Are You The Source Of Alpha For Your Competitors' Portfolios?

Surprise! An investor's ability to make superior forecasts is not enough, if their portfolio is to deliver positive alpha.

"Most portfolio decision makers should go out of business – take up plumbing, teach Greek or help produce the annual GNP by serving as corporate executives." This was the opinion of Paul Samuelson back in 1974. The debate around the value provided by active management is not new and will most probably continue to rage in various guises over time. It has become even more vigorous in today's low-return environment, where the growth in portfolio market values is not enough to soften the impact of portfolio management fees. What often goes unsaid during these debates is the impact that poor benchmark design and inappropriate risk budgeting has on the performance of active managers.

Modern portfolio theory states that, in the long run, investors should expect to be rewarded for taking on more market risk. For example, in the long run investors should expect a higher return (risk premium) for investing in equities and not cash. Unfortunately, the same relationship does not hold when it comes to active risk. Active risk is the process of building an investment portfolio where the weights of the individual securities are different from the market.

Disconcertingly, investors will not always be rewarded for taking on active risk in their portfolios. Failure to bear this in mind when investing can lead to value destruction and ultimately investment portfolios that fund the positive alpha of the more discerning investors.

Our belief is that active management should exist. Markets are inefficient and often provide opportunities for skilled investors to generate benchmark-beating returns (alpha). However, market inefficiency in itself is not a sufficient enough condition for investors to generate alpha. The fundamental law of active management described by Clarke, de Silva and Thorley (2002), states two conditions that need to be met if investors' active portfolios are to generate positive alpha:

1. Investors must have good skills at forecasting.
2. Investors must have the opportunity to express their forecasts and views efficiently.

Market practitioners often focus on the first requirement and many a story has been told about how superior research skills uncovered hidden gems that subsequently delivered great returns. But very little mention is made of the second requirement.

As far back as 1977, Keith Ambachtsheer noted that even though most fund managers have good levels of predictive ability, this skill does not show up in the

NDINAVHUSHAVHELO RABALI
Chief Investment Officer
MSc Financial Mathematics (cum laude)
ndina.rabali@limambeu.co.za

TEBOHO TSOTETSI
Portfolio Manager
MSc Quantitative Risk Management
teboho.tsotetsi@limambeu.co.za

BHEKINKOSI KHUZWAYO
Portfolio Manager
MCom Statistics (cum laude)
bhekinkosi.khuzwayo@limambeu.co.za

LimaMbeu

performance of their portfolios because of a translation problem. This means that investors must take both requirements seriously if they are to build active portfolios that deliver alpha. Fortunately for us, we are not going to make a judgement on the general ability of investors to forecast, but we will focus on the often-ignored issue of how effectively investors translate their views into portfolios. There are two elements that limit investors' ability to translate their views efficiently through the implementation of a benchmark cognisant investment portfolio:

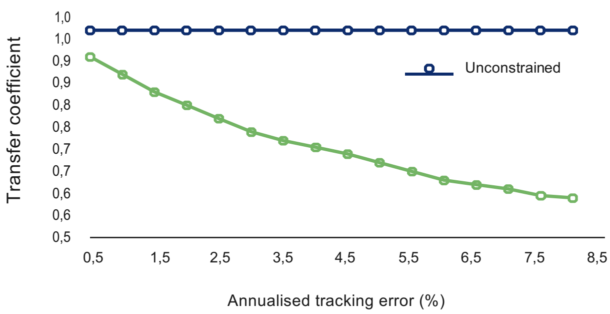
1. The long-only constraint
2. Benchmark concentration

Long only investors need to be extremely careful when building investment portfolios because the 'long-only' constraint is an impediment to how effectively they can translate their forecast skill into an alpha-generating portfolio.

For example, if a long only investor is extremely negative on a stock, the most they can do to express this view is to hold 0% of that stock in their portfolio. Investors without the long-only constraint can express this negative view more efficiently by taking a short position. This creates the following very powerful relationship for active long-only investors: the more risk they take in their portfolios, the less efficient the implementation of their views becomes. Exhibit 1 shows that the transfer coefficient for a long-only investor (the ability to translate forecasts into an investment portfolio) decreases rapidly as more active risk is taken. In this case, we measure active risk through the tracking error, which is simply a measure of how far an investment portfolio has deviated from its benchmark. For example, at a tracking error of 5%, the translation of forecasts into a portfolio is 30% less efficient (all else being equal).

On the other hand, investors that don't have to adhere to the long-only constraint, do not face such a conundrum. They can take on increasingly more risk in their portfolios without affecting the translation of their views. Long-only investors should always be mindful of this primary constraint and must take care to build investment portfolios that take appropriate levels of risk.

Exhibit 1: Transfer coeffecient versus active risk



Source: Cadiz, Simulation of transfer coefficients for the FTSE/JSE All Share Index

Benchmark concentration is the second culprit, that often leads to poor portfolio performance despite investors' good forecasting skills.

