

GENERATING ALPHA IN PUBLIC EQUITY

*Obstacles, Opportunity,
and Execution*



Fiduciary Insights

IN THIS FIDUCIARY INSIGHT, WE ADDRESS WHY THE VAST MAJORITY OF ACTIVE MANAGERS FAIL TO ADD VALUE, AND THE REASONS FOR THIS FAILURE ARE NOT SOLELY ATTRIBUTABLE TO MARKET EFFICIENCY. We focus on the U.S. equity market to identify the main manager biases that account for the widespread manager underperformance over the past 10 years. We find that correcting these biases can go a long way to improving performance. In addition, we identify four keys for success in identifying skilled active managers that are likely to add value consistently over time. These include casting a wide net across active managers, making full use of available data, developing expertise in each manager segment, and adhering to a consistent research process to monitor successes and failures. Ultimately, identifying skilled active managers requires investment of time and resources in developing an experienced team, customized analytical tools, and a disciplined process that is continuously refined.

Learn More

To explore our **Fiduciary Insights** series—focused on best practices and responsibilities for fiduciaries—please visit our website at <https://strategicgroup.com/market-insights-and-strategic-perspectives> or simply scan the QR code.

Featured topics include:

- Follow the Money
- How Does Your OCIO Measure Up?
- Building Blocks and Costs of an Internal Investment Office
- Developing a Culture of Good Governance
- The Art and Science of Manager Termination

For insights into the Outsourced CIO model, visit **OCIO.org**, Strategic's educational platform advancing best practices, education, and advocacy for OCIO clients and decision-makers.



SCAN TO BROWSE
THE FIDUCIARY
INSIGHTS SERIES



SCAN TO LEARN
MORE ABOUT
THE OCIO MODEL

Introduction

Outperforming public equity markets has always been difficult. They incorporate new information efficiently and the competition to outperform the market is fierce. In response to disappointing results over the past 5 and 10 years, many allocators have shifted toward passive strategies. Yet, we believe that active management can still add meaningful value when investors identify the right managers and construct portfolios thoughtfully. Using the U.S. equity market as a prime example, this paper examines the common pitfalls of active management and outlines practical considerations for allocators navigating public markets and seeking opportunities for alpha generation.

Performance Problems in Active Equity

A review of data on active investing in the U.S. market is sobering. About 90% of institutional investors' U.S. equity portfolios have underperformed the U.S. market over the past 10 years with an average underperformance of 0.98% per year.¹ When we look at databases of U.S. equity managers, we see similar pervasive

underperformance. Data from eVestment shows the average manager underperforming by 55bps per year before fees. If this was just a story about the market being very competitive and efficient, we would expect the average manager to roughly match the benchmark before fees.² However, for most to persistently underperform, there is something else going on.

There are three main common biases that contributed to this record of underperformance over the past decade. First, most long-only equity managers tend to be underweight the largest companies. In a period of strong outperformance by mega-cap stocks and the growing concentration of the U.S. market, this bias has contributed to the poor track record of active managers. Two other biases have also posed significant drags on performance: managers holding a lower beta than the market and managers overweighting small-cap stocks.

To measure the effect of these biases, we ran a 10-year historical analysis of all the U.S. active managers in the eVestment database and compared their excess returns against the Fama-French three factor model and a fourth factor to capture the mega-cap effect.³ The mega-cap factor we used in this case is the return of the top 10 stocks relative to the S&P. As shown in Exhibit 2, the drag on performance posed by these biases is material and statistically significant.⁴

We believe that active management can still add meaningful value when investors identify the right managers and construct portfolios thoughtfully.

¹ From Investment Metrics database of Endowments, Foundations, and Pensions.

