

Idiosyncratic alpha

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SYNOPSIS: IDIOSYNCRATIC RETURNS

Portfolio managers are now likely to be judged on three criteria: tracking error, active share, and idiosyncratic returns. The latter is the share of a portfolio's activity that comes from sources of returns not captured by strategic, long-term exposure to systematic risk factors. Idiosyncratic returns can come from dynamic allocation to themes, sectors or factors, or from stock picking.

– Bernstein; 'In defence of Active Management', May 2016.

As noted by Bernstein "emotional stock pickers, whose returns primarily come from exposure to a linear combination of systematic factors, will be at risk from cheap smart beta products. But the "real, true stock picking will always be valuable". Funds which target stock selection as a primary driver of risk and return can still generate unique returns for their shareholders – returns which aren't replicable by packaging up a combination of "smart beta" factors.

Idiosyncratic alpha is the element of return which cannot be easily replicated and is, in this way, unique.

THEMATIC CHANGES TAKING PLACE IN THE ASSET MANAGEMENT INDUSTRY

Bernstein's Blackbook, 'In defence of Active Management', elucidates several major thematic changes that are taking place in the asset management industry:

- There is, no longer a clear distinction between active and passive, so these classifications are less useful;
- We are evolving from a world in which all funds had one benchmark to a world in which all funds have a multivariate benchmark; and,
- The world of funds management is becoming more quantitative in nature. Investors are not buying more quant funds (at least not funds that have quant in the name), but the rules of the game are moving onto a quant basis.

Two big changes in the competitive landscape have been the rise of passive investments and the increased adoption of commoditized factor strategies (smart beta). Global investors have, in aggregate, bought US\$2 trillion of passive equity funds and ETFs over the last 10

years and at the same time have sold U\$1.5 trillion of active positions. The proportion of equities run passively has risen from 15% to 35% over the last decade. The most remarkable thing about this, in Bernstein's view, is how monotonic it is – unrelated to the appetite to buy or sell equities and to average pairwise stock correlation (which represents the opportunity set for active outperformance in stock selection). This Blackbook also highlights that 10 years after this trend started in equities, it is now also happening within fixed-income funds management.

Bernstein believes that part of the reason for the monotonic nature of the increase in passive allocation has been an exogenous force – namely, fees demanded for buying passive exposure have fallen continuously over this time. Looking across the funds management world, the area where fees are falling the fastest is commoditised factor products.

Aside from these structural issues, Bernstein argues that there is a case for active management stemming from more conjunctural reasons – we may be in a low-return world in which asset owners will need more help from asset managers.

AMONG FUNDAMENTAL MANAGERS

- Higher active share and higher tracking error funds are gaining assets. They also generate higher returns but, in aggregate, it is not at all clear that risk-adjusted and post-cost returns bear this out.
- The most concentrated funds do have an advantage when correlation spikes higher. This is an outperformance that they generally don't give back as correlation falls.
- Aggregate tracking error of fundamental managers generally tracks realised volatility, and is now low. However, active share is higher. This could be an attempt to take more active risk, or it could be a response to marketing departments and regulators favouring higher active share.
- The proportion of fundamental funds that use quantitative screening as an input is rising significantly. Aside from these two groups, the bright spot within fund management has been the rise of multi-assets. Bernstein formed a sample of 3,000 global multi-asset funds and shows that assets of the group have grown by 14% over the last five years. Bernstein believes that multi-asset investments will be a key part of the defence of active management.

The conjuncture of low yields in fixed-income markets and relatively high earnings multiples in equity markets creates another possible opportunity for active management, although at first sight it might appear to be an obstacle.

While making a forecast for asset markets 10 years in the future is at the very limits of forecasting ability, there are some variables that can be brought to bear for this task. Over the last two centuries, the yield on 10-year bonds has been a good guide for 10-year

forward realised returns on US sovereign bonds. Likewise, in equities, over the last 130 years, the Shiller PE (price divided by 10-year average inflation-adjusted earnings) has been the best predictor of 10-year forward total equity returns.

These imply that the current best guess for 10-year nominal returns from bonds will be 2% per annum with 6% per annum from equities (including dividends). The average expected return on plan assets for Australian superannuation is roughly 7% (CPI + 5%). However, is no 60:40 combination of 2% and 6% that equals 7%. Herein lies a problem.

A low nominal return environment does not sound like a great starting point for asset management. If nominal returns are low, then, *ceteris paribus*, it is probably harder to sell an asset management product. It is also probably harder to charge a given level of fee.

However, this is an even bigger challenge for asset owners who have to fund liabilities. Any product that can answer this need could have an advantage. Another way of interpreting this is that, for the last 30 years, passive investing – especially in fixed income, but also in equities – has benefitted from a particularly fortuitous confluence of declining inflation, declining yields and robust growth. If those conditions were not in place, or at least if one suspects they cannot be relied upon going forward, then the case for passive investing could be less compelling.

