The Hierarchy of Alpha

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"Skeptical scrutiny is the means, in both science and religion, by which deep thoughts can be winnowed from deep nonsense." - Carl Sagan

Hedge funds and private equity funds have had their share of detractors over the last few years, with many institutional investors questioning whether the returns they have generated justify the significantly higher fees paid. Certainly, on a relative performance basis, a large number of these funds have had a tough time keeping up with long-only equities. Since January of 2009, the S&P 500 total return index has nearly tripled, generating annualized returns around 18%. No one should expect alternatives to match this blistering pace over any time period.

There is also no debate that alternatives have become a much more competitive sector. Hedge funds and private equity funds alike now boast 8,000 to 10,000 active funds managing $3 to $3.5 trillion dollars respectively, each roughly doubling in size since 2006 as institutional investors have piled into the space en masse. Such growth simply cannot come without both lower quality entrants attracted to the business opportunity and the inexorable erosion of returns from larger quantities of capital chasing the same alpha strategies. Perhaps then institutional investors should not be surprised to see the return of median managers lower than in the past.

Certainly, negotiating lower fees is one way to mitigate the effect of a falling median, but successfully building a portfolio of hedge funds or private equity funds today requires more than this. For those investors continuing to pursue such strategies, success as always is likely to revolve around selection of top quartile managers. However, given the dynamics described above, the elusive search for alpha has become harder, as the costs associated with being average have gone up along with the resources needed to scour an increasingly large universe of managers. In effect, the needle has gotten smaller and the haystack has gotten bigger.

While some institutional investors have responded to these challenges by simply winding down their allocations to hedge funds and private equity funds altogether, it appears the far larger majority have not. Hedge funds continue to attract positive flows month after month, and nearly 2,000 private equity products are currently in active fund raising, according to Preqin.

Demand remains strong for these return streams, but investors continuing the search for alpha often face heightened skepticism around both the presence of true alpha and an allocator's ability to identify it. Of utmost importance here is the realization that not all alpha is created equal. The concept of a clean, binary separation between alpha and beta, although intuitively appealing, is far too simple a paradigm for the complex realities of active investing. Like many purely mathematical approaches, it fails to capture the areas of gray. Alpha to beta is a spectrum, and often what once was the former eventually becomes the latter.

This skeptical scrutiny around the presence of what I'll call "true alpha" seeks a better framework for the classification of investment skill. This classification mechanism should not only describe the nature and source of the return stream, identifying the manager's ability to access this return and the probability of it continuing in the future. But even more importantly, the framework should present investment skill as a spectrum. The endpoints of the spectrum merely provide the beginning of the analysis, not the end.

I propose such a framework below.

The rarest investment skill is that which is structured with no known correlations to other returns. Such a skill would be difficult to find, and highly expensive if one could identify it. Few managers could offer truly competing products. On the other hand, the most common return stream would be one that was highly price competitive, with thousands of managers providing nearly identical products. Still investment skill, but clearly far less valuable.

Fortunately, the argument for hedge funds or private equity does not rest on the head of a pin, or the top of a pyramid as it were. Instead, most managers in these sectors are structuring return streams that fall somewhere in between. Understanding the skill required to generate these returns is critical to manager selection.

True alpha is generally what most market participants mean when they are referring to "alpha." This is superior skill, or outperformance resulting solely from the active selection of securities that differ from the market. This kind of alpha is truly beating the market, or outsmarting the competition, without embedded style tilts. For instance, stock pickers who do not take value, dividend, growth, capitalization, or sector bets, but still generate excess returns are generating true alpha. This form of alpha, the purest form, is also the rarest. Managers that generate sustainable, repeatable true alpha are few and far between, likely only a handful at any given time. True alpha is harder to underwrite with confidence, precisely because it so rare. A much larger sample set is required to ensure that what appears to be alpha is not merely a misidentified beta or, worse, mere luck.

Manufactured alpha can also be thought of as value creation. Security selection, although not unimportant, is not the main driver of excess return in this category. Unlike pure passive

