage. Investment managers would argue that some constraints impact their ability to truly differentiate their strategy from the index which is necessary to achieve alpha. The challenge then for investors is to balance the tension between portfolio control and the pursuit of alpha.

Alpha’s proponents argue that market inefficiencies do in fact exist and that inefficiencies can be exploited by skilled investors capable of obtaining insight not reflected in the market’s price. Active managers also counter that beta returns have historically been unreliable as evidenced by significant periods of negative performance. There have been a variety of anomalies, such as the value premium, that suggest possible inefficiencies within the marketplace. Empirical research provides some evidence that a small minority of managers have consistently obtained alpha, although there is no evidence that past outperformance leads to outperformance in the future.

FIGURE TWO
Historical Performance Relative to Index

UNIVERSE (1993-2006)					
	95th	75th	50th	25th	5th
LARGE CAP CORE	-12.0%	-6.0%	-1.8%	2.6%	8.3%
CORE INTERNATIONAL	-7.5%	-2.6%	1.2%	5.7%	12.3%

The Pursuit of Higher Returns

As we endeavor to improve a portfolio’s return prospects, it is important to recognize that the primary driver of performance will be the asset allocation. Leading institutions have long recognized the benefits of alternative investments including private equity, commodities, real estate, and hedge funds. Investors can improve the risk versus return profile of their portfolios by incorporating unique and uncorrelated beta exposures into the asset allocation.

³ David Swensen, *Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment*, Free Press, A Division of Simon & Schuster, Inc., 2000.

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Once the beta exposures have been established, we can then target alpha in a more discrete manner. As mentioned earlier, market efficiency represents a natural impediment to the alpha pursuit. By investing actively in less efficient segments of the capital markets such as international equity, an investor could increase the portfolio's alpha potential.

Through the manager due diligence and selection process, Yanni Partners can address potentially detrimental agency considerations by focusing on attributes that could maximize the alpha opportunity. Such attributes include a unique investment philosophy and process, an incentivized and experienced investment team, and an alignment of interests with investors that is focused on investment performance as opposed to asset gathering and retention.

In an effort to provide more tailored solutions to our client base, we have identified a "continuum" of options in the pursuit of alpha. Each step on the continuum progressively removes constraints that have historically served as impediments to the

pursuit of alpha. The continuum begins in the long only realm, removing typical portfolio construction constraints in an effort to provide managers with a greater opportunity to identify alpha opportunities across the global markets. Moving further along the spectrum, the investor can begin to incorporate short sales, affording managers the ability to more effectively capitalize on their negative information pertaining to stocks (long-short extension strategies and equity biased hedge funds of funds). Finally, investors can completely segregate the alpha and beta decision, utilizing derivatives to obtain beta cheaply and transport the capital to segments of the capital markets which may be more conducive to finding alpha (portable alpha).

By fostering a better understanding of the full spectrum of opportunities along with the accompanying risks, Yanni Partners strives to help its clients develop a more targeted approach in the pursuit of higher returns.



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Yanni Partners, Inc. provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

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