Defining Alpha ...
It's Skill, Not Excess Return

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Alpha may be a common investment term, but it remains commonly misunderstood. Market observers often define alpha simply as a fund's outperformance relative to a benchmark. This misconception is not only incorrect, but ignores what alpha truly identifies: manager skill.

Alpha, properly defined, measures return in excess of what was expected given the risks taken to generate those returns.

Factoring risk into the fund's performance is an important distinction. A manager who outperforms a benchmark only by taking excessive risk may be a lucky beneficiary of a favorable market environment: in an up market, a fund with greater risk would be expected to outperform. Alpha gives context to the performance, and shows whether a manager's performance exceeds expectations for a given risk level.

The following example of two funds' performance illustrates the difference between excess return and alpha. As it highlights, focusing only on a fund's excess return can obscure the manager's skill, or lack thereof.

Before breaking down the two funds' alpha, let's take a quick look at how Jensen's alpha is calculated:

$$\alpha = Rp - [Rf + \beta\ (Rm - Rf)]$$

Now, let's look at the returns and characteristics of two funds and use the alpha to identify each manager's skill:

	Fund A	Fund B
Portfolio Return	17%	16%
Benchmark Return	15%	15%
Beta	1.2	0.9
Market's Risk Free Rate of Return	1%	1%

Alpha, properly defined, measures return in excess of what was expected given the risks taken to generate those returns.

- ***Rp*** is the portfolio's return, ***Rf*** is the risk-free rate, ***Rm*** is the return of the market (or benchmark) and ***β*** is the portfolio's beta. Beta measures the fund's risk relative to its benchmark.

  For example, a fund with a beta of 1.2 is expected to exhibit 20% more risk than its benchmark. When markets are up, it could be expected to perform 20% higher than the benchmark. When markets are down, it could be expected to perform 20% lower.

Fund A

$\alpha = 17\% - [1\% + 1.2\,(15\% - 1\%)]$

$\alpha = 17\% - [1\% + 1.2\,(14\%)]$

$\alpha = 17\% - [1\% + 16.8\%] = -0.8\%$

Fund A had more impressive returns, but how did the manager get there? Did the portfolio manager just benefit from taking more risk? If we plug the numbers into our alpha equation above, Fund A's alpha was negative. The fund may have outperformed its benchmark, but it performed worse than expected given its high beta.

Fund B

$\alpha = 16\% - [1\% + 0.9\,(15\% - 1\%)]$

$\alpha = 16\% - [1\% + 0.9\,(14\%)]$

$\alpha = 16\% - [1\% + 12.6\%] = 2.4\%$

Fund B had a lower excess return than Fund A, but the manager took far less risk (a beta of only 0.9). Given the lower beta and the benchmark's strength, one could actually expect the manager to underperform the benchmark. The Fund's relatively high alpha shows the manager handily exceeded expectations for the risk involved.

Alpha Doesn't Lie

While Fund A had higher excess returns, it took considerably more risk. Alpha strips away the potential benefit of higher risk on its own, and measures a manager's ability to produce excess returns for a particular risk level. When selecting active managers, it can serve as a better gauge of a manager's skill than simply examining excess returns.

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