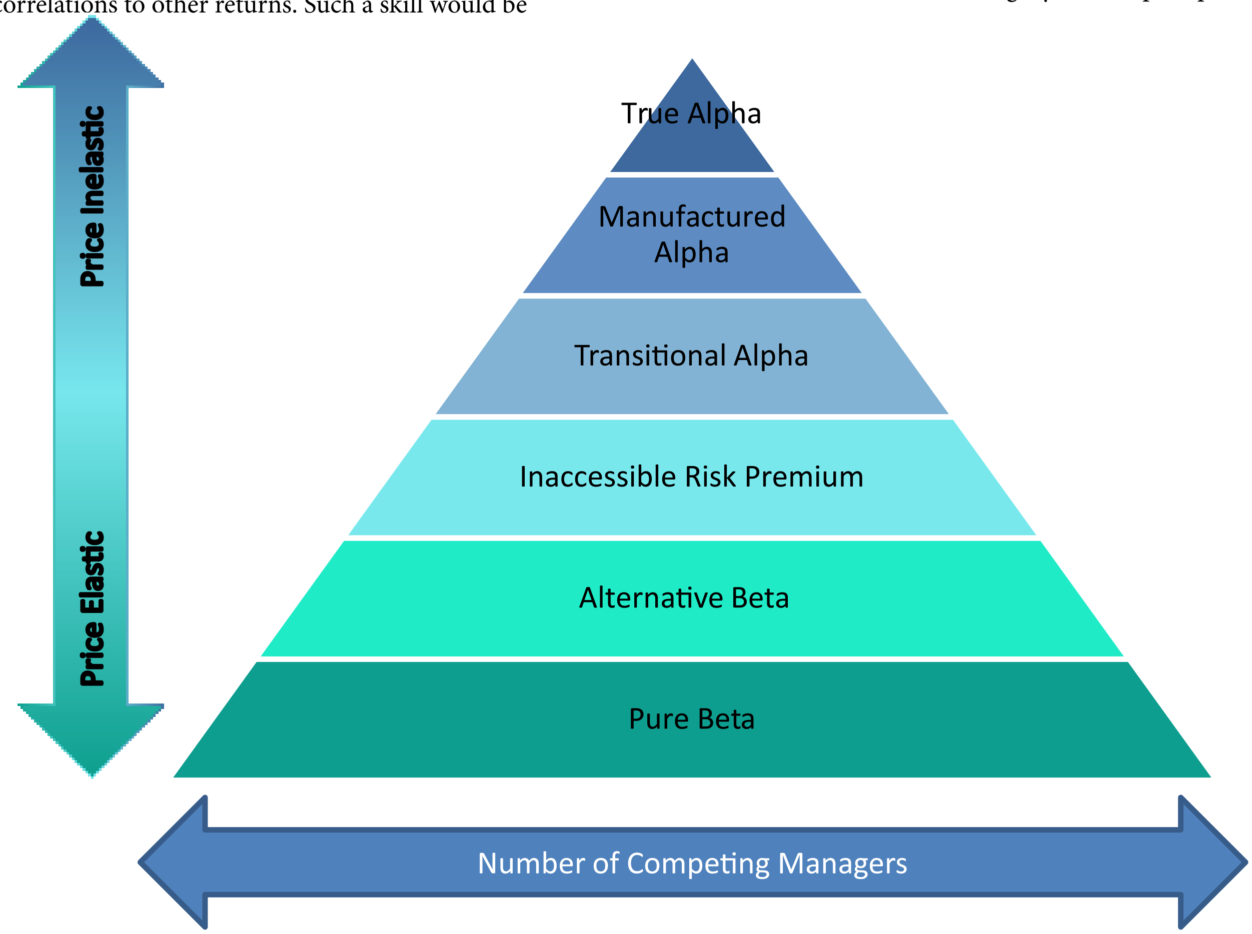


Exhibit 1 Hierarchy of Investment Skill

investment, manufactured alpha requires an investor to initiate an investment with a view to impart structural changes or operational improvements that will unlock or actually create value and then ultimately execute on that vision. This usually involves repositioning the asset for resale to another buyer with a different cost of capital, similar to transitional alpha, as we'll see below, but only after some actual value enhancement from the asset owner. For example, Re-REMICS, shareholder activism, mortgage servicing rights and re-performing loans, private equity turnarounds, and value added real estate are examples of this category of alpha generation. Given the operational, process-oriented nature of these strategies, managers who have executed successfully on them in past tend to demonstrate strong persistence of performance in the future.

Transitional alpha is the excess return that can be generated from short-term changes or specific temporal market inefficiencies. Often times, these inefficiencies result from regulatory changes, for example Basel III and the Volcker Rule, or other socio-political events which alter previous market dynamics. Other times, economic changes or even technological shifts can change the cost of capital or utility functions of market participants, which impacts their ability to transact in a given marketplace. Even other times, such transitional alpha can simply occur from shifting levels of risk aversion or changing investment fads. Think of these situations as events where typical, natural holders of a given security are structurally prohibited from transacting as easily as in the past. Several examples of these opportunities include regulatory capital relief trades, spin-offs or post-reorg equities, niche direct origination strategies where traditional lenders have exited, or even to a certain extent simply downgraded high yield bonds. In such situations, somewhat shorter term, ephemeral circumstances cause forced selling from current holders and/or remove natural buyers from the supply-demand equation. In short, transitional alpha can be generated from holding certain assets until such time as natural buyers can come back into the equation and prices normalize. One may consider this a form of alpha, as the temporary nature of the inefficiency requires active, sometimes rapid, analysis and execution in order to capture the opportunity. Often, it is difficult for an end allocator to assess the opportunity set before it is gone, making a manager's ability to identify and shift from one transitional investment to another key.