DELIVERING IDIOSYNCRATIC ALPHA

Amongst fundamental managers, there is a critical distinction to be drawn between managers who are genuinely active and achieve high active share and tracking error through generating idiosyncratic returns. Idiosyncratic alpha is the element of return which cannot be easily replicated and is, in this way, unique. Residual Alpha can be thought of as the component of alpha deemed not replicable by smart beta factors.

As the active-passive distinction evaporates, a more relevant question is "What kind of activity does a manager offer"?

Rather than measure a fund's activity level by regressing returns against the market, the fund's returns should be instead regressed against the market and also a set of the cheap, liquid, commoditised, smart beta factors now available. In other words, the concern should not be whether a fund gives a return close to the market, but whether the return will be close to the available cheap factor set.

Bernstein believes there are three axes of fund activity that are needed to map out managers and distinguish their sources of activity and ultimately their type of skill:

- tracking error;
- active share; and,
- idiosyncratic risk.

The latter is the share of a fund's activity that comes from sources of return not captured by strategic exposure to systematic risk factors.

Bernstein measures the idiosyncratic component of returns by running a regression of a fund's return on the market return and a set of risk factors.

There are various subtleties in running this regression. One question that arises is what factors should be used as the set of regressors? Do we just use the set of factors that are cheap and liquid, because that is what is making this important right now? Also, note that rewarding a manager only for what was not explained by such a regression would do a disservice to managers who got their factor allocation correct. The regression will assign coefficients to each factor in such a way as to best describe returns over the sample period, but those factor weights could not have been known *ex ante* and are valuable. Hence, the coefficients have to be constrained or defined predicated on some prior period.

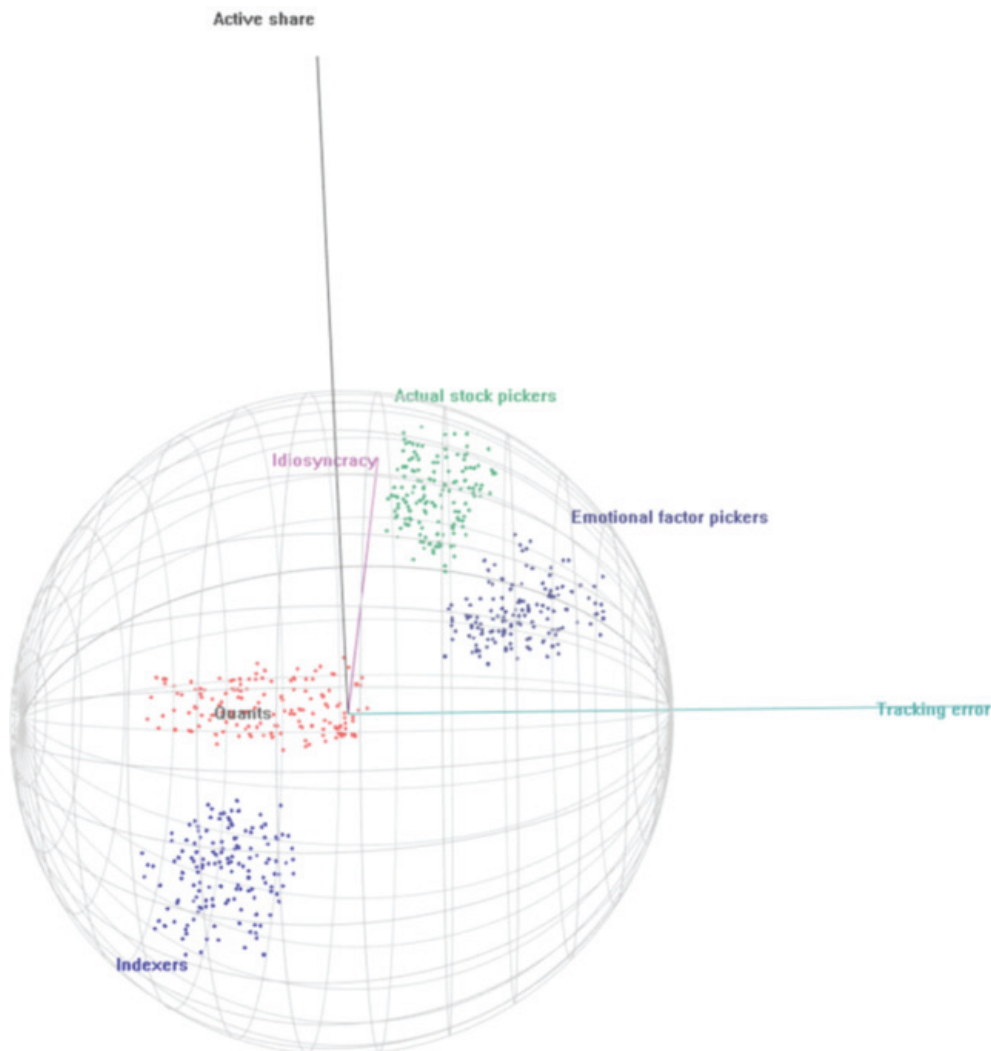
Bernstein shows these three axes of activity in Figure 1, along with suggestions of where manager groups might lie.

