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What's the source of portfolio alpha? Behavioral risk is a key part of the answer

Key Points:

- *Alpha (returns that deviate from the "market") are a zero-sum game*
- *Positive alpha is financed by negative alpha*
- *The ability to generate positive alpha through time is closely linked to managing behavioral risk*

Nobel-prize winner Professor Bill Sharpe famously advised that alpha (returns that deviate from the "market" or a benchmark) sum to zero. For every investor who beats the market, the positive alpha is financed by negative alpha that accrues for another investor.

There are several implications, starting with what is perhaps the key insight: "Properly measured, the average actively managed dollar must underperform the average passively managed dollar, net of costs," Sharpe wrote in "The Arithmetic of Active Management."

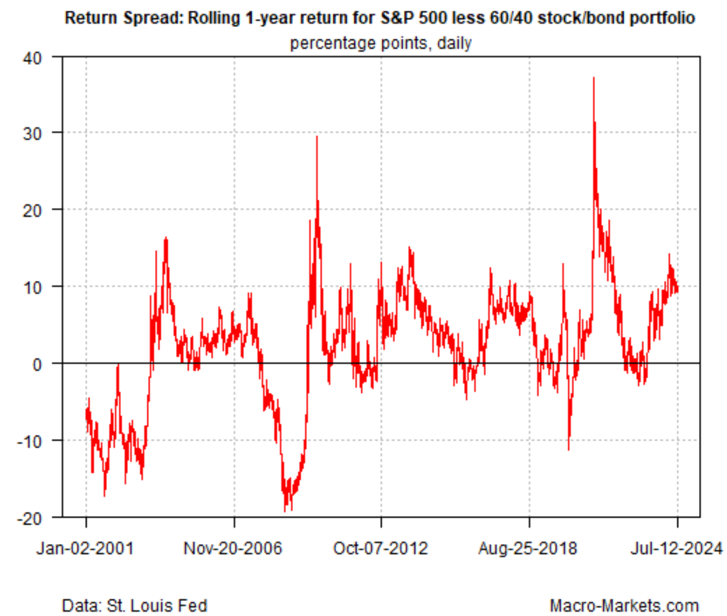
His perspective may not be terribly surprising for those who know his biography. Sharpe, after all, is a founding father of modern portfolio management. Among his many contributions to the rise of modern finance is his development of the capital asset pricing model (CAPM), a pivotal building block that laid the foundation for indexing and the power of beta, a.k.a. the "market" portfolio.

Alpha exists, of course, although consistently generating it by beating the market is challenging, to say the least. There are several reasons, including a particular form of behavioral risk that plays a key role in explaining why earning positive alpha through, say, asset allocation tends to be the exception rather than rule on a global basis.

Investigating why is the first step to possibly overcoming this headwind. Consider a simple 60/40 portfolio of US stocks and bonds that's routinely rebalanced to target weights at the end of each calendar year. In this toy illustration, this portfolio represents beta – the "market". As a practical matter, every hypothetical investor can easily and inexpensively capture this beta without forecasts, analytics or any other skill set. Rather, the only requirement is to buy and hold a 60/40 portfolio and reset the weights every Dec. 31.

For investors intent on generating positive alpha *relative* to the 60/40 beta, there are countless possibilities. Let's consider one simple variation: buying and holding the equity component of the 60/40 beta portfolio that's constructed with a pair of Vanguard index mutual fund proxies (VFINX for stocks and VBMFX and for bonds). The alpha strategy is simply holding VFINX, which tracks the S&P 500 Index. The logic here is that stocks tend to outperform bonds through time and so it's reasonable to forecast the historical record on this front will continue.

The spread between these two strategies is shown in the chart below – when the red line is above zero, the buy-and-hold stocks portfolio is outperforming the 60/40 portfolio, and vice versa. Not surprisingly, the buy-and-hold equities portfolio outperforms the 60/40 strategy most of the time. But it's crucial to note that there are periodic episodes when a stocks-only strategy dramatically underperforms (red line falls below zero). It is during the latter events when behavioral risk tends to spike.



Why does it spike? There's a finite amount of positive alpha, and supply waxes and wanes for given periods, sometimes dramatically. The sudden dearth of positive alpha's supply at times influences short-term investing decisions. The main result: some (most) investors are unable or unwilling to stand pat while their equity investments are losing money. The longer the slide, the greater the behavioral risk of selling. A portion of professionals may be more likely to resist the temptation, but managing this strain of behavioral risk is the exception rather than the rule overall.

Therein lies opportunity for a minority of investors with a longer time frame and/or a relatively robust tactical asset allocation strategy. The self-inflicted losses that prevail when many/most investors sell at or near stock market bottoms (or buy at/near market tops) provide the source for earning positive alpha by a relative few. Indeed, investors intent on earning positive alpha necessarily rely on the mismanagement of behavioral risk by the majority of investors.

Perhaps the most persuasive real-world example is the track record of uber-investor Warren Buffett via Berkshire Hathaway. His spectacular results over the decades are a byproduct of countless losing investment strategies -- investors selling shares at/near market bottoms.

The implication: a key factor for generating positive alpha through time requires a degree of contrarian-based investing rules. But for the overwhelming majority of investors, deviating from the crowd is behaviorally difficult. Therein lies the opportunity for a minority of investors to mine alpha to their advantage.

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