An inaccessible risk premium may not be alpha in the truest sense of the word, but this category logically sits between transitional alpha and alternative beta. Similar to transitional alpha, an inaccessible risk premium can exist where structural forces prevent many market participants from investing in specific investment segments. However, unlike the short-term, temporary nature of transitional alpha, an inaccessible risk premium is quasi-permanent in nature. For example, safe harbor exemptions to the 1940 Investment Company Act effectively preclude private investment companies from accepting retail investors. Sometimes, investors are unable to allocate to illiquid investments due to short-term cash flow needs or investment minimums. Retail investors simply cannot invest $5,000 directly in a privately negotiated commercial mortgage. In other circumstances, certain investors are prohibited from using derivatives or have significantly higher costs of leverage than other market participants due to suitability requirements or exchange rules. Some investors, such as some state pensions, are actually precluded by law from using leverage at all. As mentioned, these type of structural constraints tend to be long-term in nature and widely known. Not much analysis or timely response is needed to interpret and asses their affects. However, these inaccessible risk premiums have barriers to entry that require some active management in order to access, making them, if perhaps not actual alpha, something other than a simple beta. Given the structural nature of the opportunity, these investments tend to be somewhat easier to underwrite with confidence.

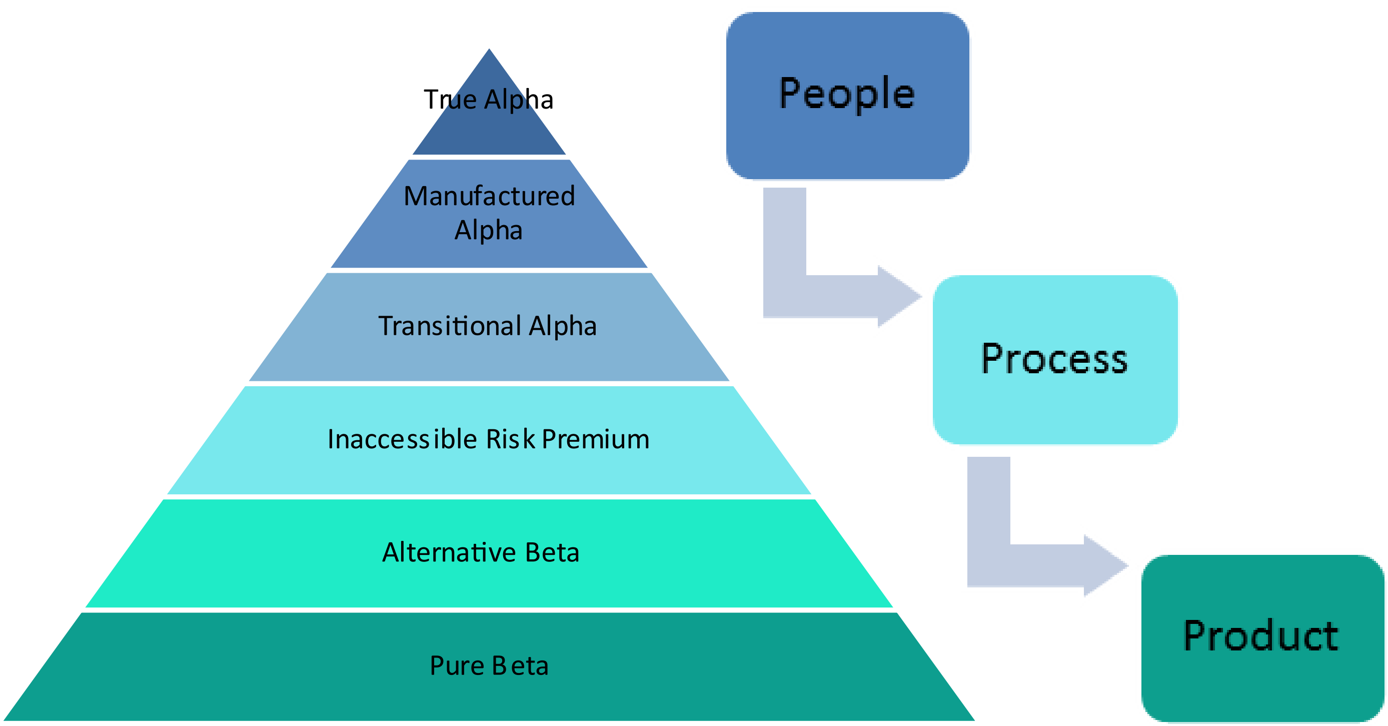


Exhibit 2 Evolution of Investment Skill

An alternative beta is axiomatically no longer alpha, nor is it however a pure beta. Alternative betas are investment opportunities that at one point may have been one of the above categories of alpha, but have become more accessible and more broadly understood. Often these opportunities have liquid, registered products which allow access to a much wider array of potential investors. Such products create relatively low fee, low minimum, investable and benchmark-able return streams similar to pure betas. Unlike pure betas, alternative betas are less widely researched, less widely championed, and subsequently less widely adopted in investor portfolios. Examples of alternative betas could be catastrophe bonds, merger arbitrage mutual funds, long only commodities, currency carry ETFs, and mechanical trend following products. These return streams simply have shorter track records and fewer adherents, at least for the time being, than do the completely ubiquitous pure betas.

