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The Sound Investor Series #85

Alpha and Beta - Is It All Just Greek?

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February 7, 2007

Financial people often use terms or phrases that others may not understand. Occasionally these confusing terms are necessary, but sometimes they seem to be used just to show-off and baffle investors. When it comes to using the terms “alpha” & “beta,” it probably is a little bit of both.

Alpha and beta are the first two letters of the Greek alphabet and have been used for thousands of years as short-hand to describe various situations or phenomenon. Now they are appearing more and more often in the everyday financial press.

These terms can have many different meanings even within the financial industry. Gary Gastineau, a good friend and author of many excellent financial books, including the “Dictionary of Financial Risk Management,” points out that in London, the largest and most actively traded stocks are called alpha stocks, while the next most active group are beta stocks. This progression of stock descriptions continues to gamma and finally delta stocks, which are not actively quoted.

The most common financial usage of “alpha” and one common use of “beta” allow investors to separate a portfolio’s return into two components. Alpha describes what part of the return is due to choosing the right investments within an asset class while beta expresses the proportion of the return that is due to the movement of the entire asset class.

Although no math is necessary to understand these concepts, readers familiar with regression analysis will recognize beta as the return that can be explained by the market and alpha as the residual return. The concept of using alpha and beta are the first steps of attribution analysis when looking for the sources of a portfolio’s return. Alpha is the return attributed to an investor’s skill and beta is the return that can be attributed to the underlying asset (i.e. stocks).

To illustrate these terms, let’s look at an example where the whole stock market was up 15 percent last year and your portfolio of stocks was up 20 percent. When analyzing the source of your investment return, one could say that 3/4 of the return came from the change in the whole market (15 percent) – and this is called the beta. The other 1/4 (5 percent) was alpha and was earned as a result of your superior investment skills.

A critical concept is that little or no skill was required to earn “beta.” That return was available to every person who invested in an index tracking mutual fund or Exchange-Traded Fund (ETF). Everyone who had full exposure to the entire asset class (stocks) earned this return.

“Alpha” on the other hand is all about a person’s investment skill. In this example with your portfolio up 20 percent, your alpha was a positive 5 percentage points. The alpha could have been generated by any number or combination of different investment techniques. For example, maybe you were good at market timing and sold out in early May and bought it back in July. Another possibility might be that you generated alpha by owning the best performing stocks and avoided stocks that underperformed the market. As you can see a more in-depth analysis is required to determine the sources of alpha.

The \$10 billion mutual fund industry is built on trying to deliver “positive alpha” to investors, but unfortunately it often fails since it is extremely difficult to generate positive alpha over the long term. The result is that most funds produce negative alpha which eats into an investor’s market, or “beta” return.

That is why advisers like me recommend investors just forget about “alpha.” We would love to find positive alpha, but are more concerned about avoiding negative alpha. To earn the returns the market has historically generated, investors need to concentrate on making sure they capture the full beta of the market.

In the past I have often discussed the importance of asset allocation and this is an investors most critical set of decisions. Within the context of today’s discussion, asset allocation could also be called beta allocation.

Drawing this discussion to a close, I want to acknowledge the other common financial use of the term beta. Beta, as Mr. Gastineau’s dictionary points out is “a measurement of stock price volatility relative to a broad market index. If a stock moves up and down twice as much as the market, it has a beta of 2. If it moves one-half as much as the market, its beta is 0.5.” Access to the dictionary is free at <http://www.amex.com/dictionary/>.

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