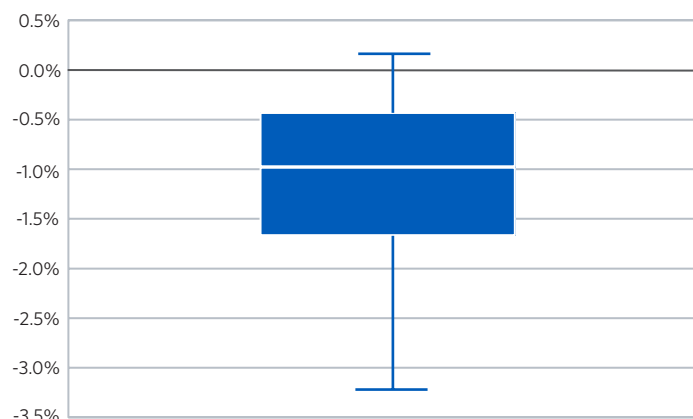
² Including funds that are no longer active, those that reported returns for at least 36 months over the last 10 years, and excluding funds with less than \$50 mill in assets.

³ The analysis covers the period January 2016 - December 2025. Data as of June 2026.

⁴ More detailed information on the regression and the factors is shown in Appendix 1 and 2.

EXHIBIT 1: INSTITUTIONAL U.S. EQUITY PORTFOLIOS' EXCESS RETURN 2016-2025

Source: Confluence Technologies.



Factor Analysis of U.S. Equity Managers 2016-2025 (Gross Excess Return)			
Factor	Avg. Exposure	Annual Impact	Statist. Significant
Market (MKT)	(0.02)	(0.20%)	*
Small vs. Large (SMB)	0.05	(0.12%)	*
Value vs. Growth (HML)	(0.02)	0.01%	*
Top 10 vs. Market (Mega Cap)	(0.08)	(0.51%)	*
Alpha		0.31%	
Total ⁵		(0.52%)	-

The first column on average exposure indicates the magnitude and direction of the bias. The second column on annual impact indicates the annual impact of each bias on relative performance. An asterisk in the third column indicates that the results are significant to the 95th percentile.

We see that managers on average exhibited a negative exposure to the market factor, a positive exposure to small caps, a negative exposure to value, and a negative exposure to the top 10 stocks. Together, the impact of these four factors explains over 100% of the managers' underperformance, with the mega-cap underweight having the biggest impact. Their average alpha, based on the regression, was actually positive. Although the alpha is not statistically significant, this still provides some evidence that active managers on average have some edge in the market. The good news is that an investor can, through thoughtful portfolio construction, eliminate these factor exposures – thus eliminating or reducing the performance drag. This, by itself, would likely put the allocator in the top quartile of the institutional universe. We address techniques for accomplishing this later in the paper.

From our analysis, the average manager generates alpha of 31 basis points even with the drag posed by the three common factor biases. An alpha of 31 basis points is not enough to cover typical manager fees, resulting in net-of-fee underperformance. Does this mean that the market is too efficient and an investor would be better off using a passive strategy? Not necessarily. Active investing is always a zero-sum game. If a certain group of managers (in this case the eVestment database) is large enough relative to the given market, it is inevitable that the average alpha will be relatively low.

The question is can an investor pick the above-average managers from that universe?⁶ Getting from zero or low alpha to positive alpha is where an allocator should spend most of their time and will be our focus next.

The Alpha Potential in Public Equity

We first start with a question: What can an investor reasonably expect from active management in public equities? Most investors use rules of thumb from experience or the returns of other investors. They may use a target, for example 1-2%, over the benchmark (we have even heard of targets as high as 8% over the market). However, we can use data to make a rough estimate of what excess returns are possible and what an investor would need to do to achieve them.

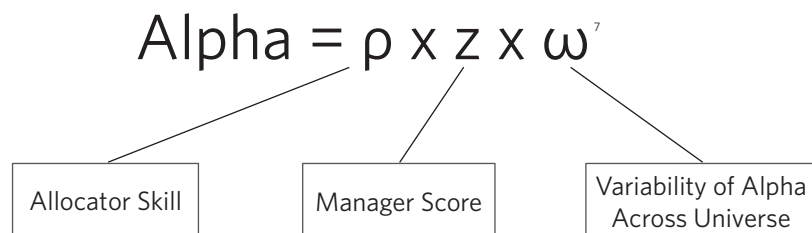
To answer that question, we have employed a simple model to forecast the expected alpha of a manager. In this model, the expected alpha is a product of the skill of the allocator picking the manager, the allocator's rating of the manager relative to its peers, and the variation in alpha across the universe of managers.

