Alpha Generating Strategies: A Consideration

By Ben Warwick

Investment pros have tried numerous methods to protect their clients against the occasionally vicious whims of market volatility. They all lead to one rather unconventional conclusion: Hedge funds and other alternative investments are better suited to generate exceptional returns than their more traditional mutual fund progenitors.

Having trouble adding value to the investment process? Take heart. Even Smokey Bear had his problems.

In 1942, Americans were in the midst of the largest world war in history. Many were fearful that an enemy of the United States would attempt to burn down the nation’s woodlands, an act of terrorism that would have done considerable damage to the war effort. In response to this threat, the War Advertising Council heavily promoted fire prevention in the nation’s forests. Even naturally occurring fires were to be extinguished “by 10 o’clock the following morning.”

The advertising campaign took on a face in 1945, when a black bear cub was rescued from a fire at the Lincoln National Forest in Capitan, New Mexico. Later dubbed Smokey, the animal became the symbol for fire safety and prevention.

There was only one problem with the campaign: No one seemed cognizant that fire is a natural part of the ecological cycle.

That all changed in 1998, a year that witnessed the greatest drought in nearly a century. Catalyzed by the accumulation of five decades of excess underbrush, pine needles, and other organic material that make up a forest’s “fuel load,” fires devastated millions of acres of forest and timberland.
The Forest Service suddenly became infatuated with the idea of prescribed burns. What a great way to preserve the nation’s natural places for future generations! All that was necessary were a few controlled fires, and the woods would once again be safe for all to enjoy.

There was only one problem with this new approach: Land management policies, based on commercial logging and cattle grazing, removed surrounding prairie grasses. Such grasses encourage moderate fires that tend to burn out quickly. As a result, prescribed burns were hotter, deadlier, and spread much faster than anyone had anticipated. All of a sudden, the term “controlled fire” took on less and less meaning.

Take the Cerro Grande Fire, for example, which was started at Bandelier National Monument on May 4, 2000. It was supposed to burn 968 acres but was fanned by winds of 50 miles per hour in drought conditions. It burned more than 47,000 acres and engulfed 235 homes. About 25,000 people were forced to evacuate.

**THE ULTIMATE INVESTMENT**

The current state of investment management has a lot more in common with the prescribed burns than most professionals would care to admit. In an effort to curtail naturally occurring disasters, such as the 1998 Russian ruble-inspired stock market meltdown or the equally vicious Nasdaq carnage of late 2000, investment pros have tried numerous methods of protecting their clients against the occasionally vicious whims of market volatility. Much like the Forest Service, it remains questionable whether these attempts have resulted in any positive consequences.

Sadly, investment managers have been as unsuccessful in adding value during bull markets as they had during bear market periods. As a result, actively managed funds have become increasingly correlated to passive indices. What solutions are available to those truly committed to producing excellent risk-adjusted returns?

The purpose of this chapter is to describe the components necessary to build an actively managed fund capable of generating consistent, market-beating returns. In this context, the term “market beating” is defined in two ways:

1. A return in excess of a broad representation of the U.S. equity market.
2. A return on par with the U.S. stock market but achieved with less volatility.

The previous requirements assume that the fund is considered in lieu of an investment in the stock market. If the fund is to be used as a diversifier in a traditional portfolio, it must be non-correlated with the return of either
the stock or bond market. The fund should also generate an absolute return that is large enough to keep from dragging down the performance of the overall portfolio.

As we shall see, the requirements for building such a fund are vexing. Factors at the root of this difficulty include dealing with the issue of idea generation, the problems of asset size versus performance, and the question of determining which parts of the investment landscape are best suited for that most illusive of quarry—tradable market inefficiencies.

This exercise will lead us to a rather unconventional conclusion: Hedge funds and other alternative investments are better suited to generate exceptional returns than their more traditional mutual fund progenitors.

A DUBIOUS TRACK RECORD

Financial gurus have a term for adding value to the investment process: alpha (\(\alpha\)). If the underlying market gains 10 percent for the year and an active manager is able to generate a 12 percent return, the alpha is +2 percent. This example is much more the exception than the rule: Over the last decade, there has been only one year when more than 25 percent of actively managed mutual funds beat the S&P 500 Index.

Of course, this period coincided with the most spectacular bull market in history—a point not missed by proponents of active management. Fans of the approach claim that it is during periods of tumult that investment pros add the most value, perhaps by holding a larger cash position or avoiding certain stocks that have such deteriorating fundamentals that the only direction possible for their stock’s price is south.

