Robots and Alpha

Is it disappearing?

Several months back we joined a call with colleagues who were interviewing Larry Fink, the CEO of Blackrock. Blackrock – already a very passive, ETF driven shop – had just announced that it was firing several prominent active fund managers, and that a more quantitative, passive, or systematic, manager (aka a robot) would replace them. On the call, Larry even said that most of Blackrock's remaining "active" managers would only be able to buy stocks that had been "pre-approved" by a black box, programmed (presumably) to filter on factors known to historically provide excess returns (e.g. value, quality, momentum, etc.).

This news from Blackrock is not unique. The trend from active to passive (or systematic) investing is now well-entrenched. Morningstar estimates that in the US in 2016, $340 billion flowed out of active management and $505 billion flowed into passive vehicles. When I worked at Fidelity, we were twice as big as Vanguard. Today, Vanguard is twice as big as Fidelity. So is Blackrock.[1]

So, what does this all mean for active stock picking?
Does the trend necessarily make things better or worse for the fundamentally active investor that holds-out and stays the course? The answer is not as obvious as you might think. Firstly, speaking as active stock pickers, we must acknowledge that our perspective may be biased. If my old professor Gene Fama read this defence of concentrated, active, fundamental stock picking, he surely might quote Upton Sinclair, who famously said "well, it is difficult to get a man to understand something when his salary depends on his not understanding it."

So we can only hope I understand it, as this "active vs passive" debate is important, and incredibly relevant to us and to our partners for whom we are stewards of capital. As we attempt to tackle the issue, we will attempt to be as objective as we can. Moreover, we believe it is easier for us to understand this by breaking it down into two issues. One is the generic trend from active toward passive investing and what impact it might have on opportunities for stock-pickers; while the other is the trend within systematic investing toward factor-based investing (branded as "smart beta", but we should really call "systematic active") and what that means for "unsystematic" value and quality investing in particular.

Passive Investing and Bill Sharpe
Professor William Sharpe showed us (over 25 years ago) active management is a zero sum game, and even that is before fees. In other words, for every dollar that wins, there is a dollar that loses, in relative terms. I apologize for repeating this again, but to be very clear, for every dollar that we make over a benchmark, someone else is losing a dollar.[2]

If money is flowing out of active into passive this doesn't change the realities of the equation. If all investors in the world were passive except for just two of us, each of whom had the same amount of capital invested actively in benchmark securities (say, one or more constituents of the S&P 500 or MSCI Europe or whatever benchmark we choose) – if one of us beats the benchmark by X dollars, then the other must lose by X. It's just math.[3] Professor Sharpe naturally concedes that "it is perfectly possible for some active managers to beat their passive brethren, even after costs" just as others may underperform. Unsurprisingly, we at Alpha Europe believe (see Upton Sinclair above) that it is at least possible to beat both our active and passive brethren not just once or randomly, but repeatedly and over time.

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[1] *And today, Fidelity's largest fund is not Contrafund or Magellan, but a S&P 500 index tracker.*

[2] *Moreover, when you consider that we active managers charge for our services, in aggregate, active management is a net loser.* *https://web.stanford.edu/~wfsharpe/art/active/active.htm*

[3] *That said, Lasse Pedersen at AQR has cast a little bit of doubt on this whole Sharpe view (because passive investors sometimes are forced sellers, or turn their portfolios over just like active investors, perhaps for exogenous reasons, creating a potential for active guys to generate positive alphas in the aggregate), but in general I'm happy to assume for now that the Sharpe framework holds.* *https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2849071*

If we end up being right about this, it will be probably be because our undiversified, idiosyncratic, capacity-constrained, best-ideas portfolio held securities where we discovered and processed information more expertly and objectively than our active and passive peers.

