The eternal chase for alpha

by Roger Montgomery

Key points

- *For corporate earnings to grow, the companies you invest in need to make good on their expansion plans.*
- *It helps to be fully invested. A portfolio with a large chunk allocated to cash is rarely going to outperform the index.*
- *Finding alpha needs access to a wide universe of stocks, and some detailed research.*

We all know alpha, that elusive figure of outperformance that sustains the industry of investment management (of which yours truly is a part of). We all wish to own portfolios with positive alpha, such that our wealth will grow to new heights on the back of long-term compounding returns. However, alpha is notoriously difficult to acquire and with some slight of thought it's quite easy to answer the question of why this is so.

In a nutshell, alpha is calculated by subtracting the annual return of a stock index (such as the ASX 300) from the annual return of your stock portfolio.

A sum of two parts

We can break stock returns down into two basic parts, corporate returns, e.g. higher stock prices, which are driven by increasing earnings, and random returns. The index is basically just another portfolio of stocks with returns that comprise both a corporate part and a random part.

For the earnings (and hence corporate value of the firm) to grow at a good clip going forward we need to see high returns on the expansionary plans the stocks in our portfolio decide to take up. The same can be said for the group of firms in the stock index. From this, we can see more tangibly that to earn positive alpha, we need the firms in our stock portfolio to grow their earnings at a higher rate than that of the stock index portfolio.

Of course we don't want just want one or two years of outperformance before we call it a day, we'd really prefer say 10, 20 or more years of (averaged out) outperformance to build our wealth significantly. We require some sort of mechanism for each firm in our portfolio that will protect the growth of their earnings over the long haul from competition, i.e. a competitive advantage.

If we have a portfolio of, say $100,000 with only $10,000 allocated to stocks with the remainder in cash, we're going to have a pretty tough time outperforming the stock index. For example, if our stocks achieve an excellent 30% return and our cash earns 3% in interest, the combined portfolio return is 5.1%. The stock index only needs to achieve 5.2% for our alpha to be negative in this case (and note, the long-term averaged return of the ASX 300 accumulation index is 10-11% per annum). Hence alpha generation requires that we have a sufficient weighting to stocks in our portfolio such that the growth in earnings will still produce a positive alpha.

Price point

Finally we need to consider the price level at which we are holding our shares. This point is slightly more complicated, but we can summarise by saying that if a share is trading significantly above its intrinsic value, its growth going forward is unlikely to be spectacular. For example, if we hold a stock that's trading at $2 when our analysis determines it is worth $1 this year, $1.10 next year and $1.21 the year after due to growth in earnings. We can see that we'll likely have a long wait before value catches up with price. In the interim, there's little in the way of a case to expect the high returns to continue.

So we now have a few tools, which can help us to gauge the propensity for our portfolio to generate positive alpha. Reverting to our original question of why it's generally difficult to outperform the stock index, consider that the index is made up of some of the largest companies in Australia and whilst they're not all perfect, generally they are profitable and can grow their earnings at a fairly good clip over the long haul. The index is also 100% invested at all times, leveraging its performance to the benefits of long-term growth in earnings to the utmost.

To beat this index, the investor is challenged to find a firm to invest in that can both grow its earnings for an extended period of time at a high rate and be available for purchase at a suitable price level. The investor must also find several of these companies so as to not be under diversified or hold too much cash, the former presenting a concentration of risk and the latter would almost certainly lead to negative alpha over the long haul.

Positive alpha is difficult to achieve as noted, yet through detailed research and a wide enough basket of potential stocks to research it is very possible.

Mind you, if it were easy, there would be no alpha to catch.