Finally, pure betas are quite simply basic asset class exposures that have been around for a long time. Pure betas have decades of price history and extensive research that is widely available. These betas are broadly, perhaps universally, accepted as the basic building blocks of portfolios. Pure betas are usually offered via thousands of competing low-fee products, as opposed to sometimes just a few, as is the case for many alternative betas. Pure betas are available to investors of any experience level or asset size. In short, pure betas are entirely commoditized return streams.

It's worth mentioning that these categories of investment skill are themselves spectrums rather than discrete individual classes. Fundamental indices and smart beta products fit neatly in this hierarchy, although it's debatable whether they fall more towards the alternative beta or pure beta side. The point is, such strategies take advantage of factors that are widely known, quite commonly employed and offered across numerous similar, if not identical, easily accessible competing products.

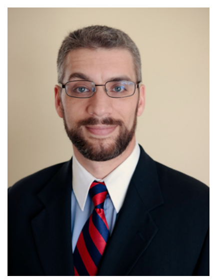
This framework of investment skill can also provide insight into prioritization of due diligence efforts for manager selection professionals. For example, investment opportunities that fall nearer to the top of the spectrum require more attention on the skills, abilities, and experience of the people making risk decisions. As the strategy becomes more institutional and more widely adopted, due diligence efforts should focus on the investment process itself, such as how ideas are generated and technical aspects of portfolio construction. Finally, once a strategy gains even more adherents, commoditized factors such as fees are increasingly relevant.

Interestingly, this parallels the migration or evolution of investment skill from alpha to beta. A select few individuals adept at pattern recognition are able access an investment strategy initially. The process becomes systematized, institutionalized, and others internally and externally begin to learn the strategy and are able to replicate it. As other market participants implement it and often academics write about it, the strategy eventually becomes more widely implemented and ultimately turns to beta, whereby relative performance and costs are dominant considerations when hiring a manager.

In order to underwrite some expected level of alpha for an investment in a hedge fund, private equity fund, or any investment product, an allocator must truly understand the source, scope, and nature of that alpha, or more fundamentally, whether or not it is truly alpha. Historical performance analysis plays a role in this, but like any analysis of data, the best it can do is merely provide evidence of a relationship. A comprehensive qualitative framework that focuses the process on determining exactly why and how a manager generated past excess returns is helpful in establishing a descriptive, theoretical foundation for why that relationship may have existed. Only then can an investor turn to what the competitive dynamic in that particular market currently is, what might be reasonable expectations for future returns, and finally accurately price those return streams.

A heaping dose of skeptical scrutiny, a scientific approach to evaluation, and a clear theoretical framework can be helpful towards the task of winnowing true alpha from the deep nonsense of short- term performance noise, luck, and the never-ending pitches of high-energy salesmen.

Author's Bio



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Christopher is currently the Director of Private Equity at the $24 billion Texas Municipal Retirement System. In this role, Mr. Schelling is responsible for all aspects of building out the system's private equity portfolio. Previously, Mr. Schelling was the Deputy CIO and Director of Absolute Return for Kentucky Retirement Systems where he implemented the plan's first direct allocations to hedge funds and real asset funds. Mr. Schelling was also an Adjunct Professor at the Gatton School of Business at the University of Kentucky, lecturing on Alternative Investments. Prior to joining KRS in 2011, he was a Senior Associate at Mercer Investment Consulting on the manager research team performing due diligence across hedge fund strategies. Previously, he served in a number of front and middle office roles spanning traditional and alternative investments at firms such as ThomsonReuters, Bear Stearns, and Calamos Investments.

In addition to being a member of the CAIA Association, Mr. Schelling has also served on the association's Due Diligence and Regulation Curriculum Committee and the Exam Council. He received an MBA from the University of Illinois-Chicago and a Masters Degree in Financial Markets from the Illinois Institute of Technology. He holds a Bachelor's Degree in Psychology from the University of Illinois as well. Mr. Schelling was named one of Money Management Intelligence's 2012 Rising Stars of Public Funds, and a Rising Star of Hedge Funds by Institutional Investor in 2014.