January 18, 2015

LOL Journal, Swallowing the Hard Truth: Alpha is Disappearing

The absence of LOL's over the past few weeks is explained by two things:

1. The holidays and my general laziness, which my wife calls a "good thing," ("My name is Jim, and I'm a recovering workaholic…")
2. A new white paper that FCG has been nurturing, now coming to fruition. The white paper is called, "Answering the Investment Challenge: Relevance through Compelling Value." Or something close to that. My partners will have a say in the final title.

Nevertheless, the point of the paper is that the investment landscape is changing. Casey Quirk did a nice piece called "Life After Benchmarks" which describes some of the changes and provides a model for responding to them. And, of course, Charley Ellis and many others have written about disappearing alpha.

In our work with traditional long-only equity managers, we are seeing potent examples of disappearing alpha. I spent time recently with three different managers who were once proud producers of alpha and are now in their third (or more) year of under-performance. More importantly, each of them—when pressed—admitted that they could not describe their current edge. That is, the piece of their philosophy that allows them to win. To create alpha. One of the managers seemed to never have had a real definable edge, the other two had one but lost it. For example, one manager relied heavily on earnings revisions as a tool for buying and selling stocks, but that no longer works for them. Their belief: the adaptive market (a la Andrew Lo) has arbitraged out those opportunities.

So, let's bring together two different concepts: 1) the idea of compelling value, meaning that investment managers will only thrive in the future if they deliver compelling value to their clients, with 2) the track records of the managers in question. All three managers have in common that they have under-performed for at least five years. Yes, that's right: five years. Picture the scene in your mind. We are having conversations about performance—how to improve it—and what changes might improve performance. We are looking at the track records for five years, all the products under-performing for this period of time. And with straight faces we're talking about the future of these products. Each of the firms in question has at least one successful product unrelated to the failing product(s). So, each can boast of some value-add. But NOT in the long only US equity space.

Here are my insights:

1. It is difficult to out-perform these days. Alpha is scarcer than hen's teeth.
2. The people on these investment teams are good people. Honest and well-intentioned, like you and me!
3. The power of denial is alive and well in the investment arena.

The fact is that clients of these firms would have been WAY better off investing in the S&P index fund at a passive fee rate than in paying an active fee for LESS return! So, now we arrive at "swallowing the hard truth." I want to thank my colleague Michael Falk for sharing this wonderful quote with me, because it is so accurate:

"It is difficult to get a man to understand something when his salary depends upon him not understanding it." --Upton Sinclair

So true. The conversations described above are becoming the most difficult ones that FCG has with active managers: when an investment manager has been under-performing for five years and has no answer to the question, "what will you do differently to out-perform in the future?" Isn't the honest and integrous response: "we cannot provide compelling value to our clients, so we should give them their money back." Ouch. That is a tough bite of the truth sandwich. In good conscience, managers should not simply hope that things will improve if they haven't taken significant steps to change their philosophy, process or execution. Right? After all, "hope is not a strategy."

So, what is the answer for the many traditional managers who are struggling to perform? Stay tuned for the new white paper I mentioned above, as FCG will put forth their best thinking on "remaining relevant" in the New Era. Obviously, the answer is "provide compelling value." But the insights on how to do it are not so obvious. More to come…

Stay curious,

JW