

It all adds up... well, sometimes it doesn't

Michael Furey | Delta Research & Advisory | 19 August 2017

BACKGROUND

For quite a few years now, many commentators and researchers have criticised active investment strategies that charge active fees to receive benchmark-like returns. If a portfolio looks a lot like the benchmark it is trying to outperform, it doesn't mean there won't be outperformance – but after taking fees into consideration, it is much more difficult. Taking larger positions that are different from the benchmark will provide a portfolio manager with more opportunity to add alpha (risk-adjusted return). But, at the same time, if those bets are wrong, then there is greater negative alpha potential, too.

So, a popular portfolio construction method of many practitioners building multi-manager portfolios is to build portfolios of strategies that have greater idiosyncratic (or non-market) risks. The hope is to create greater alpha potential for their portfolio by avoiding the benchmark huggers and, at the same time, diversify away various manager risks with the multi-manager approach. Sounds reasonable? It does – unless you end up building the same type of portfolio you are trying to avoid.

Ultimately, portfolio construction is about the efficient capture of risks we believe will add value and the avoidance of risks we believe won't add value. Combining highly active strategies is about capturing idiosyncratic risks of an active manager in the hope that positive alpha is created. What is sometimes forgotten is that market risk cannot be diversified away (except by other markets) and the diversification of strategies may actually diversify away the idiosyncratic risk you may be trying to capture.

IDIOSYNCRATIC RISK VERSUS ALPHA

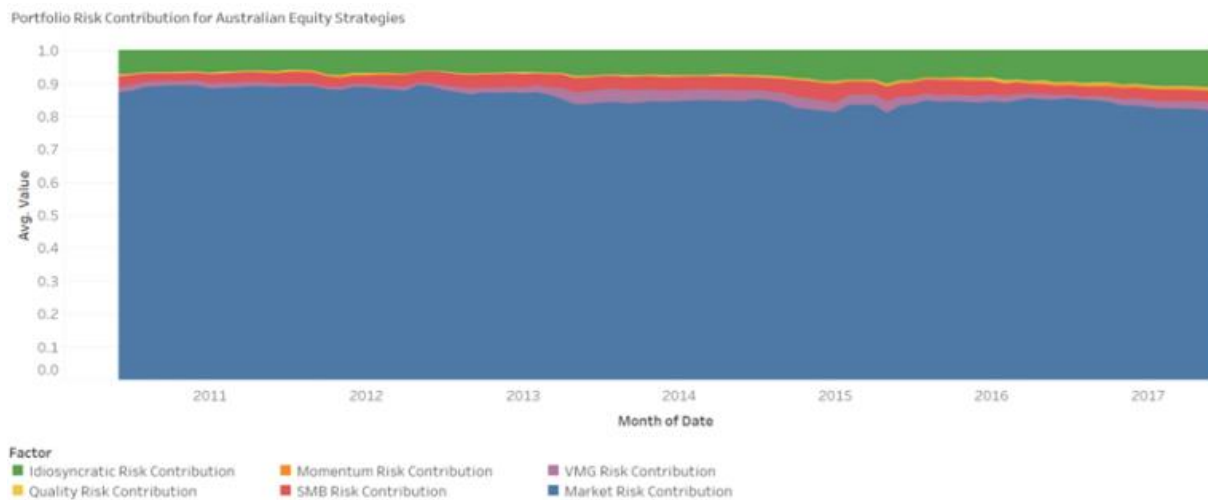
Idiosyncratic risks are non-systematic risks of a portfolio. In the context of equities, those systematic risks include the market (e.g. S&P/ASX 200 or MSCI Australia), and, perhaps, various other systematic risks – factors such as value, size, momentum, et al.

We pay active managers higher fees to turn idiosyncratic risk or these non-systematic bets into positive returns (otherwise known as positive alpha). But how much idiosyncratic risk is normal?

