The Journal of Portfolio Management

The Great Alpha Tree

Peter L. Bernstein

When I learned investment theory, and the capital asset pricing model in particular, alpha was an extremely scarce commodity. Alpha, they told me, was effectively zero for the market as a whole, earned beyond luck by only a tiny number of skilled portfolio managers who were by no means easy to identify in advance. The active search for alpha involved taking risks, risks that could not only incur absolute losses but—heaven forbid!—also result in a pattern of returns significantly different from what an index fund investor might achieve.

At best, because alpha is a small residual, you had to expect alpha to come and go in big swings from year to year. Earning alpha was next to impossible, but consistency in earning alpha was totally impossible. Careful performance calibrators would under all conditions have a hard time trying to determine whether measured alpha is genuine alpha or just a matter of good luck.

But that was a long time ago.

In today's world, alpha appears to be all over the place. It grows on trees, ripe for the picking. If you think I am kidding, take a look at the serious literature in our profession.

According to what I read just about everywhere, the important thing to understand about alpha today is not that it is difficult to earn or even to measure—but that it is portable.

This Journal is one of the great joys of my life, but four of eleven articles in the Winter 2004 issue were about alpha: alpha "drivers," managing portable alphas, managing multiple alpha sources, and, most tempting of all, "expected outperformance alpha." I could hardly wait to get to my computer and start picking stocks until I remembered that not one of these exemplary articles included even a passing comment about the difficulties and risks involved in earning alpha before you could drive it, port it, multiply it, or even expect it.

I recently read an imaginary conversation among members of an investment committee. The source of this story is an impeccable one. One participant in this conversation asserts, "We ought to be able to deploy our endowment so we can spend more than...."

Ought to be able? No *might* be able? No uncertainty? Has the market finally become an accommodating machine, ready to provide whatever we need for the asking?

At another point in this conversation, one member does express some degree of conservatism when he suggests, "I don't think your current policy portfolio is certain to get the job done moving forward." Certain? When is any policy portfolio *certain* to get the job done moving forward?

In the world of pension funds, endowment funds, and charitable foundations today, alternative investments are taking a growing share of the portfolio. One of these strategies is a search for a good absolute return rather than the more conventional strategy of seeking a return better than an appropriate benchmark would earn. Although I welcome that approach for many reasons, I am amused at the nomenclature some participating investors have bestowed upon it: a *pure* alpha play.

If removing a benchmark transforms the entire return into a pure alpha play, I urge everyone to remove all benchmarks, thereby turning the beta element of the CAPM into zero. Wouldn't life be beautiful if the total return were 100% alpha? Even better, we would also have turned the *e* term into zero. Then we would all look smart, even if we would not necessarily be rich.