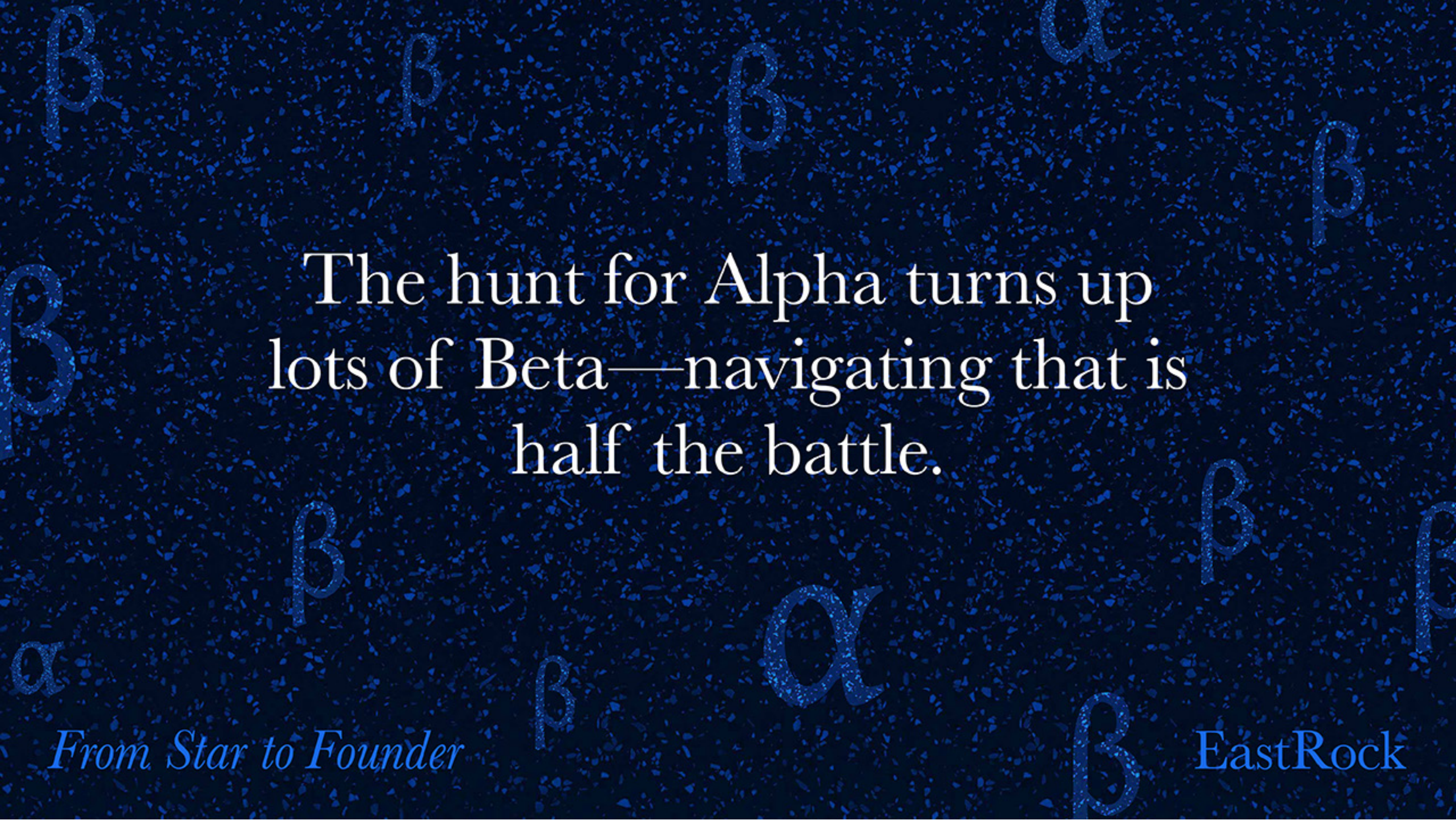

Alpha Is Rare. Here Are Five Places to Find It.

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April 11, 2024

WHERE YOU FIND GOLD, you are probably going to find copper. Where you find diamonds, you are probably going to find graphite. And where you find Alpha, you are probably going to find Beta.

If you are managing a large pool of assets, Beta is present in nearly everything you do.

Is this a problem?

So long as you manage Beta carefully, no. In fact, the better you navigate your "Beta budget," the more you can access rich pockets of Alpha that come with Beta inextricably attached.

[As a reminder, Alpha is the "abnormal" return of an investment—the portion of the return that is independent from market returns. Beta is the portion of the return that

correlates with market returns. More Alpha and less Beta helps us avoid losses in down markets.]