Figure 1 below breaks up total portfolio risks of all active strategies in the Australian market over the last 10 years, into various systematic risks as well as idiosyncratic risk (green). It shows that over the last 10 years, the average idiosyncratic risk of all strategies (equal

weighted) has been between 5% and 10% of total portfolio risk on a rolling three-year basis, with the dominant component being the market, which caters for around 85% to 90% of total portfolio risk. The other components of risk in this analysis come from a variety of factors which are important, but are not the focus on this paper.

Figure 1: Portfolio risk of active Australian equity strategies
28/6/10 to 30/6/17 AM



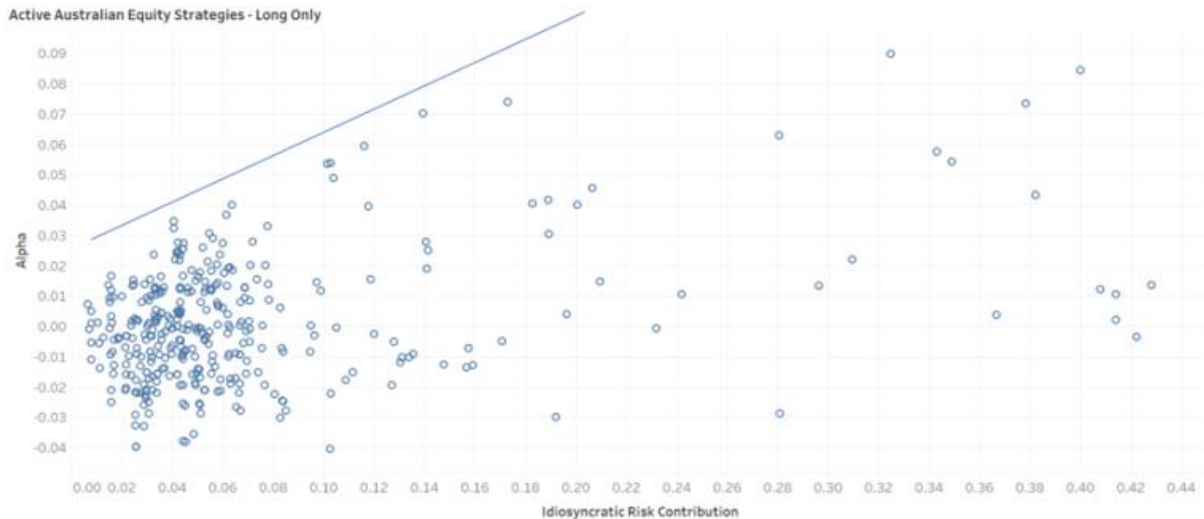
Source: Delta Research & Advisory. Benchmark – MSCI Australia. Rolling three years

The simple conclusion from this piece of analysis is that the market is easily the major component of the Australian equity active strategies' total risk. This is consistent with numerous studies of long-only strategies including Brinson, Hood and Beebower (1986), who showed that more than 90% of portfolio risk came from the asset allocation decision (or market allocation decision).

Basically, if a strategy is long only, market risk is going to play a significant role in the portfolio outcomes and, on face value, the alpha potential comes from a much smaller component of a portfolio's risk.

Figure 2 shows the relationship between Idiosyncratic and Alpha for Active Australian Equity strategies over the last 5 years.

Figure 2: CAPM alpha vs market risk contribution
5 Years to 30 June 2017



Source: Delta Research & Advisory. Note: Benchmark – MSCI Australia.

While the data on Figure 2 as a whole does appear to be a fairly random, the line is placed to show that there may be a relationship between maximum alpha and idiosyncratic risk such that maximum alpha appears to diminish with decreasing idiosyncratic risk. Figure 2 may also suggest that the lower the idiosyncratic risk, the lower the spread of alpha, potentially supporting concerns about benchmark huggers not producing high enough alpha but also avoiding negative alpha (which many in the past have suggested relates to minimising career risk, but I digress!).

