"99% of fund managers demonstrate no evidence of skill whatsoever."

— ***William Bernstein, "The Intelligent Asset Allocator"***

The Never-Ending Pursuit of Alpha

July 22, 2011 | by Jay D. Franklin

As we have pointed out on many occasions, both stock-picking and hiring an active manager to pick stocks on your behalf are mug's games. While some investors diligently study individual stocks and other investors handsomely pay active managers to deliver alpha (an additional return above and beyond what can be explained by exposure to risk), very few, if any, investors receive alpha on a consistent basis. Considering that the amount of alpha in the world that is available for capture is zero 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 nearly 7,000 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 can be 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 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-statistic greater than two indicates a 5% or lower probability that the excess returns are due to luck. IFA recently conducted its own study of 602 US equity mutual funds with

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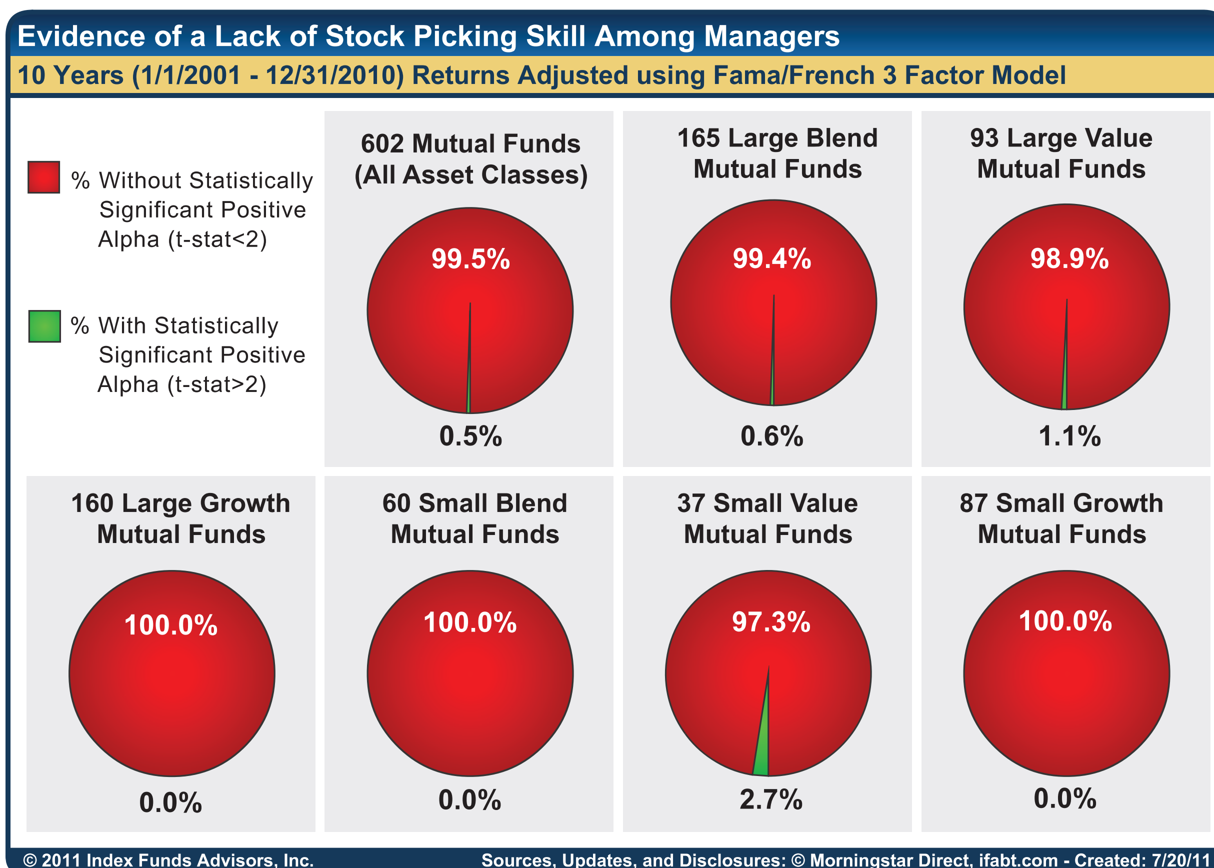
ten years of returns data. We required that at least 90% of the funds holdings be in US equities and that the prospectus objective concur with the size/value style of the fund's holdings (to minimize the impact of style drift). The results are shown below:



The fact that so few managers delivered positive alpha is explained by the high hurdle of their own expenses that must be overcome; this is especially difficult in a market that while perhaps not 100% efficient, is efficient enough that the expenditure of resources in an attempt to outperform the market is likely to exceed any increase in returns resulting from said expenditure. Although a few managers appeared to deliver alpha, IFA cautions investors that the fact that there are so many managers virtually guarantees that there will be some who appear to have demonstrated true skill. 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. Two studies that elegantly address this point are:

1. "False Discoveries in Mutual Fund Performance: Measuring Luck in Estimating Alphas" by Barras, Scaillet, and Wermers which evaluated 2,076 fund managers over 32 years and found that 99.4% of active fund managers showed no genuine stock-picking ability.

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2. “Luck versus Skill in the Cross Section of Mutual Fund Alpha Estimates” by Fama and French which evaluated 819 actively managed funds over 22 years and found that 97% could not be expected to beat a risk-appropriate benchmark.

The myth of persistency in positive alpha was completely debunked in the Standard and Poors Persistence Scorecard which showed that the number of managers who remain in the top half or quartile of their peer group is lower than what we would expect from chance alone. The conclusion of all of these studies is inescapable. Investors’ resources are far better spent in focusing on the risk factors of market, size, and value. Asset allocation remains by far the most important determinant of future returns. After determining a risk-appropriate asset allocation, the next important task is to control costs. 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 are the more reliable sources of returns.

It is IFA’s privilege to share this information with you. Each of our investment professionals welcomes the opportunity to assist you in your quest for risk-appropriate, low-cost returns. To learn more, please call 888-643-3133 or visit ifa.com.

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