Highly concentrated benchmarks limit investors' abilities to translate their views into a benchmark-beating investment portfolio. This is an especially troublesome issue for investors in African markets where the equity market indices are much more concentrated compared to their global counterparts, as show in Exhibit 2. We used the Herfindahl-Hirschman Index (HHI) to measure benchmark concentration across different geographies. Investors into African equity markets should not be quick to take similar levels of active risk as their counterparts investing in developed markets.

Failure to understand the characteristics of a market benchmark and to adjust the risk-budget of a portfolio accordingly can lead to an investment portfolio's underperformance, despite good forecasting skill. Paul Samuelson once stated that the investment activities of unskilled investors only serve to suck economic resources out of useful GNP activities into broker solicitations and bookkeeping. In this case, we would agree, and investors in highly concentrated markets should take time and effort to evaluate the level of risk that is appropriate for a benchmark.

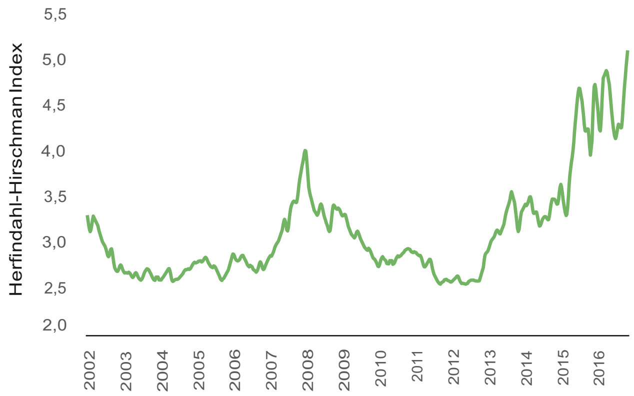
Exibit 2: Concentration levels for select markets

Country	Index	HHI
United States	iShares Russell 2000 Index Tracker	0,1
United States	iShares S&P500 Index Tracker	0,8
Eurozone	iShares Euro Stoxx 600 Index Tracker	0,9
China	Shanghai Shenzhen CSI 300 Index	1,1
United Kingdom	UK FTSE All Share	1,8
Japan	Japan Nikkei Index	1,9
South Africa	JSE Capped SWIX Index	2,7
Australia	iShares Australia S&P/ASX200 Index Tracker	2,8
Canada	iShares Canada S&P/TSX60 Index Tracker	3,5
United States	Dow Jones Industrial Average	4,4
Brazil	Ibovespa Brasil Sao Paulo Index	4,9
Germany	iShares German DAX Index Tracker	5,5
South Africa	JSE All Share Index	5,9
Botswana	Botswana Gaborone Domestic Index	7,7
South Africa	JSE Top40 Index	8,3
Tunisia	Tunisia TUNIndex	8,3
Morocco	Morocco MASI Free Float	8,8
Egypt	Egypt Hermes Index	8,8
Nigeria	Nigeria Stock Exchange	11,3
Namibia	FTSE Namibia Overall Index	13,5
Tanzania	Tanzania All Share	16,2
Kenya	Nairobi All Share Index	23,5

Source: Bloomberg, Lima Mbeu Research

Furthermore, the risk structure of markets often changes over time and investors must also keep abreast of these changes if they are to take rational investment decisions. The chart below provides an example of one such scenario. In 2016, Anheuser-Busch InBev acquired SABMiller leading to a dramatic increase in the concentration level of South Africa's FTSE/JSE Shareholder Weighted Index. Investors who had built their investment portfolios cognisant of this benchmark should have subsequently lowered their active risk to account for this change. Failure to do so would have led to investors receiving less 'bang for buck' with a heightened risk of underperformance despite no change in the level of their forecast skills. A regular, disciplined evaluation of the risk structure of the market will ensure that investors take active risk prudently, whilst minimizing the potential of accumulating wastage through costly research and trading activities.

Exhibit 3: Benchmark Concentration: FTSE/JSE SWIX



Source: Bloomberg, Lima Mbeu Research

In summary, we would caution that active management entails much more than just demonstrating good forecast skill. Investors need to be aware of how effectively they can translate this skill into investment portfolios. The fact that not many practitioners make mention of this makes us wonder whether Keith Ambachtsheer's observation (in 1977) is still relevant today. How many portfolios deliver poor performance, not because the fund manager lacks forecast skill, but simply because not enough effort has been made to understand the characteristics of the market?

Long-only investors into African markets that are much more concentrated than their global counterparts should consider the use of risk-controlled portfolios or portfolios that deliberately set out to balance the risk-reward relationship by considering the risk structure of the market. Investors with higher levels of risk appetite should consider the use of hedge funds, although this opens the door to other potential risks that need to be considered.

Ultimately, we should bear in mind that investing is a zero-sum game in the long run. Investors should leave no stone unturned in their quest to ensure that their portfolios are not the source of alpha for the more discerning investors.

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