The year 1998 was the perfect year for evaluating the promise of active management to produce attractive returns during periods of declining stock prices and increased market volatility. Instead of the broad market advances that made indexed funds the investment of choice in the last decade, 1998 proved to be a year in which a select handful of stocks performed spectacularly enough to take the market indices to new highs. According to Morgan Stanley equity analyst Leah Modigliani, 14 companies accounted for 99 percent of the S&P 500 Index’s returns for the first three-quarters of the year. Moreover, just a handful of stocks made up the gains in the S&P in the fourth quarter of 1998, and two stocks alone—high-fliers Microsoft and Dell Computer—produced one-third of the year’s gains.

Thus, 1998 should have been a stock picker’s dream—an environment where a portfolio consisting of a selected few issues would have trounced the returns of the overall market. So how did active managers fare?
Unfortunately for the throngs of individuals invested in such funds, 1998 will be remembered as one of the worst years for actively managed mutual funds in history. One-third of all actively managed domestic equity funds trailed the S&P 500 Index by 10 percentage points or more, and one-third of them actually lost money—a seemingly impossible result in a year when the index gained nearly 29 percent. The recent carnage was far more severe than the industry experienced in 1990, when the S&P 500 Index lost 3.12 percent (the average fund lost 5.90 percent), and in 1994, when the S&P 500 Index was essentially flat (and nearly one-third of funds beat the index).

Still, investment managers seem to be obsessed with beating the market, even though they often end up defeating themselves in the process. As we shall see, the problem is more with the latter than with the former.

**FULLY REFLECTED**

Investment managers use a variety of methods in their attempt to generate outsized returns. The most common method is the use of company fundamentals in discerning the fair value of a firm. This style of investing was inaugurated in 1934, when the landmark text *Security Analysis*, by Benjamin Graham and David Dodd, was published. According to this text, securities that trade below their fair value can be purchased and later sold for a profit as prices are eventually corrected by the marketplace to reflect a company’s true financial performance.

Like many great ideas, fundamental analysis is much easier to perform on paper than it is in the real world. This is partly due to the large herd of investment professionals who use the method to manage billions of dollars in client assets. The resulting plethora of suspender-clad fund pros chasing the few incorrectly priced stocks that boast enough trading volume to buy and sell in large chunks makes a difficult game nearly impossible to win.

This simple fact has not stopped the throngs of Ivy League MBAs from trying. There are some winners, but so few have generated consistently outstanding results that the term “random walk” starts to rear its ugly head.

Curiously, the group most enamored with fundamental analysis is its biggest customer. Institutional investors seem absolutely giddy about discussing various fundamentally-based methodologies with investment management candidates. Yet, it seems that this fundamental fetish shared by many big-time consumers of investment advice is a response to the bad reputation of the other school of investment philosophy: technical analysis.

Market technicians believe that all of the information necessary to make a valid buy or sell decision is contained in the price of the security in ques-
tion. As a result, an examination of sales growth, profit margins, or other company-specific metrics is deemed to be unnecessary for predicting stock price movement. A cursory examination of price trends, trading volume, and other market indicators is all that is necessary, proponents of the approach argue.

Even though security prices have an occasional tendency to move in trends, the financial witchcraft associated with technical analysis is anathema to the gatekeepers of pension assets and other sizable pools of money. *Perhaps my investment manager is not keeping up with the market indices, these investors seem to be thinking, but at least they are not reading price charts.*

Fortunately for technicians, there is about as much academic evidence supporting the use of price charts as there is touting the scrutiny of a firm’s financial statements. Unfortunately, this evidence amounts to a molehill compared to the mountains of data that suggest the market-beating potential of human intervention in the capital markets—regardless of the approach used—is close to nil.

**A COSTLY CONUNDRUM**

Traditional active management essentially relies on in-depth research to supply insights that are good enough to overcome the tenacious efficiency of the capital markets. When one examines just how good his or her forecasting ability must be, the difficulty in generating market-beating returns takes on a particularly astringent taste.

Figure 1.1 plots the combination of accuracy (depth) and repetition (breadth) that is required to generate an exceptional level of investment performance. As shown on the extreme left portion of the curve, one could become a market beater by being “bang on” just a few times per year. Market calls, such as “Buy IBM today” or “Sell Amazon now,” are nearly impossible to repeat without making a few gaffs.

On the flip side, one could make a large number of prescient but less accurate predictions. Note that the depth requirement dips dramatically as the number of useful insights approaches 100. The curve only begins to flatten out as the number of good ideas passes 400.

A natural conclusion after examining Figure 1.1 would be to hire a mass of analysts. After all, how can one generate such a large number of investable ideas without a cadre of highly trained professionals?

