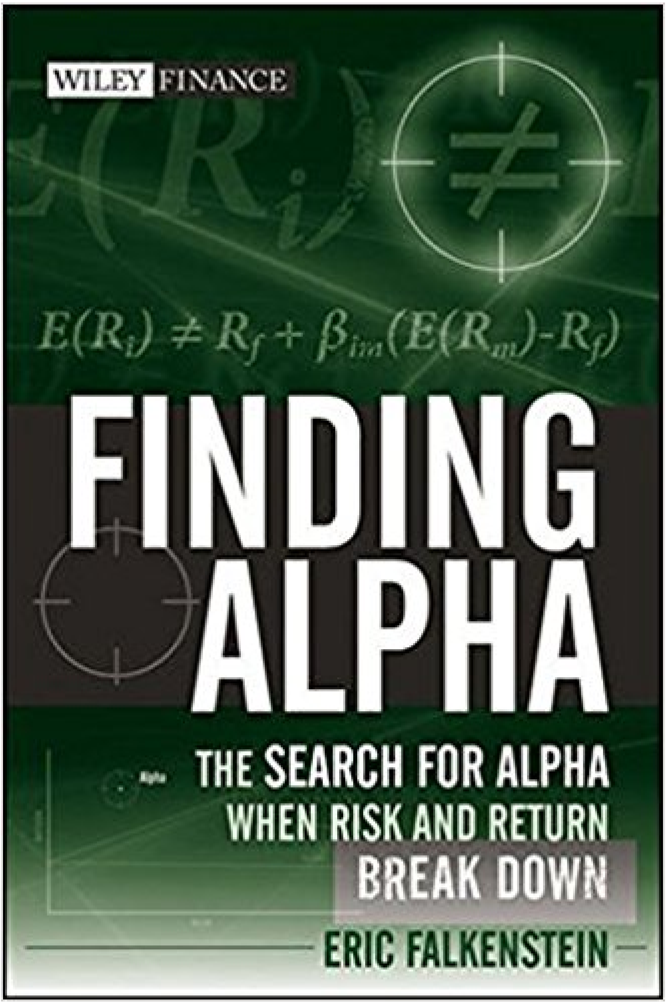
Finding Alpha: The Search For Alpha When Risk And Return Break Down



Synopsis

Praise for Finding Alpha "Eric Falkenstein is more than one of the smartest and funniest people in finance. He’s been a banker, a key model builder at a major rating agency, and a hedge fund trader. In this tour de force, he outlines the successes and failures of financial theory applications in the real world from the perspective of an aggressive early adopter of the best ideas in finance. To this day, I think Eric’s private firm default model is one of the best papers ever published in applied finance, and this wonderful book falls into the same category." â ”Donald R. van Deventer, PhD, founder and Chief Executive Officer, Kamakura Corporation "People dismissed Columbus when he said the world was round. Thank goodness he persisted. Like Columbus, Falkenstein challenges standard thinking, only this time about risk and reward. As the meltdown of the capital markets has shown, the financial industry clearly missed something with regard to risk management. As an industry, we need to consider alternative theories on risk, and clearly Falkenstein is on to something here. Agree with him or not, Finding Alpha is worth a read." â ”Kevin M. Blakely, President and CEO,The Risk Management Association "Writing through the lens of an experienced practitioner, Falkenstein digests decades of research in capital markets, financial economics, and investment psychology that have shaped modern investment theory. This text is an excellent companion for portfolio managers, investment students, or anyone seeking to better understand the relationship between risk, returns, and financial reward." â ”Todd Houge, PhD, CFA, The University of Iowa How do we find alpha whenrisk does not correlate with return? Finding Alpha is a practical guide to achieving alpha when conventional measures of risk rarely correlate with higher returns. Author Eric Falkenstein-a PhD who has also been a risk manager and portfolio managerâ ”tells the story of alpha from its beginnings to its current reversal, where risk is now evidenced by return as opposed to vice versa. Falkenstein begins by walking readers through the Capital Asset Pricing Model (CAPM), as well as other well-documented theories about risk and return, and explores how these theories measure up to current empirical evidence being documented by researchers and academics. He also outlines a novel approach to the issues of how benchmark risk and investor overconfidence affects expected asset returns, how to understand the nature of alpha and risk, and how to use practical applications of alpha-seeking strategies that he developed as a successful hedge fund manager. Finding Alpha concludes by outlining some real-life applications of alpha in finance and explains how the search for alpha affects the day-to-day life of all financial professionals.