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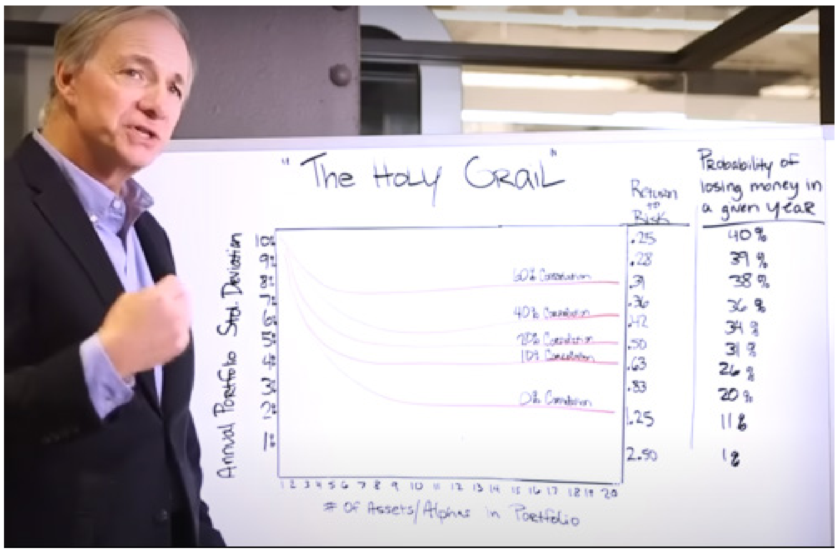
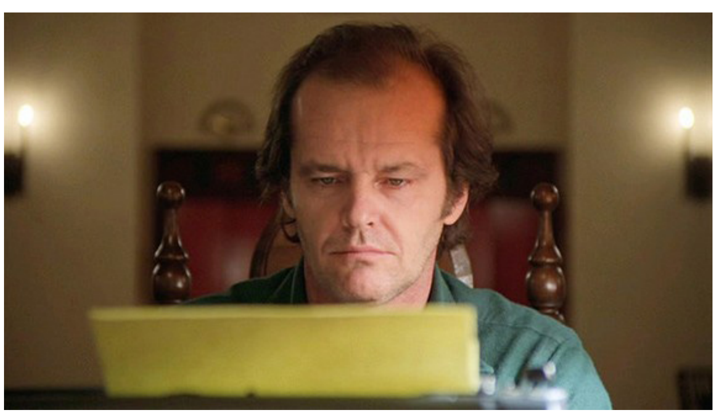
Often, we hear about the search for Alpha as the search for fully independent return streams. Ray Dalio calls this the “holy grail” of investing. [In this video](), he shows the benefits of finding 10-15 investments with nearly 0% correlation to each other (i.e. nearly zero Beta):



But this standard is not only unrealistically strict, it is actually self-defeating.

Why? Like diamonds and gold, Alpha is relatively scarce. If you confine yourself to only the “pure kind”— the kind that comes with no Beta— you’ll be severely limiting your opportunity set and likely constraining your returns to single digits.



All Alpha and No Beta Makes Jack a Dull Allocator

With a reasonable Beta budget - we tend to keep our family endowment portfolios in a 0.5 to 0.75 Beta range - as well as an illiquidity budget, a much wider world of Alpha becomes available.

As I explained in "A Meta Rule for Golf and Portfolios," the world's best university endowments allocate roughly 70% of their assets to private investments and absolute return strategies. By doing this, they accept illiquidity and a medium amount of market risk in exchange for high expected returns. Over long periods of time, elite endowment returns typically match or exceed market returns, with less risk and volatility.

In "Family Portfolios: A New Framework," I explained why families that can afford illiquidity should also follow this model. Why do we recommend only 30% in traditional liquid strategies? Mainly because we don't like using up our Beta budget on assets that don't produce Alpha.

