SEI INVESTMENTS

WEEKLY COMMENTARY
©2005 SEI Investments Developments, Inc.

November 23, 2005

An Introduction to Alpha Generation

By Jonathan M. Heller, CFA
Director of Investment Communications

Introduction

The concept of generating alpha -- excess return -- is nothing new. The idea of combining multiple alpha sources that are diverse in nature and low in correlation in one portfolio -- thus eliminating style, benchmark and other constraints -- is truly cutting edge.

Relaxing Constraints and Broadening Mandates

Constructing portfolios with multiple diversified alpha sources reduces reliance on traditional anticipatory investment strategies -- where investment decisions are based on the expectation of future events or circumstances -- which dominate the institutional marketplace. While some managers successfully generate alpha within a narrowly defined investment mandate, strict adherence to a particular mandate can severely limit opportunities. As a manager of managers, the identification of managers that can exploit opportunities outside traditional mandates provides a broader array of potential ways to generate excess returns.

Removing constraints may improve the ability for a manager to generate excess return. A "long-only" constraint, for example, limits the ability to meaningfully underweight stocks. A manager with such a constraint can generate returns on stocks they believe are attractive but can't capitalize on stocks they don't, by shorting them. Removing the constraint offers opportunities such managers would otherwise be unable to exploit, resulting in potential to generate alpha and increase portfolio efficiency. A 120/20 strategy, that allows up to 20% of a portfolio to be shorted with the proceeds invested in long-only securities, may not increase portfolio risk but may generate up to 40% more active decisions than a long-only portfolio.[1]

Identifying managers that generate excess returns using non-traditional approaches opens up potentially fruitful new areas of the investment spectrum. For example, the use of alpha transport strategies, where beta exposure, a measure of volatility relative to the overall market, is generated from one asset class and alpha from another, can enhance portfolio construction.

[1] Martielli, James D. "Quantifying the Benefits of Relaxing the Long-Only Constraint" SEI Investments research paper, January 2005.

New Fish/Old Pond

Accepting the view that certain market sectors are fairly efficient brings the realization that opportunities to exploit inefficiencies within them may be scarce using traditional investment approaches. To consistently generate excess returns, it is necessary to broaden the scope of managers and the techniques they utilize.

An efficient sector, such as the US Large Cap Equity Market, is like a pond where fishermen try to catch two kinds of bass. Some will only keep large mouth bass, others only the small mouth variety and some may keep both types. None, however, are interested in the many varieties of trout the pond offers, even though trout may be of equal value. Some of the trout are also bigger, because they haven't been regularly harvested. If these fishermen (traditional managers) expanded their horizons to include trout (diversified sources of alpha), they would not only have a chance to catch more fish, but potentially to keep bigger fish. By expanding their mandate and eliminating some constraints, they would have greater opportunity to succeed in a small, restricted and seemingly over-fished pond (the US Large Cap Equity Market).

The same is true for expanding manager mandates beyond their traditional investment areas. By allowing flexibility and removing certain constraints, they may discover greater opportunities to generate alpha.

Identifying Alpha Sources

Managers seeking alpha do so using a variety of methods, both quantitative and qualitative, and a variety of skill levels. Success is dependent not only on how skillful the manager is, but also how much opportunity exists within the area they seek excess return. Not all alpha sources are equivalent, nor are they always effective. Identifying and selecting successful managers is a rigorous process that demands a great deal of research, prudence, due diligence and good old-fashioned tire kicking.

Putting it All Together

One of the most important lessons investors learn is also a very basic one: "Don't put all your eggs in one basket." Yet, the importance of diversification is often overlooked and misinterpreted. Investors may assume, for example, that combining specific investment styles in a portfolio provides them with the benefits of diversification. While such a portfolio may provide some level of diversification, there may be other methods to achieve more effective diversification.

Diversification is imperative for effective portfolios. If alpha sources are highly correlated or generate alpha in a similar manner, the benefits of combining them in a portfolio are significantly reduced. Successful portfolio construction requires the identification of alpha sources that are not only ***effective***, but also ***not highly correlated***.