Judging by the vast increase in hiring by securities firms, this line of thinking is hardly original. MBA graduates keen on maximizing their after-tax net worth have honed in on the trend; as a result, first-year associates
often make $150,000 on Wall Street. After three years, the figure rises to $400,000.

The numbers become even more staggering for experienced players. Analysts who reach *Institutional Investor* magazine’s coveted "first-team" status typically earn $2 million to $5 million annually. The next lower tier is paid about $1 million per year. Veteran telecommunications analyst Jack Grubman became the first of his ilk to achieve pop-star status when he signed a one-year, $25 million package with Salomon Smith Barney.

Some forward-thinking firms with the need to decrease their per-thought costs have sequestered at least part of their decision-making needs to computers. Quantitative models are excellent at sifting through mountains of economic and company-specific data, of course, but human intervention (in the form of programmers) is necessary to make this possible. The investment managers who have employed computers as number crunchers always filter the machine’s output with a human’s. As a result, computers have minimized—but not completely eliminated—the cost problems associated with generating the next great investing idea.

In addition to the obvious quantity/quality issues, another problem with producing high-quality investment ideas is the level of costs incurred in their implementation.

Much has been written about the decreasing levy charged by brokerage firms in the past few years, which has served to vastly increase the vol-
volume of trading on domestic exchanges. However, it is the other costs associated with buying and selling securities that is most troubling among market professionals.

One of the most egregious is market impact, which is defined as the difference between the execution price and the posted price for a stock. Market impact can be substantial and is often quite large at the worst possible moment. For example, after the release of a negative earnings report, a company’s stock can be quoted “49–50” ($49 per share to sell; $50 per share to buy) by a specialist on the floor of the New York Stock Exchange. If the portfolio manager for a large fund wants to sell a large block of this stock—say, 100,000 shares—the bid/ask spread might widen to “47–50” ($47 per share to sell; $50 per share to buy). In fact, the spread could widen so much that the manager may decide that, based solely on market impact, the trade is simply not economically feasible. Managers are thus forced to hold a position they do not want, which prevents them from using the cash gained from the transaction to buy a stock they do want to own. The profit potential lost from the manager’s not owning the stock of choice can be equally onerous and is commonly referred to as opportunity cost.

According to Charles Ellis, author of the classic tome Investment Policy, active managers would have to be correct, on average, more than 80 percent of the time to make up for the implementation costs incurred in active trading. Unless market pros can get a grip on the onerous effects of such costs, the odds of generating market-beating returns appear quite slim.

This one fact explains why so many investment managers are called to greatness . . . and why so few are chosen.

THE REAL PROBLEM

Unfortunately, there are few ways for investment managers to minimize transaction costs. The most effective solution—limiting the amount of client assets that they are willing to accept—seems an abomination to many. However, by directing a relatively modest-sized portfolio, there is no doubt that advisors are able to implement their market strategies in a more effective manner.

Investment firms are barking up the right tree when they obsess about minimizing their transaction costs. The term that best captures their inherent desires is “economic rent,” which was developed by one of the founders of the Classical School of Economics, David Ricardo (1772–1823). According to him,
Economic rent on land is the value of the difference in productivity between a given piece of land and the poorest, most costly piece of land producing the same goods under the same conditions.

According to Ricardo’s thinking, rational agents would naturally seek to maximize the economic rents derived from their trading activities. If managers think that they have truly found a way to generate market-beating returns—be it through fundamental analysis, technical analysis, or a combination of the two—the trick is to maximize their fee revenue per unit of client assets under management.

This solution can take many forms. Some market pros may want to manage a much larger pool of client monies. In this view, managers assume that their revenue (which would consist solely of an asset-based fee in this model) is as dependent on their marketing acumen as it is on their breadth of market knowledge.

Managers with a bit more ingenuity might decide to cap the amount of client assets they are willing to oversee. In return, they demand higher fees per dollar under advisement. This usually takes the form of a performance fee, which enables managers to profit from the success of their trading activities.

This latter course of action is commonly packaged in an unregulated pool of client assets referred to as a hedge fund. Such vehicles have the additional advantage of giving managers the freedom to express themselves in any way they deem most prudent in the capital markets. This lack of regulatory constraint is lauded by some and derided by others.

It should be noted that the hedge fund alternative is only rational if the investment pro is truly generating positive alpha. Unfortunately, a plethora of non-rational money managers have decided on this approach.

It seems that David Ricardo tilled the soil of his intellect quite well indeed. He left school at the tender age of 14 to pursue his career as a speculator. By his mid-20s, he had amassed a fortune on the stock market. He retired from business at the age of 42 and spent the remainder of his life as a member of Parliament.