⁵ Does not add to -55bps because of compounding

⁶ An interesting phenomenon is that many allocators who go passive in U.S. equity because they believe the market is too efficient will still invest in equity hedge funds even though the bulk of those hedge funds are investing in large-cap U.S. stocks.

EXHIBIT 3: EXPECTED ALPHA EQUATION

Source: Strategic.



In the equation, alpha is the level of outperformance, ρ is the allocator's skill, z is the relative score of the manager, and ω is the variability of alpha across the manager universe.

Next, we can put some numbers into the model. ω is the standard deviation of the alpha of the manager universe. Using the eVestment database and restricting the group to active equity managers, we get a ω of around 3% for large-cap U.S equity managers. This means that over a 5-yr period, we see realized alphas that vary by about 3% across the universe. The allocator's rating of the manager, the " z " in the formula above, needs to be in a z-score for this model. However, it is often easier to start in terms of a percentile. If the allocator judges the manager to be better than 90% of other managers, then this would correspond to a z-score of 1.28. The skill of the allocator, ρ in the equation, is defined as the correlation of the allocator's score of a manager and the manager's subsequent alpha. This is probably the most difficult variable to estimate, but it is very important for an investor to look critically at their own skill. One way to estimate ρ is using a batting average. As a rough rule-of-thumb, this formula gives a translation of batting average to ρ .⁸

$$\rho = 2x - 1$$

x = batting average.

If, for example, an allocator expects to pick an outperforming manager 60% of the time, then they could use a rough estimate of $\rho = 0.2$. Putting it all together, the expected alpha of the manager relative to the universe is 80bps, calculated as $0.2 \times 1.28 \times 3\%$.

Next, we adjust for the average manager alpha in the universe. Using the estimated average alpha from the regression in Exhibit 2,

we would add the expected outperformance of 80bps to the average manager alpha of 30bps for an estimated gross alpha of 110bps. With a 50bps fee, the net expected alpha is only 60bps. This is not a very exciting result from a manager considered to be better than 90% of the universe.

Note, however, that we are using "expect" in the statistical sense here. The allocator in this case has a very high expected alpha from this manager. In fact, the 90th percentile manager in the universe will typically generate $1.28 \times 3\% + 0.3\% = 410\text{bps}$ alpha. The difference between the 110bps and 410bps arises because the allocator's batting average is 60%. The allocator will sometimes mistakenly select an underperforming manager. As a result, the more realistic, long-term expectation for alpha should be lower than what the allocator "expects" for any given individual manager.

This simple model suggests a few actions the allocator can do to generate more meaningful alpha after fees – take the time to be more selective in the managers screened, focusing on those with a high z-score, improve the allocator's batting average, or skill in choosing good managers, and focus on a manager universe populated by high-tracking error managers. The first action is the importance of being very selective. The more selective the allocator, the higher the z-score of the manager chosen. To pick a manager in the 90th percentile, they would typically need to research 10 managers for each manager they hired. To get a z-score of 2, they would need to select a manager in the 98th percentile, which would correspond to researching 50 managers for each one hired. Simply put, the more time the allocator spends researching managers, the more likely they are to find a great one.

Simply put, the more time the allocator spends researching managers, the more likely they are to find a great one.

⁷ This is a simplified version of a model used in M. Barton Waring & Sunder R. Ramkumar (2008) Forecasting Fund Manager Alphas: The Impossible Just Takes Longer, Financial Analysts Journal, 64:2, 65-80

⁸ Waring, Ramkumar (2008)

Success in manager evaluation requires a combination of an experienced team, thoughtful use of data, and a robust investment process that minimizes psychological biases.

