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SEI's Alpha Sources: An Overview

Snapshot

- Alpha is the measure of excess returns relative to a benchmark index—and alpha sources are the drivers of these excess returns. Evaluating potential alpha sources is a key aspect of our investment process.
- At SEI, our alpha sources fall into two broad categories: Systematic (tied to quantifiable historical market inefficiencies) and Idiosyncratic (generated by unique insights of traditional active managers.)
- We further categorise alpha sources by "factor groupings," which we employ as proxies to measure and potentially capture underlying drivers of return.

Evaluating potential alpha sources—that is, drivers of excess returns relative to a benchmark—is a key aspect of our investment process. We continuously study characteristics that are historically associated with excess risk-adjusted returns, which we call factors, along with common investor decision-making biases that tend to foster and give rise to opportunities presented in the overall market. This research allows us to identify desired alpha sources across our equity, fixed-income and alternative investment portfolios. It also informs a framework from which we can assess prospective managers and the efficacy of their respective investment processes. We place investment managers in a given portfolio based on our view of their ability to provide persistent exposure to a specific alpha source or alpha sources.

Our alpha-source framework continues to evolve over time, reflecting the ever-changing nature of global markets. The terminology can therefore be expected to change periodically, as the value of our effort is not in naming specific alpha sources, but rather in recognising that sources of return can and will vary over time.

Our alpha sources fall into two broad categories:

Systematic alpha sources

- Arise from the collective irrational behaviour of market participants, which causes security prices to deviate from their intrinsic or fair values
- Can be accessed systematically through two different investment approaches:
  - Traditional active management, which employs qualitative and quantitative analysis of fundamentals and factors (characteristics historically associated with excess risk-adjusted returns)—seeking to provide exposure to both systematic and idiosyncratic alpha sources
  - Factor investing, which employs quantitative rules-based portfolio construction—seeking to provide systematic exposure to known market inefficiencies. Factor investing typically comes with lower costs than fully-active strategies

Idiosyncratic alpha sources

- Generated by unique insights that traditional active managers can garner through research and analysis
- Cannot be systematically replicated

Our alpha-source framework

We further categorise alpha sources by "factor groupings"—which we employ as proxies to measure and potentially capture underlying drivers of return. The charts below include examples of these factor groupings.

EQUITY FRAMEWORK

Alpha source	Description	Investment strategy	Factor groupings	Examples of factor metrics
Value	**Mispriced securities** due to **investor overreaction** caused by an aversion to loss.	Systematic (behavioural)	• Cyclical value • Stable value	• Price-to-earnings • Price-to-book
Momentum	**Trending stock prices** due to **investor under-reaction** caused by anchoring—as perceptions change serially on incoming data, and causes herding behaviour.	Systematic (behavioural)	• Price momentum • Earnings revisions	• 12-month price momentum • Earnings revisions
Stability	Investor tendency to undervalue lower-risk, higher-stability businesses—resulting from a focus on **short time horizons and overconfidence** in forecasts for momentum-driven stocks. Stability-oriented stocks have the potential to exceed market expectations by consistent outperformance (rather than reverting to average market returns) along with potentially stable, long-term **compounding returns.**	Systematic (behavioural)	• Quality • Low volatility	• Volatility • Interest coverage
Selection	**Idiosyncratic opportunities** through individual security, country or sector selection.	Idiosyncratic (analytical)	N/A	N/A

FIXED-INCOME FRAMEWORK

Alpha source	Description	Investment strategy	Factor groupings
Macro	**Excessively discounted risk** of interest-rate-sensitive assets, such as long-dated bonds, in response to **macro-economic factors**—can be captured by taking advantage of duration and yield-curve opportunities.	Systematic (behavioural)	• Term premium
Credit	**Excessive discounts** in some classes of bonds because of **perceived risk factors** such as regulation, cash-flow cyclicality or balance-sheet risk—can be captured as valuation discounts revert to "mean."	Systematic (behavioural)	• Risk premium
Selection	**Idiosyncratic opportunities** through individual security, country or sector selection.	Idiosyncratic (analytical)	N/A

ALTERNATIVES FRAMEWORK

Alpha source	Description	Investment strategy	Factor groupings
Value	**Mispriced securities** due to **investor overreaction** caused by an aversion to loss.	Systematic (behavioural)	• Cyclical value • Stable value
Macro	**Excessively discounted risk** of interest-rate-sensitive assets, such as long-dated bonds, in response to **macro-economic factors**—can be captured by taking advantage of duration and yield-curve opportunities.	Systematic (behavioural)	• Term premium
Momentum	**Trending stock prices** due to **investor under-reaction** caused by anchoring—as perceptions change serially on incoming data, and causes herding behaviour.	Systematic (behavioural)	• Price momentum • Earnings revisions

It is worth noting that our long-term, strategic baseline allocation is to cheaper, higher quality/lower risk securities with positive momentum/improving fundamentals. While we think of this as our “neutral” position, it is not “style neutral.” Generally speaking, even though our starting point for portfolio construction is an equal allocation to each alpha source, portfolio managers determine the actual allocations to reflect expected risk contributions and local market nuances for each individual portfolio.

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