Quants usually have low active share and will have a tracking error that is likely to vary from low to middling, but can achieve idiosyncratic returns. Therefore, they can aim to be in the back half of the sphere. The real distinction comes within the universe of fundamental (non-quant) funds, where Bernstein distinguishes between actual stock pickers, who have a high active share and tracking error and also high idiosyncratic returns, and what they call "emotional stock pickers".

The latter group looks like they are active because they have high active share and high tracking error, but all of this comes from taking exposure to a linear combination of systematic factors. They might even think they are picking stocks but, without realising it, they are just inefficiently reproducing factors.

While the former group have a stable outlook and no need to reduce active fees, it is the latter group that are going to come under pressure both on pricing and in terms of reputation in an environment where market participants are aware that simple factors are available cheaply.

Figure 1: Three axes of fund activity



Source: Bernstein analysis. Figure shows where different groups of asset managers are likely to lie on three axes of investor activity: tracking error; active share; and, idiosyncratic returns. Tracking error is defined as the time series standard deviation of deviations in return from benchmark. Active share is one-half of the sum of absolute weight differences between the portfolio and its benchmark, while idiosyncratic returns captures the proportion of returns that are not due to common style factor exposures. The clusters of points indicate where Bernstein believe different managers lie. For example, indexers have a low level of activity on all three measures and actual stock pickers have a high level on all three measures. The group of investors who have high active share and high tracking error but only exhibit low idiosyncratic returns, they call emotional factor pickers. For active quants, Bernstein suggests the goal is likely to be high idiosyncratic returns, low active share and a range of tracking errors from low to medium dependent on risk budget.

TECHNICALITIES

How can one think about the relative contributions of these elements? How are tracking error, active share and idiosyncratic returns linked?

Amihud and Goyenko (2013) distinguish between what they call "selectivity" and "active share". Their definition of selectivity is similar to Bernstein's definition of idiosyncratic risk, in the sense it is $1 - R^2$ from a regression of a fund returns on a set of factors. They point out that selectivity and active share are similar but not the same. They will differ, for example, if:

- A fund deviates from its benchmark by taking a position in a different (passive) index. In this case, active share would rise but selectivity would not; and,
- Likewise, if a single stock outside the benchmark index is added that has a perfect correlation with the stock that it is replacing, active share will rise but selectivity will not, i.e. active share does not account for the correlation of securities that are held in the fund.

A way of thinking about the relative scale of the inputs and their relationship is to decompose active risk or tracking error. We can write:

$$TE = \sqrt{\text{systematic risk}^2 + \text{idiosyncratic risk}^2}$$

Sapra and Hunjan (2013) show that through this approach, we can separate the expected value of the tracking error into a term that is dependent on a sum of systematic risk factors and a term that is dependent on active share and the idiosyncratic risk of stocks. So, expected value of tracking error becomes:

$$TE = \sqrt{b'Wb + AS^2 \frac{2\pi}{N} \sigma_e^2}$$

where:

- b is the portfolio exposure to systematic risk factors
- W is their mutual covariance
- AS is the portfolio's active share, and the average idiosyncratic stock risk.

Note that this only works if the latter term is the idiosyncratic risk of stocks, as the total risk of each stock would include both a systematic and idiosyncratic element. For completeness, we would choose to add an extra term for the timing of systematic factors.

The point is that not all tracking error is equal. Yes, this has been known in theory for a long time. But it is product pricing that is making it more important. Mapping out funds in this way is no longer just an issue of risk management. It now becomes an issue of fund pricing.

In general, we could write:

Fund return = stock selection + market exposure + factor/theme exposure + timing ability where timing ability is broadly defined as skill in seeking out market, factor, or thematic opportunities.

There will also be other elements that could arguably be included, such as terms for portfolio construction, factor interaction and portfolio implementation. Writing this way has an implication for fund pricing as we can observe the market rates for these inputs and that some of them have changed. Buying passive market exposure is now essentially free for large institutions. As discussed, the fee on simple smart beta is now about 10bps in the US.

SUMMARY

Stock picking – real, true stock picking (by which we mean idiosyncratic returns apart from those generated from dynamic thematic, sector, or factor allocation) – will always be valuable. As explained in this Bernstein Blackbook, it is only a small minority of investors who can achieve this. Many people who think they are picking stocks are really just running a strategy – but those who can, will be able to charge a premium.

[Read Bernstein's "In defence of active management"](#)

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