How about the p ? Are there ways to improve the allocator's skill in evaluating managers? An allocator should always be working on this, but there is no simple solution. Success in manager evaluation requires a combination of an experienced team, thoughtful use of data, and a robust investment process that minimizes psychological biases. We will discuss some qualitative aspects of manager selection later.

The third term, the ω , would seem to be a given. It represents what is available in the universe of managers. However, there are subsets of managers that have higher or lower variability than the average across the whole universe. If, for example, we split the universe into high, medium, and low tracking error managers, we will see that the ω (the variation in alpha) is higher for high-tracking error managers. We can see similar results for certain market segments like emerging markets, small-cap, or healthcare specialists. Does this mean that an allocator should focus their portfolio on high-tracking error managers to generate higher alpha? The answer is possibly, but there are two very important qualifications.

First, focusing on high-tracking error managers presupposes that the allocator's skill (the p in our equation) is the same across high and low tracking error managers. This may not be true. Higher tracking error managers generally have more concentrated portfolios. As a result, their track records are the result of fewer individual investment decisions and are likely to contain more noise. There may be more cases of a manager getting lucky on a couple of good stock picks among this group of managers than among those with a lower tracking error. This can make this type of manager more difficult to evaluate. The second qualification relates to the risk in the total portfolio. Ideally, we would like to have managers that are not correlated so that the returns and alpha of the total portfolio are less volatile. The managers within the high-tracking error

group may all have similarities in style that cause their returns to be correlated. By restricting the portfolio to only high-tracking error managers, the allocator will miss out on some very good managers that would be more diversifying to the total portfolio. We have found that, although high-tracking error managers can be strong alpha generators, looking across the universe to find high-quality managers with different styles produces the best overall results.

Let's see how an improvement in these areas would result in higher expected alpha. If the allocator spends more time researching more managers, they could get to a manager with a z-score of 2 instead of 1.28. If the allocator can improve their hit rate, the estimated p could increase from 0.2 to 0.25. Finally, let's assume the allocator is looking at a part of the manager universe with slightly higher tracking error. This would raise the ω from 3% to 4%. Now we have a manager with an expected alpha of 230 basis points gross. To be realistic, we should assume a higher fee, which is common for a high performing manager. A fee of 80bps would result in a net alpha of 150 basis points. A portfolio of such managers generating 150 basis points above the market return would provide a meaningful improvement in returns for the investor. In comparison to a representative group of institutional investors, 150 basis points above the market over the past 10 years would put that investor in the top percentile relative to peers.

How to Find Alpha

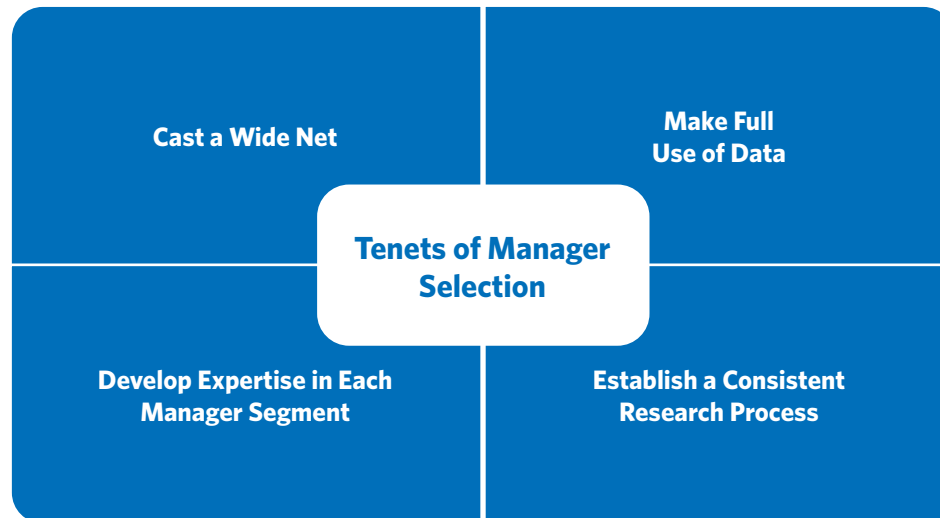
To successfully execute an investment program requires the right resources. An experienced team is a necessary although not sufficient component since experienced, knowledgeable allocators are the rule rather than the exception in investment management. The amount of resources available can be critical. We saw how the number of managers the team researches is a key input into performance. However, researching a large number of managers takes time and resources. In addition, a sufficient level of turnover in the portfolio is required to generate alpha. It is common for an allocator to have several managers in the portfolio that

