

Digging deeper: Reckoning with risk

2. Alpha

Alpha

Alpha is the excess return produced by an investment relative to the market.

It is derived from the investment's beta (market risk), the market return, the risk-free rate (a notional figure usually derived from short-term government bond yields) and the actual return received.

Alpha allows investors to quantify any value that is added by a fund manager's stock selection.

- **Positive alpha** - indicates that an investment has performed better than would be expected from its beta.
- **Negative alpha** - indicates that an investment has performed worse than would be expected from its beta.

Alpha indicates whether an active manager's stock selection is adding value (alpha is positive) or not adding value (when alpha is negative).

Formula for calculating alpha (α) of a fund:

$$\alpha = \text{actual portfolio return} - [\text{Rf} + \beta_i (\text{Rm} - \text{Rf})]$$

- > α = alpha
- > Rf = risk-free rate of return
- > β_i = beta of the fund or portfolio
- > Rm = market return

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Example

Actual portfolio return = 12%

Rf = risk-free rate of return = 3%

β_i = beta of the fund or portfolio = 1.64


Rm = market return = 8.5%

$$\alpha = 12 - [3 + 1.64 (8.5 - 3)] = -0.02\%$$

The fund in this example has produced a **negative alpha (α)**.

The manager has detracted from the fund's performance through stock selection, although only very modestly.

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