Ricardo’s other great contribution to economics is the law of comparative cost, which demonstrated the benefits of international specialization in international trade. This law became the foundation of the free-trade movement, which set Great Britain on the course of exporting manufactured goods and importing raw materials.

As we will see, this idea forms another important topic for alpha-producing investment managers—whether to specialize in a given style or sector of the market or branch out to include other strategies.
THE DANGERS OF CONCENTRATION

Let us assume that a savvy, intelligent market professional has engineered a way to extract a sizeable amount of alpha from the securities markets. How will this talented manager’s future be affected by frequent appearances on Louis Rukeyser’s *Wall Street Week* and the ever-increasing throngs looking to replicate the manager’s success?

Andrew Lo and A. Craig Mackinlay put a unique spin on this issue in their book, *A Non-Random Walk Down Wall Street*. When they began examining stock price changes in 1985, they were shocked to find a substantial degree of auto-correlative behavior—evidence that previous price changes could have been used to forecast changes in the next period. Their findings were sufficiently overwhelming to refute the Random Walk Hypothesis, which states that asset price changes are totally unpredictable.

The most important insight from their work occurred when they repeated the study 11 years later, using prices from 1986 to 1996. In stark contrast to their earlier finding, the newer data conformed more closely with the random walk model than the original sample period. Upon further investigation, they learned that over the past decade several investment firms—most notably, Morgan Stanley and D.E. Shaw—were engaged in a type of stock trading specifically designed to take advantage of the kinds of patterns uncovered in their earlier study. Known at the time as “pairs trading”—and now referred to as statistical arbitrage—these strategies fared quite well until recently but are now regarded as a very competitive and thin-margin business because of the proliferation of hedge funds engaged in this type of market activity. In their Ricardan view, Lo and Mackinlay believe that the profits earned by the early statistical arbitrageurs can be viewed as “economic rents” that accrued via their innovation, creativity, and risk tolerance.

David Shaw, a former computer science professor cum investment manager, reported similar market exploits. When he founded D.E. Shaw and Company in the early 1980s, a number of easily identifiable market inefficiencies could be exploited. According to him, increased competition caused many strategies to disappear. However, as an early adopter, he was able to use the profits earned from this prior trading to subsidize the costly research required to find more market eccentricities.

There lies the rub. Specialists who limit themselves to one particular market anomaly may soon find themselves out of a job if they do their job correctly in the first place—that is, if they mine a market inefficiency to its extinction. It is much better to use profits from such a discovery to underwrite further financial expeditions in other areas of the investment universe.
Of course, some of the holes in market efficiency are deeper than others. One such grotto may be the universe of small cap stocks. Wall Street analysts generally do not follow many stocks that are significantly below $1 billion in market capitalization, probably because the opportunities for brokerages to earn significant investment banking revenues from such tiny firms is so low. As a result, an opportunity appears for savvy buy-side analysts to pick the next diamond in the rough.

Some evidence supports this view, as nearly one-half of all small-cap domestic mutual funds have exceeded the return of the Russell 2000 Index over the last five years. Perhaps this is one rip in the efficient market veil that will take a while to mend.

**A QUESTION OF AGENCY COSTS**

Much has been said in the popular press regarding the performance of buy recommendations from the major brokerage firms. The failure of analysts to keep up with the major market indices has been widely explained by the conflicts of interests inherent in such an environment.

Many believe that the dramatic underperformance of analyst recommendations is due to the conflicts of interest that arise when the Wall Street firms act as investment bankers to the companies their analysts cover. That certainly explains part of the problem; another issue less commonly raised is the tendency for analysts to act in herd-like fashion, recommending one stock in near unison. The thinking that perpetuates such actions is simple: A mistake, even a serious one, will only injure one’s career if your peers at other firms disagreed with you and made the right call.

That same thinking is rife in the investment management business. Job security is preserved if the returns of mutual funds are sufficiently close to the market indices and tightly clustered so that mistakes cannot be easily discerned.

I believe that these behavioral biases explain why traditional mutual funds with asset-based fees have produced mediocre results over the years. Simply put, the managers of these funds are not motivated to generate the best possible return; they are paid to follow the indices and not rock the boat.

As Ricardan thinkers, alternative investment managers have an entirely different view of their role in the investment process. Hedge fund managers are a good example. Hedge fund fees encourage exceptional performance, while the commonly high amount of manager investment in the fund serves as a stopgap measure against excessive speculation. A further incentive to performance is the widespread practice of limiting the amount of funds under management.
Alternative investment strategies aren’t perfect, of course. Transparency issues, liquidity issues, and the tendency of convergence strategies to correlate highly during tumultuous market periods are all important topics worthy of discussion. However, in our experience, they fulfill an important objective in client portfolios—the generation of market-beating returns.