they would like to replace but do not have the resources to do so right away. As a result, sub-par managers remain in the portfolio for an extended period. The allocator needs to consider the number of senior and junior people on the investment team and whether they are able to focus fully on investing or have multiple responsibilities like trading, operations, and document reviews. The right data, systems, and technology support is also critical to the investment process as this can significantly boost the capacity of a team to evaluate and monitor a number of managers. In short, scale is an advantage.

Next, we will outline some key tenets for picking great managers. There are many actions that are important for manager selection. The following are important actions that are commonly missed.

EXHIBIT 4: TENETS OF MANAGER SELECTION

Source: Strategic.



First, cast a wide net. Because the universe of managers is so large (over 6,000 large-cap equity managers), how an allocator finds managers and decides which to research is a key part of the investment process. With such a big universe, many allocators want to spend time only on “the best” managers. As a result, they may consult other allocators to get recommendations. This can be useful to take advantage of the work others have done and speed up the process. However, if this is the sole sourcing method, the allocator will have the disadvantage of often being late investing in a great manager. They also run the risk of “group think” and ending up with a narrow range of manager styles or types. Using multiple sources, like conferences, placement agents, databases, and even other managers, in addition to other allocators, will take more time but increase the likelihood of finding a great manager.

Second, make full use of data. It is standard now for equity managers, including many hedge funds, to provide historical positions to potential investors. With the proper tools, this data can provide a wealth of information on how the manager generated their historical performance, their decision making, and their risk management. Understanding whether their track record is the result of stock selection (which is more indicative of repeatable skill) or factor exposures (which is more likely due to a style bias) is a key point of evaluation. This type of analysis also allows the investor to pose more informed questions to the manager.

Third, be an expert in the given market segment. Managers fall into different categories. They differ, for example, by style, geography, or business structure. Evaluating managers across styles and strategies requires bespoke analytical tools adapted to the manager’s investment approach. For example, analyzing the performance of a quantitative manager will require different tools, techniques, and criteria from an

analysis of a fundamental manager. An allocator needs to spend time with a sufficient number of managers in a given segment to develop insight into what to look for in that type of manager. When looking at a new area, it is not enough to research a few promising managers. We find that researching at least 20 managers is necessary to get an understanding of the characteristics of that particular manager segment and how managers in that segment generate (or fail to generate) alpha.

Fourth, establish a consistent research process. Ideally, this should include gathering data on the allocator’s own process and their results over time. The investment team needs to be realistic about what they can do and be willing to revise that expectation based on data. Regularly rating their existing managers with a numerical score can help prevent complacency and force decisions related to underperformance. These ratings can also be saved and compared to subsequent manager performance providing an objective estimate of the allocator’s “p”. This process helps the investor develop better intuition about the uncertainty inherent in investing. It is all too common for investors to selectively remember the successes while putting the failures out of their mind. Keeping a record of the overall track record and what worked and what did not guards against this bias and hones the allocator’s skill, boosting its p.

We have also seen pitfalls in the investment process that will hinder performance.

One of the biggest impediments to generating alpha comes from an investment process that puts too many constraints on manager selection. To control risk in the portfolio, allocators will often set targets on exposures to certain geographies or traditional styles. For example, they may want to have an international growth manager to balance the exposure to an international value manager. The danger is

that when they search for a manager, they have a list of requirements that the manager must meet even before considering the potential alpha from that manager. This will tend to result in worse alpha as the allocator excludes more and more managers from consideration based on the list of requirements.

