Portfolio Asset Allocation: Alpha and Beta

In advising on asset allocation, I often split the portfolio into a pure beta component and a pure alpha component. The beta component of the portfolio is "passive" and seeks to track the risk and return characteristics of equity and bond market indices at the lowest possible cost. In the alpha component I attempt add additional risk-adjusted upside to the portfolio through rigorous research. The challenge in managing the alpha component of the portfolio is to select strategies and securities based on current market, political and economic conditions which have below market risk and above market returns. Oftentimes this alpha portfolio component has a low correlation with the beta portfolio component, which serves to partially protect the overall portfolio against systemic risk.

On the alpha side, being that the risk-adjusted expected return of the U.S. equity market is sub-par in my opinion, I have searched for alternative ways to add alpha, using asset classes that are not available to most in traditional employer sponsored qualified plans (401k, 403b). As an aside, I tend to advise that individuals allocate their retirement plans to a pure beta strategy.

The following is a broad overview of two of the investment strategies and asset classes which I have been using lately to add alpha to a portfolio. In my opinion each of these strategies has the potential for above market return and below market risk. I will avoid recommending or discussing individual securities and refer only to asset classes and strategies.

Master Limited Partnerships

These entities combine the liquidity of an exchange-listed security with the tax benefits of a limited partnership. Under the U.S. internal revenue code the business activities of master limited partnerships must be related to natural resources, with some exceptions. Most master limited partnerships are involved in coal, oil, and natural gas extraction and transportation. In the "pass-through" partnership structure, partners are taxed only once, on their share of partnership earnings. This is in contrast to shares of a "C" corporation, where profits are taxed once at the corporate level and again when dividends are distributed to shareholders. Besides the obvious advantage of being more tax efficient overall, there is an additional way in which these entities are advantageous to C corporation shares, and this has to do with political risk. Specifically, being that we are in an era of high political risk, having one level of taxation, as in an MLP, creates less exposure to political risk than the double taxation of exchange listed C corporation shares, where the investor is exposed to political risk on both the corporate side and on the individual side.

Covered Call Writing

Compared to many other options strategies, this one has a low non-systemic risk. A negative scenario for the covered call writer is to get called away from the position, resulting in a loss of upside potential on the stock. This is in contrast to naked call writing, where there is an unlimited potential for loss on the part of the call writer. A directionless equity market will reduce the probability of getting "called away" on the position, and a high market volatility should increase the premium received from writing the calls. We are therefore "hedging" away much of the stock market risk, or volatility, by utilizing this strategy. There are several closed end funds which employ this strategy which can eliminate the administrative task of executing it.

Alpha and beta are both important portfolio components and each serves its purpose within the framework of an investing program and financial plan. By adding alpha using some of the strategies outlined here we can help to protect the portfolio against systemic risk, with the goal of increasing the risk-adjusted returns of the overall portfolio.