Chasing Alpha:

What is Alpha:

Alpha is a measure of the risk adjusted return that a manager (in the case of an investment fund) or management (in the case of a company or stock) is able to generate based on their skill and value add. Alpha is what the manager brings or takes away from the return of an investment.

Alpha is one of five technical risk ratios; the others are beta, standard deviation, R-squared, and the Sharpe ratio. These are all statistical measurements used in modern portfolio theory (MPT). All of these indicators are intended to help investors determine the risk-reward profile of a mutual fund. Simply stated, alpha is often considered to represent the value that a portfolio manager adds to or subtracts from a fund's return.

A positive alpha of 1.0 means the fund has outperformed its benchmark index by 1%. Correspondingly, a similar negative alpha would indicate an underperformance of 1%.

'Alpha' is a finance term referring to a stock's performance relative to the market; it is used more loosely by fund managers to describe beating their index - so every stock picker is essentially "seeking alpha."

Investors are averse to risk. In general, they do not like it and they do not believe it is a good thing. The more risk one bears, the more compensation or return one deserves.

What is Beta:

Beta is the standard for measuring market risk. Beta is the measure of a particular stock’s movement in relation to the movement of the overall market (typically the Sensex or Nifty). Beta measures co-movement between the market (all stocks) and the individual stocks that comprise the market. For example, a stock with a Beta of 2 will move on average, at two (2) times the rate that the market moves. Beta adjusts for market risk by adjusting an individual stock’s return relative to the overall return of the market.

The predominant component of investment returns is attributable to Beta - the return of the market. If you invest in a broad market index or index fund, there will be a highly significant correlation between your return and the overall return of the market as in the above example. When you invest in such a diversified portfolio, you essentially assume the same risk as the market; and, since you did, you will typically receive no more than the market’s return.

Total Return means :

In order to get more than the market’s return, you have to look elsewhere and alpha is that place to look. Generating alpha (return) is the only way to get a risk adjusted return in addition to the market. It is the risk adjusted return over and above the return that the market generates, i.e. total return= beta or market return + alpha or manager return.

Suppose a stock with a “Beta” of 2 has a return of 25% over a certain period and the risk free return during that same period is 5%. Therefore, we can say with surety that the excess return of that particular stock’s return over the risk free return is 20% (25%-5%). Also, the market generated a market return of 14% during the same period. Therefore, the market’s excess return was 9% (14%-5%) for the period. The expected return for a security with a Beta of 2 during this period is 2 times the market’s return (excess return) because it has 2 times the market’s risk. This translates into 18% (2 X 9%). Therefore, the stock’s Beta return or its return adjusted for its risk relative to the market’s return is 18%. This constitutes 90% of the security’s total excess return during the period (18%/20%). It helps to keep in mind that all we are doing in this example is adjusting the stock’s return relative to the market return and we do that by taking into account its Beta.

The example we used above for illustrating Beta also works for explaining Alpha. In the example, the security’s total return adjusted for the risk free rate was 20%. The security’s market or Beta return was 18%. The difference between these two numbers (2%) is the security’s alpha return.

Earning alpha in real life:

Many investors believe alpha is the definitive measure of risk and return because it is the only one that matters when you realize that the other component of return is the generic contribution of the market.

To generate anything other than a market return, one must create alpha. Most of the thousands of investment managers are well aware of this fundamental investment truth - in order to "beat the market", you must generate value added return in excess of the market. In reality, few investment managers ever do (especially after considering expenses of the scheme).

Few investment managers ever achieve performance that compares with the simple strategy of just investing in the broad market as a whole over a sustained period of time.

The problem with alpha is that there are too many chasing it and too little of it to go around. It is finite in nature and just not enough is available for any more than a select few to capture it at any point in time. This is because the capital markets, for the most part, are "efficient".

John Mauldin, a renowned financial expert summarises alpha as under:

- the best place to find alpha is in an inefficient market.
- the best time to find alpha is at the beginning of a new market.
- the majors or the large investment funds and banks have trouble finding alpha because they are not interested in some of the back-water markets that smaller, more entrepreneurial managers and funds might find of interest."
- there is always alpha somewhere, but as markets get larger and more liquid and efficient, it is harder to find. The 'new pockets' (of alpha) mean it will take smaller and more nimble funds to exploit them.
- indeed this may signal a major and structural change over the next few years to the very nature of investing in alternative markets.
- further, as you look to make your investments, you need to think about the potential alpha in the particular area of the market in which you invest.

How is alpha calculated:

Jensen's alpha [1] (or Jensen's Performance Index, ex-post alpha) is used to determine the abnormal return of a security or portfolio of securities over the theoretical expected return. It is calculated as Jensen's alpha = Portfolio Return − [Risk Free Rate + Portfolio Beta * (Market Return − Risk Free Rate)]

Alpha generated by some schemes in India:

The following table shows the performance of select diversified equity schemes in India and the alpha earned by them.

Returns generated by largecap equity diversified funds having corpus of more than Rs.800 cr.

Scheme Name	Latest Corpus Rs.Cr.	1 Month Annualised	6 Months Annualised	1 Year Annualised	3 Years Annualised	Beta	Jensons Alpha Daily
HDFC Equity Fund - (G)	9419.27	-5.24	-17.00	7.14	25.72	0.88	0.03
Franklin India Prima Plus - (G)	1744.32	0.81	-10.50	6.41	15.35	0.84	0.03
HDFC Top 200 Fund (G)	10644.84	-0.61	-17.33	5.05	21.92	0.92	0.03
Franklin India Bluechip Fund - (G)	3904.05	-2.43	-15.43	5.19	18.11	0.78	0.02
DSP BR Top 100 Equity Fund (G)	3020.67	-13.14	-15.56	2.96	14.37	0.82	0.01
DSP BR Equity Fund (G)	2555.65	-17.52	-17.36	1.76	16.10	0.84	0.01
HSBC Equity Fund (G)	902.57	-9.03	-20.84	0.37	6.07	0.93	0.01
Kotak 50 (G)	862.02	-5.15	-18.21	0.28	8.46	0.84	0.00
Morgan Stanley Growth Fund (G)	1543.89	-19.21	-27.98	-2.60	7.13	0.96	0.00
Templeton India Growth Fund - (G)	869.84	-22.49	-26.51	-2.28	12.64	0.87	-0.01
Sundaram Select Focus - (G)	853.00	-20.58	-26.58	-2.51	4.90	0.92	-0.01

HDFC Securities Limited, I Think Techno Campus, Bulding –B, ”Alpha”, Office Floor 8, Near Kanjurmarg Station,
Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Fax: (022) 30753435

Disclaimer: This document has been prepared by HDFC Securities Limited and is meant for sole use by the recipient and not for circulation. This document is not to be reported or copied or made available to others. It should not be considered to be taken as an offer to sell or a solicitation to buy any security. The information contained herein is from sources believed reliable. We do not represent that it is accurate or complete and it should not be relied upon as such. We may have from time to time positions or options on, and buy and sell securities referred to herein. We may from time to time solicit from, or perform investment banking, or other services for, any company mentioned in this document. This report is intended for Retail Clients only and not for any other category of clients, including, but not limited to, Institutional Clients