Diversifying across managers that are all trying to "catch" the same alpha sources increases the risk of portfolio underperformance. Given the increased competition for traditional sources of alpha in the marketplace, some managers have moved to other ponds (other sources of excess returns). These managers may not fit neatly inside a style box, but may be highly successful.

As a manager of managers, it is our mandate to develop portfolios that offer a high probability of success, low relative risk and attractive excess returns. It is imperative for us to diversify among alpha strategies rather than simply to assemble groups of anticipatory managers (traditional managers that base investment decisions on expectations of some future event) in each style.

Glossary of Alpha Source Strategies:

Volatility Capture- A mathematically based approach that assumes market indices are inefficiently constructed and systematically exploits price movements in the underlying constituents. Through this approach, a portfolio of high volatility stocks with low correlation is built and systematically rebalanced.

Value Premium- This approach favors stocks that are cheap relative to earnings, book value, sales, cash flow or other metrics.

Momentum- This approach favors stocks that have positive price, earnings and/or analyst earnings estimate/ratings revisions.

Adaptive Markets/Factor Rotation- An approach based on the assumption that markets are adaptive. These investors utilize different metrics to value stocks over time. Factor weights in these models are varied based on whether stocks are classified as growth or value.

Customized Factor Weightings/Behavioral Bias- Stocks are valued differently depending on their growth rate, sector and/or sector classification. Factor weights in the model are also varied based on the same factors.

Stock Earnings Potential/Anticipatory Growth – An approach based on the belief that, although the market is largely efficient, insightful stock research can create an information advantage to provide excess returns. This is done through the identification of stocks whose future earnings or intrinsic value is currently undervalued by the market.

Alpha Transport- This approach separates alpha from the market return. Beta is taken from one asset class, while alpha is generated by a different source. For instance, beta exposure may be from S&P 500 futures contracts, while alpha comes from fixed income instruments, currencies or other securities.

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any stock in particular, nor should it be construed as a recommendation to purchase or sell a security, including futures contracts. There is no assurance as of the date of this material that the securities mentioned remain in or out of the SEI Funds.

SEI Investments Management Corporation (SIMC) is the adviser to the SEI Funds, which are distributed by SEI Investments Distribution Co. (SIDCo.) SIMC and SIDCo are wholly owned subsidiaries of SEI Investments Company. For those SEI Funds which employ the 'manager of managers' structure, SEI Investments Management Corporation has ultimate responsibility for the investment performance of the Fund due to its responsibility to oversee the sub-advisers and recommend their hiring, termination and replacement.

To determine if the Fund(s) are an appropriate investment for you, carefully consider the investment objectives, risk factors and charges and expenses before investing. This and other information can be found in the Fund's prospectus, which may be obtained by calling 1-800-DIAL-SEI. Read it carefully before investing.

In addition to the normal risks associated with equity investing, international investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles or from economic or political instability in other nations. Narrowly focused investments and smaller companies typically exhibit higher volatility. Products of companies in which technology funds invest may be subject to severe competition and rapid obsolescence.

Index performance returns do not reflect any management fees, transaction costs or expenses. One cannot invest directly in an index. Past performance does not guarantee future results.

- *Not FDIC Insured*
- *No Bank Guarantee*
- *May Lose Value*

Jonathan M. Heller, CFA

Jon joined SEI investments in August, 2005 as Director of Investment Communications. In this role, he is responsible for the development and delivery of strategic and timely investment communications to SEI's internal and external clients. Prior to joining SEI, Jon spent 16 years with Bloomberg Financial Markets. A former Senior Markets Editor for Bloomberg Personal Finance Magazine, and Associate Markets Editor for Bloomberg Markets Magazine, he previously managed Bloomberg's Equity Data Research Department, and Bloomberg's Equity Fundamental Product. He holds an MBA from Rider University, a BA in Financial Planning and Economics from Grove City College, and is a CFA charterholder.