**Fake alpha or Heads I win, Tails you lose.**

Banks have recently been acknowledging enormous losses, yet those losses are barely reflected in employee compensation. For instance, Morgan Stanley recently announced a $9.4 billion charge-off in the 4th quarter, and at the same time increased its bonus pool by 18 percent. The justification was that many employees had a banner year, and their compensation should not be held hostage to mistakes that were made in the sub-prime market. CEO John Mack, however, assumed some responsibility and agreed to take no bonus this year -- though he got a $40 million payout last year. Most readers would suspect something is not right here. Indeed, compensation practices in the financial sector are deeply flawed, and probably contributed to the ongoing crisis. Here is why.

The typical manager of financial assets generates returns based on the systematic risk he takes – the so called beta risk – and the value his abilities contribute to the investment process – his so called alpha. Shareholders in asset management firms, such as commercial banks, investment banks, private equity, or insurance companies, are unlikely to pay the manager much for returns from beta risk – for example, if the shareholder wants exposure to large traded U.S. stocks, she can get the returns associated with that risk simply by investing in the Vanguard S&P 500 index fund, for which she pays a fraction of a percent in fees. What the shareholder will really pay for is if the manager beats the S&P 500 index regularly, that is, generates excess returns while not taking more risk. Hence pay for alpha.

In reality, there are only a few sources of alpha for investment managers. One comes from having truly special abilities in identifying undervalued financial assets – Warren Buffet, the US billionaire investor, certainly has this, but special ability is by definition rare. A second source of
alpha is from what one might call activism. This means using financial resources to create, or obtain control over, real assets and to use that control to change the payout obtained on the financial investment. A venture capitalist who transforms an inventor, a garage, and an idea into a full fledged profitable and professionally managed corporation creates alpha. A third source of alpha is financial entrepreneurship or engineering – creating securities or cash flow streams that appeal to particular investors or tastes. So long as the investment manager does not create securities to exploit investor weaknesses or ignorance (and there is unfortunately too much of that), this sort of alpha is also beneficial, but it requires constant innovation.

Alpha is quite hard to generate since most ways of doing so depend on the investment manager possessing unique abilities – to pick stock, identify weaknesses in management and remedy them, or undertake financial innovation. Unique ability is rare. How then can untalented investment managers justify their pay? Unfortunately, all too often it is by creating fake alpha – appearing to create excess returns but actually taking on hidden tail risk.

For instance, an investment manager who bought AAA rated tranche of CDOs in the past got a return of 50 to 60 basis points more than a similar AAA rated corporate bond. That “excess” return was actually compensation for the “tail” risk the CDO would default, no doubt perceived as small when the housing market was rollicking along, but not zero. If all the manager disclosed was the high rating of his investment portfolio, he would have looked like a genius, making money without additional risk, even more so if he multiplied his “excess” return through leverage. Similarly, the management of Northern Rock followed the oldest strategy in the book of taking on tail risk, borrowing short and lending long, and praying that the unlikely event of a liquidity shortage in financial markets never materialized. All these strategies essentially earn the manager a premium
in normal times for taking on beta risk that materializes only infrequently. These premiums are not alpha since they will be wiped out when the risk eventually materializes!

   True alpha can only be measured in the long run and with the benefit of hindsight – in the same way as the acumen of someone writing earthquake insurance can only be measured over a period long enough for earthquakes to have occurred. Compensation structures that reward managers annually for profits, but do not claw these rewards back when losses materialize, encourage the creation of fake alpha. Significant portions of compensation should be held in escrow, to be paid only long after the activities that generated that compensation occur.

   The managers that blew a big hole in Morgan Stanley’s balance sheet this year probably earned enormous bonuses in the past – John Mack certainly did. If Morgan Stanley did its compensation right, those bonuses should be clawed back, and should be more than enough to pay those who did well this year without increasing the bonus pool. At the very least, shareholders deserve better explanation. More generally, unless we fix incentives in the financial system, we will get more risk than we bargain for. And the enormous pay of financial sector managers, which has hitherto been thought of as just reward for performance, will deservedly come under scrutiny.

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