A better approach is to look within a broad area first and identify the best manager from an alpha generation point of view. Then, look to incorporate that manager into the portfolio, while considering all of their exposures. Using some passive ETFs or reweighting other managers may be needed to control overall portfolio risk. We have seen some outstanding managers whose strategy may not fit neatly into a conventional “bucket”. By making other adjustments to the portfolio, we have incorporated these strategies without taking excessive risk or having unwanted exposures. This can make the portfolio construction process more complicated, but it is critical to generating alpha.

Another problem can occur when an allocator does a targeted search and forces a timeline on the process. Even after researching a number of potential investments, the best manager they find may only be “good” rather than “great”. Settling for the best of the current group will not produce a great outcome. Excellent managers do not appear on a schedule, and it pays to be both patient and opportunistic. Being patient may mean spending a lot of time on a search and not hiring any manager. This can be frustrating for the investor who wants to take action and “be productive”. But, waiting for a better opportunity will generate the best performance in the long run. On the other hand, being opportunistic means hiring a great manager even when there isn’t an obvious “need” in the portfolio for a manager of that type. We have found that it is best to seize the opportunity to invest with a very talented manager even if the timing is not perfect.

One of the biggest impediments to generating alpha comes from an investment process that puts too many constraints on manager selection.

Portfolio Construction & Risk Management

Portfolio construction is a critical part of generating alpha in public equity, and the performance of active equity investors over the last 10 years shows this. We have seen how the very weak performance from the universe of active managers has been largely the result of a persistent bias away from mega-cap stocks and toward mid and small caps. To some extent, this bias is inherent among long-only strategies. In a concentrated market, like the U.S. market now, it is hard to hold positions in the very largest companies at a weight that matches the index. How should allocators address this issue? One way is to expand the set of managers beyond long-only to include strategies that use short selling. We have found that employing extension strategies, hedge funds with high net market exposure, and portable alpha strategies has been very productive, especially in concentrated market segments like U.S. large-cap.

Being able to short provides two big advantages to a strategy. First, the manager can bet against companies that they believe are overvalued. For managers who have this skill, shorting provides an additional way to generate alpha. The second advantage is that a manager can take active long positions in small and mid-cap stocks and offset them with shorts in other small and mid-cap stocks so that their net capitalization exposure still matches the broad market. This mitigates the persistent bias that long-only equity managers have of being underweight the largest companies. Another approach is to use a completion portfolio to offset the underweights. This could include ETFs or a custom basket. Regardless of the approach, having regularly updated data on the holdings of each manager is necessary to manage the exposures in the portfolio.

The case of market cap bias brings to light a larger issue in portfolio construction, namely where to take risk. To generate alpha, a

portfolio must be different from the broad market. This creates risk, but not all risks are created equal. Some, like risk from idiosyncratic stock selection by a skilled manager, are more likely to generate alpha. Others, like a persistent bias away from large stocks, are not. Knowing the difference between these two types of risks and adjusting the portfolio accordingly can make a dramatic difference in performance.

The idea is to take risk where you are likely to get paid and minimize the unproductive risks. This requires detailed data on the holdings of the individual managers and a robust risk management system. Relying on the manager's chosen benchmark to estimate the overall exposures of their portfolio is not sufficient. For example, we have seen some very talented managers who run U.S. strategies hold a significant percentage of their portfolio in Europe at certain times. Although these managers have skill in stock picking, it is unlikely that they have an edge in the top-down decision of Europe vs the U.S. including issues like the currency, macroeconomics, and so on. As a result, when we see this, we will shift other investments in our portfolio from non-U.S. to U.S. stocks to offset the change in geographic exposure. This keeps the risk we want, namely the individual stocks held by the manager in Europe, but eliminates the risk from shifting from the U.S. to Europe, which is not likely to add value.

