Alternative Investing

The Alpha in Portfolio Construction

January 1, 2013

Investments and Pensions Europe

We believe that portfolio construction, risk management and cost control are the “low-hanging fruit” of managing a long-term portfolio. We contend that the skillful combination and management of the various components of the portfolio constitute a form of alpha on its own — this is what we call alpha through portfolio construction.

Here are some specific suggestions for improving a portfolio:

- Allocate by risk, not dollars. Measuring portfolio shares by dollar allocations can mislead. The 60/40 dollar split between stocks and bonds may sound balanced but actually is roughly a 90/10 risk allocation, given the greater risk of equities.
- Ensure you are building a truly diversified portfolio. Investing in alternative portfolios that are highly correlated with the equity market only provides the illusion of diversification. Aim to assemble a portfolio of assets with high Sharpe ratios and attractive diversification abilities.
- To generate returns comparable to equities-heavy strategies, diversification almost certainly requires the prudent use of leverage, short-selling and derivatives. Such tools involve financial risks to consider, but these risks have proven to be manageable even through some vicious downturns.
- It is essential to not pay alpha prices for what is not alpha. The prospect of a prolonged period of low returns underscores the importance of cost-effectiveness, whatever returns investors are harvesting. Fair fees depend on the return source.

We also recommend that investors create a drawdown-control methodology for their overall portfolios — in short, a plan to systematically reduce risk because of losses and to add it back in a similarly systematic way as markets turn back up.

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