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In the following table, I outline five types of Alpha, most of which naturally co-exist with Beta:

Five Types of Beta

Type	Description	Associated Beta	Examples
1. Pure Alpha	The underlying company, asset, or "bet" is independent from all other factors	Nearly zero	▪ Merger Arb ▪ Catastrophe Bonds ▪ Life Settlements ▪ Timberland ▪ Litigation Finance
2. Purchase Discounts	Accretion from discounted purchase price to fair value is a non-correlated return stream	Matches the underlying company or asset	▪ Real Estate Acquired Via Foreclosure ▪ Spinoffs ▪ Debt-for-Control Distressed
3. Value-Added Strategies	Successful transfor-mation of a company or asset that results in a non-correlated increase in value	Matches the underlying company or asset	▪ Downsizing Business to Correct Size ▪ Rollups with Synergies and Economies of Scale ▪ Public Market Activism
4. Structured Investing	Securities that trade away the full upside of common equity in exchange for downside protection can result in less correlated outcomes	Less than the issuer's equity	▪ Convertible Loans ▪ Trade Claims
5. Hedge Fund Allocations	Portfolios run by proven managers known to generally avoid beta	Zero to moderate	▪ Long-Short Equity ▪ High Frequency and Algorithmic Strategies

The nice thing about Pure Alpha (Type 1) is that it provides complete insulation from market risk. Unfortunately, Pure Alpha represents a fairly small subset of the investing universe—and much of that subset is susceptible to three significant limitations:

- **Modest returns.** Let's say we are shooting to replicate David Swensen's 36-year track record of 13.7% per annum (And why not?). In that case, we want our liquid investments to produce 8-12% returns and our illiquid investments to produce 15-25%+ returns. In contrast, here are representative past returns of some typical Pure Alpha strategies:

Long-Term Returns of Pure Alpha Strategies

Strategy	Liquid / Illiquid	20-Year Annual Returns	Source
Merger Arbitrage	Liquid	3.6%	S&P Merger Arb Index
Catastrophe Bonds	Liquid	7.0%	Swiss Re Global Cat Bond Total Return Index
Life Settlements	Illiquid	8.0%*	Journal of Risk & Insurance
Timberland	Illiquid	5.5%	NCREIF Timberland Index via Bloomberg

** 16 Years Ending 2009*

- **Difficulty evaluating investment managers.** Pure Alpha products are often esoteric, such as purchasing claims on an athlete's future earnings, making bets on FDA approval of a new drug, or funding plaintiffs seeking monetary damages. In our experience, investment managers that gravitate to these products are long on domain expertise but can be short(er) on traditional investment skills and track record. Manager selection in these products can therefore be more uncertain and (anecdotally) fraud is more common.

- **Unpredictable payoffs.** Certain assets, especially certain commodities, behave quite independently from other financial assets. Localized natural gas and electricity markets stand out as an example. Regional carbon credit markets are another. However, these assets have an inherent volatility that makes them a hard choice for investors (like us) that emphasize predictable cash flows.

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If Pure Alpha is not the solution, at least not all of it, where should we look next?

The answer is private investments that offer Purchase Discounts (Type 2) and/or Value-Added Strategies (Type 3). Yes, they add Beta, but for better deals the Beta is more than worth it, **so long as we don't get stuck in them for too long**.

To see why, consider the following example.

Let's say a sponsor brings us an opportunity to invest in an industrial business with a Beta of 1. However, the business can be purchased at a 30% discount because it has suffered an environmental accident. Now let's say that the sponsor has a credible plan to clean up the accident in two years at a cost of 10% of the value of the company. For simplicity, let's assume no leverage. So, we have an opportunity to earn 10% excess annual returns (Alpha) for two years while adding substantial Beta to our portfolio.

Should we do it? Obviously there is lots of diligence to do on the sponsor, company, and cleanup. But in addition, a key question is whether we can sell the investment shortly after the cleanup is done. Otherwise, we are adding two years of Alpha for many more years of Beta. [Note: this doesn't mean we won't invest long-term—there simply needs to be a longer-term Alpha opportunity.]

In getting to the right time horizon, alignment with the sponsor is very important. We find that our [non-standard approach to private markets] helps us get better aligned.

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Structured Investing (Type 4) and Hedge Fund Allocations (Type 5) are also important tools in the toolkit.

Investments that are **only** Type 4 should be viewed with caution. Sometimes, adding structure is simply sacrificing return for a modest amount of protection. But the combination of structure plus an additional advantage can be a powerful way to add Alpha while muting Beta.

I earlier mentioned having an illiquidity budget. When that runs out, we accept a lower return for liquid investments. For investments that are liquid and non-correlated, albeit with a bit less octane, Hedge Fund Allocations (Type 5) are our preferred place to look.

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A final note: While Alpha doesn't make Beta go away, it does act as an offset to losses and therefore reduces risk. Consider a portfolio with 6% Alpha and 0.5 Beta. If markets go down 12%, the portfolio should be flat.

Sure, zero Beta would be great in down markets, but if the cost is drastically reduced Alpha and no participation in up markets, it's simply not worth it. Live with some Beta and free up your search for Alpha.

NEWSLETTER
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