Allocationmetrics Limited

Alpha Isn't Dead, but CAPM should be Killed

Much ink has been spilt over the active – passive debate, about the benefits of active investing and the virtues of passive funds. However, no one has stopped to question if this demarcation should exist in the first place. Isn't this gulf between alpha and beta is nothing more than an artificial boundary created by the Capital Asset Pricing Model (CAPM).

CAPM was created as a framework to understand the source of asset return. However, it also created an artificial division between beta and alpha and between systematic and unsystematic returns. The investment industry went on to use this concept beyond its original intent, by creating active and passive products, structuring organizations and advocating that the basic mandate of most investment professionals should be to be engaged in beating a market cap weighted benchmark. None of these activities are however in the interest of the asset owner, whose objective has always been of absolute return.

At a basic level, asset returns are a function of the risks inherent in the asset, the exposure to these risks and the return attributable to that risk variable. The risks can be fundamental or quantitative, conceptual or tangible and macro or micro. While it is obviously not feasible to have an attribution for any asset to a definitive complete list of risk variables, the dilution of this concept to mere alpha and beta appears naïve. Dispensing with the CAPM framework, and embracing this APT type framework for asset returns can however have dramatic consequences for the investment management industry, for the benefit of the asset owner. To name a few:

- We no longer need market cap weighted benchmarks as a base case portfolio. These indices may well represent the aggregate market movement, but they do not represent the risk free or naïve portfolio for asset owners, like they are being used today.

- There will be nothing like passive indexation. The benchmark for asset owners is absolute return. A strategy replicating a market cap weighted benchmark (i.e. what we call passive today) is actually an active strategy with cash as the benchmark

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- For smart beta to be smart, it has to beat a cash benchmark, not a market cap weighted benchmark.

- Active management will have the objective of absolute return, to align with the asset owner. All strategies should have a cash benchmark.

- There is no such thing as systematic and unsystematic risk. The risk factors for each security universe are different. There is no universal truth that we accept today labeled as systematic and unsystematic.

At the end of the day, all investment products and instruments, with any label we have put on them – active, passive, smart beta or alternative, are simply return distributions, each with a package of risk factors. All we do in the investment industry is package risk factors with different wrappers and labels – much like a tray of sandwiches: all with a basket of ingredients with a wrapper of some bread, and give it different names – a wrap, a club sandwich or a baguette.