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Customer Reviews

Edit: I’m not going to rewrite this review, it’s an honest account of what I thought after reading the book. But I’ve raised the rating to five stars and want to add the comment that I appreciate it more after letting it settle for a year, and after rereading some parts. I still think it’s sloppy and doesn’t give enough credit to others, but I take back the mean line about not having read the references and not understanding Minksky (I think I must have been a bit mad after wading through the sloppiness). On further reflection, the good points have grown better while the flaws remain the same.What I like about this book:* It contains important new ideas that can help any risk-taker with quantitative skills succeed* It challenges conventional wisdom* The meat of the book is based on practical experience, not just things that seem right to the author, but things he has tried, and generally with successWhat I don’t like about this book:* $95, this should be a $25 list book available for $15 on and $9.99 Kindle* Sloppy argument and editing, to the point that some passages are not intelligible (doubly annoying in view of the first criticism)* Lack of appreciation for other people’s thought, which leads to missing useful linksAn example of the sloppiness (and there are many) is on page 21, "The key to the portfolio approach is the variance of two random variables is less than the sum of their variance." This makes no sense. He might mean "The variance of THE SUM of two random variables is less than the sum of their varianceS," but this is true only if their covariance is negative, while portfolio theory is more concerned with the positive covariance case.

Eric Falkenstein’s book Finding Alpha is a thought provoking book that focuses on the most important issues for a financial practitioner - risk and return. He integrates a variety of research and data sources, some of which are his own, into an unexpected, yet coherent worldview, namely that risk and return are not generally positively correlated.Falkenstein reaches four basic conclusions:For most assets, the rate of return is unrelated to its volatility.Really safe assets have below average returnsReally volatile assets have below average returnsInvestors are overconfident, creating excess costs and position concentration.He argues that this is because:People are more envious than greedy (i.e. they are more concerned with their position relative to others than in their own absolute wealth.)People are willing to accept risks in return for the hope (often unfounded) of outsized gains, in investing and other aspects of life.People save some money in supersafe assets to avoid the chance of losing everything.Chapter 1 asserts that the common belief that risk begets return (as assumed by most economists and the CAPM) is wrong. He argues that "risk tolerance [in financial markets] is not like physical courage, the ability to withstand a physical pain, but rather like intellectual courage, the ability to withstand ridicule. He argues that finance needs a paradigm shift from CAPM, which doesn’t even approximately fit the data, but which dominates the conceptual frameworks of academia and finance practitioners.Chapter 2 presents the history and derivation of CAPM and later generalizations such as APT, and points out that all share the same basic assumptions about risk aversion.

I found this book both easy and hard to review. Easy, because it adopts two of my biases: Modern portfolio theory doesn’t work, and the equity premium is near zero. Hard, because the book needed a better editor, and plods in the middle. I don’t ordinarily do this, but I felt the reviews at were valuable, particularly the most critical one, which still liked the book. I liked the book, despite its weaknesses.One core idea of the book is that risk is not rewarded on net. It doesn’t matter if you measure risk by standard deviation of returns, beta, or credit rating (with junk bonds). Junk underperforms investment grade bonds on average. Lower beta and standard deviation stocks overperform on average.A second core idea is that some people are so risk averse that they only accept the safest investments, which leaves investment opportunities for those that are willing to compromise a little with credit quality or maturity. Moving from money markets to one year out is an almost riskless move for most, and usually adds a lot of excess return. Bond ladders do the same thing, though Falkenstein does not discuss those.Also, the move from high investment grade to low investment grade does not involve a lot more investment risk, but it does offer more yield on a risk adjusted basis.A third core idea is that equities, though more risky than high quality bonds, have not returned that much more than bonds when the returns are measured properly. See this post for more details.A fourth core idea is that people are more willing to take risks to be wealthy than theory would admit. Most of those risks lose money on average , but people still pursue them.A fifth core idea is that alpha is hard to define.