PORTFOLIO CONSTRUCTION

Alpha Beyond Expected Returns

March 1, 2012

Many institutional investors focus primarily on one source of alpha: expected returns, perhaps relative to a benchmark. There are many drawbacks to this approach, including manager search costs, limited performance persistence and (potentially) high fees. We argue that “alpha” can be more reliably captured in virtually every other stage of the investment process. In this paper, we suggest seven sources of value-added beyond the traditional view of “alpha,” grouped under three themes:

- Portfolio Construction — diversification, that only “free lunch,” can be applied in aggressive and innovative ways
- Risk Management — practices that generate a smoother ride enable investors to stick to their game plan in bad times
- Cost Control — cost-effective execution and fair fees gain importance in a world of low expected returns. Our ideal portfolios aggressively exploit breadth; this almost always improves risk-adjusted returns.

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