The Never-Ending Pursuit of Manager Alpha

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As we have pointed out on many occasions, hiring an active manager to pick stocks on your behalf isn't the best idea.

It's true that some investors diligently study individual stocks. Meanwhile, others choose to handsomely pay active investment managers to deliver alpha — i.e., an additional return above that of a manager's appropriate benchmark.

But very few, if any, have provided evidence that they can generate alpha on a consistent basis.

Considering the amount of alpha in the world that is available for investors to capture is negligible (before costs) and negative (after costs), it is not difficult to understand why this is the case.

The dearth of alpha is borne out by numerous academic studies by luminaries such as Eugene Fama and Ken French. Nevertheless, hope springs eternal as evidenced by the thousands of actively managed mutual funds in existence today.

In order to determine whether or not a fund manager has reliably delivered alpha, a multivariable regression analysis of historical returns can be conducted. This analysis reveals the extent to which the returns could have been replicated with a combination of index funds as well as the value added or subtracted by the manager (i.e., alpha).

One very important quantity produced in the analysis is the t-statistic (or t-stat) of alpha, which provides a measure of the probability that the alpha could have occurred from chance alone.

In general, a positive alpha with a t-stat of 2 or greater indicates a 97.5% probability that the excess returns were statistically significant, indicating a manager's skill contributed to such results.

IFA has conducted its own study of more than 500 U.S. equity mutual funds with 20 years of returns data. We required that at least 90% of the fund holdings be in domestic equities and that the prospectus objective concur with the size/value style of the fund's holdings (to minimize the impact of style drift). The results are shown below:

Out of 544 mutual funds analyzed, only six (1.1%) had a t-stat greater than or equal to 2 (signifying skill at a 97.5% confidence level). But the significance of that alpha largely disappeared when a second type of test comparing the funds to their Morningstar analyst-assigned benchmarks was performed — showing an inconsistency of such results.

Although investors might be tempted to invest in one of these six funds, IFA cautions that the sheer number of managers virtually guarantees that there will be some who appear to have demonstrated true skill at any given time. Unfortunately, the number of such managers is no higher than what we would have if all of them were monkeys throwing darts at the Wall Street Journal.

We've reviewed many studies over the years that've elegantly addressed this point. In particular, two stand out to IFA's investment committee as still being highly relevant and instructive to our clients in terms of comprehensively addressing 'big picture' trends regarding alpha. These are:

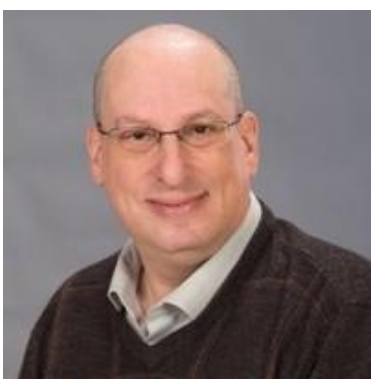
1. "False Discoveries in Mutual Fund Performance: Measuring Luck in Estimating Alphas" by Barras, Scaillet and Wermers, which was published in the Journal of Finance in February 2010. It evaluated 2,076 fund managers over 32 years and found that total observed alpha is consistent with the following breakdown of the population: 75.4% of the funds had a true alpha of zero after costs; and 24.0% had a true alpha that is negative. That left only 0.6% with a true positive alpha, a number that the authors noted were "statistically indistinguishable from zero."
2. "Luck versus Skill in the Cross Section of Mutual Fund Alpha Estimates" by Fama and French, which was published in the Journal of Finance in October 2010. It evaluated 819 actively managed funds over 22 years and found that 97% could not be expected to beat a risk-appropriate benchmark. Furthermore, there was no reliable way to identify the 3% in advance.

Anyone who is still convinced that reliable alpha can be easily found should carefully examine the chart below which plots the same actively managed funds for both the observed level of the alpha and the variability of the alpha. The two points labeled "AVG" show the averages of the funds with positive alpha and the funds with negative alpha. The positive alpha funds had an average alpha of 1.17% with a standard deviation of 7.20%. This means that we would need 151 years of returns to conclude the presence of skill at a 97.5% confidence level.

The myth of persistency in positive alpha has been debunked by the Standard and Poor's Persistence Scorecard. This ongoing research series biannually compares how consistently recent top-performers are able to keep producing winning records in subsequent years. It has found a consistent and overarching trend: namely, the number of managers remaining in the top half or quartile of their peer group over time is lower than what we would expect from chance alone.

To us, the conclusion of all of these studies is inescapable. As a result, we keep finding a wealth of evidence to tell us that investors' resources are far better spent focusing on the risk factors of market, size and value. Such research also informs our risk management team that asset allocation remains by far the most important determinant of future returns.

The pursuit of alpha has two essential problems: It is costly, and it may lead to missing out on the return associated with the risk factors of market, size and value, which still stand as the more reliable sources of returns. We invite investors who are ready to abandon the seemingly never-ending quest for alpha to take IFA's Risk Capacity Survey. This online tool is designed to methodically assess how much risk a person really needs to be exposed to in order to meet his or her long-term financial goals.



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