So if one believes, as we do, that it is at least possible for “smart money” to sustainably beat the “dumb money” this is very important as it relates to the active-to-passive trend. In other words, if some of the smart money is switching from active to passive, this *could* mean that the remaining smart money guys will have an easier time of it (and that even some of the dumb money can pull a *Flowers for Algernon* and become temporarily smart). However, if it is dumb money that is switching from active to passive, this could make it *harder* for the smart money to generate excess returns (Michael Mauboussin’s “Paradox of Skill” in full effect).

In other words, the shift mix from active management to passive management may or may not be positive for the active stock pickers that remain, even the smart ones. Our job isn’t necessarily going to get easier.[4]

The Beta Formerly Known as Alpha

Making things even more difficult, and interesting, is the trend toward “smart beta”. The codification of good investing rules is actually a very scary thing for traditionally diversified, purportedly “active” fundamental investors. “Smart beta” starts to invade the turf of mutual fund managers or other asset gatherers as it captures, at a very low cost, some of the features of a portfolio that everyone used to call “alpha”. We all certainly called it alpha before Fama and French codified the three factor model in 1993, which coincidentally was the same year that Prince changed his name to the symbol. With that paper, the game was on, both in the search for new factors, as well as the debate as to what causes these factors to outperform.

A New Symbol for Smart Beta

Fast forward to today and dozens of factors later, the boys at AQR have postulated that even Warren Buffett can be captured by a model. They’ve shown that Buffett’s excess returns were simply linked to factor loadings on different independent variables. They started with the single-factor CAPM beta (MKT), then added Fama and French’s SMB (size) and HML (value) factors, then added UMD (momentum) as per Carhart, and then added two new factors, BAB, and QMJ. BAB, or “Betting against Beta” is basically the “low volatility anomaly” where if you lever the returns of a low beta portfolio up to 1.0x, you get a return profile that is better than a portfolio of 1.0x beta stocks without leverage. This one really flies in the face of efficient markets, almost as much as momentum does. Then QMJ is “Quality Minus Junk” where they create long-short portfolios showing the excess returns to a quality factor, and how the factor has time-varied. Anyway, when you consider the leverage that Buffett employs, and his portfolio’s sensitivities since the inception of Berkshire Hathaway, to these factors, there is no more alpha left:

> *“In essence, we find that the secret to Buffett’s success is his preference for cheap, safe, high-quality stocks combined with his consistent use of leverage to magnify returns while surviving the inevitable large absolute and relative drawdowns this entails. Indeed we find that Buffett applies about 1.6-to-1 leverage financed partly using insurance float with a low financing rate, and that leverage safe stocks can largely explain Buffett’s performance.”*[5]

Hmmm, it would seem that even Warren Buffett could have been mimicked by a HAL 9000 (although surely HAL could not have had as close a relationship with the Secretary of the Treasury). This sounds terrible for the active management industry, right?

Well, perhaps, and perhaps not. The ex-post explanation of return drivers may not actually spell a certain problem for stock-pickers. For some of those factors, there can be a) efficient market reasons why the variable is a proxy for an actual risk, and we all need to earn compensation for exposure to the risk factor or, b) there may be a behavioural reason why the market might persistently make mistakes, allowing more objective minds to capitalize on the resulting mispricing or, c) both.[6] This isn’t to say that predicting factor returns is easy, or even possible (we aren’t so sure it is), but it certainly keeps the door open for discovering individual idiosyncratic stories where a behavioural underreaction or overreaction is creating a window to capture alpha without taking as much risk as Mr. Market believes we are taking.

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[4] *But to be clear our overriding philosophy is that smart, objective, informed stock-pickers without behavioural bias and less subject to noise is probably at an advantage in the trend toward passive investing than the unsophisticated or behaviourally-biased investor.*

[5] *Frazzini, A., Kabiller, D., and T. Moskowitz. “Buffett’s Alpha.” NBER Working Paper No. 19681, November 2013*

[6] *Our view, for what it is worth, is that the value spreads for most of these factors vary too much and too quickly for the pure risk story to be compelling – and this goes doubly for momentum, where we have even more trouble finding a good risk story.*

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