On the other hand, for the "good" risks, primarily stock selection, it often makes sense to lean into the risk. This may involve investing in strategies that use leverage. We have seen some attractive portable alpha strategies that have relatively low net exposure to factors or industries but high stock selection risk coming from leverage rather than concentration.⁹ When paired with solid portfolio construction and risk management, adding leveraged strategies is a way to amplify manager skill for a portion of an equity portfolio. The point here is that the goal of portfolio construction is not to limit risk. Rather the goal is to take risk where the investor will benefit most.

⁹ By employing leverage, these managers boost the tracking error and risk of their portfolios and increase the magnitude of their alpha. This group of levered managers will tend to have a larger ω than the broader universe of managers.

Conclusion

Successful active equity investing rests on two pillars: manager selection and portfolio construction. The first requires a sustained focus on identifying excellent managers and an examination of each step in the investment process to improve the probability of success. This includes being realistic about what an investment team can achieve and equally realistic about where it does not have an edge. The second pillar, portfolio construction, should then be used to focus exposures on the areas where the allocator has the greatest confidence that it will be rewarded.

We don't believe that today's market environment is less favorable for alpha generation than those of the past. In some respects, it may be more favorable. High volatility and dispersion across individual stocks in the current market creates opportunities for skilled active managers. In addition, the growing amount of capital devoted to short-term and trading-oriented strategies may create opportunities for investors who take a longer-term perspective.

Public equity markets will remain competitive, and alpha will never be easy to generate. Success in active investing has never been easy, but for a skilled investor it is as good now as it has ever been.

Appendix 1: Regression Summary

EXHIBIT 5: REGRESSION STATISTICS

Source: Strategic.

Regression Statistics	
Metric	Value
Multiple R	0.67
R Square	0.45
Adjusted R Square	0.43
Standard Error	0.0025
Observations	120

Factor	Coefficients	Standard Error	t Stat
Intercept	0.00026	0.00024	1.09
MKT	(0.017)	0.0057	(2.96)**
SMB	0.051	0.0102	5.00**
HML	(0.021)	0.0086	(2.45)*
Top 10	(0.075)	0.0116	(6.48)**

* Statistically significant at 95% confidence level

** Statistically significant at 99% confidence level

The regression measures the average monthly excess return vs a manager's chosen benchmark for a universe of 2,238 products against four factors over Jan 2016 – Dec 2025.

It includes all funds in eVestment with a large-cap US benchmark including inactive products with these characteristics: a minimum AUM of \$50 mill, a minimum number of 36 months of return, and a minimum tracking error of 1% (to eliminate passive and index enhanced products).

Appendix 2: Correlation of Factor Returns

EXHIBIT 6: CORRELATION OF FACTOR RETURNS

Source: Strategic.

Correlation of Factor Returns			
	Mkt	SMB	HML
SMB	0.42	-	-
HML	0.05	0.14	-
Top 10	0.14	(0.12)	(0.66)

Disclaimer

The research/white paper is for informational purposes only and is not intended as investment advice or an offer or solicitation for the purchase or sale of any financial instrument. This research paper represents the current best thinking of Strategic as of the date of publication. It is not a guarantee that the views expressed are correct, will result in any particular level of performance, or that Strategic will act in accordance with these views in any given situation. The views and strategies described herein may not be suitable for all investors. Prior to making any investment or financial decisions, any recipients of this material should seek individualized advice from their personal financial, legal, tax, and other professional advisors that takes into account all of the particular facts and circumstances of their situation. Predictions, opinions, and other information contained in this material are subject to change. Actual results could differ materially from those anticipated. All investments involve risk, and investment recommendations will not always be profitable. Strategic does not guarantee any minimum level of investment performance or the success of any investment strategy.

Page intentionally left blank.

Page intentionally left blank.

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., venture capital/private equity, real estate, and/or hedge funds) or international investments, or manage strategies with high potential for adding value. Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

For more information, please email us at inquiries@strategicgroup.com.



1001 Nineteenth Street North
16th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com