JENSEN'S ALPHA

THE EQUITY COMPASS | EDITION 12

Understand whether a fund generated returns beyond what would normally be expected for the level of market risk taken.

Imagine two cyclists participating in the same race.

Both complete the race in the same time.

However, one cyclist rode on a smooth road, while the other rode through steep climbs and difficult terrain. Although both achieved a similar outcome, the second cyclist performed better after considering the difficulty of the route.

***Jensen's Alpha** follows a similar idea. It helps investors understand whether a fund manager generated returns beyond what would normally be expected for the amount of **market risk** taken.*

Jensen's Alpha is one of the most widely used performance measures in equity investing. It helps evaluate a fund manager's ability to generate **excess returns after adjusting for market risk** and is commonly used to assess actively managed mutual funds.

WHAT IS MARKET RISK?

Market risk refers to the possibility that the value of investments may rise or fall because of movements in the overall market.

Even fundamentally strong companies can experience price fluctuations due to broader economic events, interest rate changes, geopolitical developments, or changes in investor sentiment.

A portfolio with higher exposure to market movements is generally expected to earn higher returns over the long term, but it also carries **higher risk.**

Formula :- Market Risk ≈ Beta

Example :- If the overall market rises by **10%** and a stock with a **Beta of 1.2** rises by around **12%,** the stock is more sensitive to market movements than the overall market.

WHAT IS JENSEN'S ALPHA?

Jensen's Alpha measures the difference between a portfolio's **actual return** and the return that would be expected based on the amount of **market risk (Beta)** taken.

In simple terms, it helps answer an important question:
Did the fund manager generate additional returns beyond what the market would normally have delivered for the level of risk taken?

FORMULA :- Jensen's Alpha = Actual Portfolio Return – Expected Portfolio Return where,
Expected Portfolio Return = Risk-free Rate + Beta × (Market Return – Risk-free Rate)

Example :- Risk-free Rate = 6% | Market Return = 16% | Portfolio Beta = 1.0

Expected Return = 6% + 1.0 × (16% – 6%) = 16% If the fund actually generated 18%, then:

Jensen's Alpha = 18% – 16% = +2%

This means the fund generated **2% additional return above what was expected for the level of market risk taken.**

MUTUAL FUND
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WHAT DOES JENSEN'S ALPHA TELLS US?

JENSEN'S ALPHA	WHAT IT MAY SUGGEST
Positive Alpha	The portfolio generated returns **higher than expected** after adjusting for market risk.
Zero Alpha	The portfolio generated returns **in line with expectations** for its level of market risk.
Negative Alpha	The portfolio generated **lower returns than expected** for the amount of market risk taken.

JENSEN'S ALPHA IN MUTUAL FUNDS

- A mutual fund's performance is influenced by both **market movements** and the **investment decisions made by the fund manager.**
- Jensen's Alpha helps separate these two effects by comparing the fund's actual return with the expected return for its level of market risk.
- A fund with a consistently **positive Jensen's Alpha** may indicate that the fund manager has been able to **add value through active management.**

Example :

*If two funds have similar **market risk (Beta),** but one consistently delivers a **higher positive Jensen's Alpha,** it may suggest relatively **better risk-adjusted performance.***

*However, **Jensen's Alpha** should always be evaluated along with other measures such as **Beta, Sharpe Ratio, Information Ratio, investment style, market conditions, and consistency of performance.** On its own, it does not provide a complete picture.*

IMPORTANT POINTS :

- **Jensen's Alpha is based on historical performance** and should not be interpreted as an indicator of future returns.
- A positive Alpha in one period does not guarantee consistent outperformance in the future.
- The measure is most useful when **comparing funds with similar investment objectives and market exposure.**
- Jensen's Alpha should always be **interpreted alongside other risk and performance measures.**

> ***Jensen's Alpha helps investors understand whether a fund manager generated returns through investment decisions beyond what would normally be expected for the level of market risk taken.***