AN EXPERIMENT – A PORTFOLIO OF HIGHLY ACTIVE STRATEGIES

So, to demonstrate some of the effects of building a portfolio of highly active strategies, I conducted a simple experiment.

Using the Delta Factors database of actively managed strategies, I chose five strategies that each produced positive alpha over the last five years, had high levels of idiosyncratic risk (i.e. more than 15% of total portfolio risk). I imagine this is a relatively common approach – that is, choose the strategy with the best relative performance with some basic appealing characteristics.

The portfolio of strategies, for the sake of simplicity and to avoid accidental strategy bias, is equal weighted and rebalanced monthly (and transaction costs are ignored). Figure 3 shows the basic market characteristics of five chosen funds.

Figure 3: Five active Australian equity strategies
June 2012 to June 2017

Fund	Market Beta	(CAPM or Market) Alpha (pa)	Idiosyncratic Risk
A	1.12	5.2%	24%
B	0.97	1.2%	21%
C	0.88	6.8%	18%
D	1.1	2.1%	41%
E	0.96	10.3%	20%
Average	0.99	5.1%	25%

Source: Delta Research & Advisory

The five funds, which all appear within the data in Figures 1 and 2, have very impressive characteristics insofar as they historically satisfy what would typically be wanted from an Australian equity portfolio. That is, they:

- have full exposure to the Australian sharemarket (i.e. a Market Beta of approximately 1);
- show strong value-add (i.e. average Alpha of around 5.1% per annum); and,
- are truly active compared to peers, with average Idiosyncratic Risk of around 25%.

Obviously, this is historic analysis over one the last five years and we all know the past doesn't equal the future... but it doesn't stop us hoping. The construction of these highly active funds is about moving away from the benchmark huggers to produce the stronger possibility of high alpha.

So far so good!

Obviously, multi-manager portfolios are comprised of more than one manager per asset class. This is always done for diversification purposes. It may be diversification of styles, managers, or a variety of other risks. What many don't measure or deeply understand is that a guaranteed outcome of diversification will always be the diversification of Idiosyncratic Risk, as you cannot diversify away market risk.

As Figure 3 shows, this portfolio of active strategies has an historic average Idiosyncratic Risk of 25%. On its own that may be appealing but when they are combined into this portfolio, ignoring rebalancing transaction costs, the Idiosyncratic Risk decreases to 10% – a 60% reduction in the very risk we are hoping to capture!

Now, this 60% reduction in risk is specific to the portfolio and would be lower if fewer strategies were chosen. Either way, combining these five strategies has created a portfolio with significantly lower Idiosyncratic Risk than every single component strategy. If there is a belief that greater Idiosyncratic Risk is required for high alpha, then this portfolio has significantly reduced that opportunity on a forward-looking basis. The past does not equal the future, but it would be difficult to see that this is not a move towards a benchmark-like portfolio, with highly active fees.

CONCLUSION

Many might argue this is just one example and not all combinations of managers will reduce Idiosyncratic Risk by this much – and that is absolutely correct. The question becomes, do you know the impacts of the risk characteristics of your multi-manager portfolio? I would guess many would answer, "no".

Over-diversification is a common reality in multi-manager portfolios and can result in paying big bucks for index-like returns. But, to manage this risk, it is essential to measure it. Measuring risk contributions will help those constructing multi-manager portfolios ensure the desired risks are being captured more efficiently and can help reduce the desired risks being diversified away. Given the growth in managed accounts across the financial planning industry and the shift towards single strategies for many clients, increased measurement of risks has never been so important for many investors.

Diversification is the only free lunch in investing. Mathematically, it is due to less than perfect covariance or correlation, as Harry Markowitz's Nobel Prize winning paper showed. But better portfolio construction occurs when you don't diversify the risk you are trying to capture. Beware the benchmark hugger – it might be you?

REFERENCED PAPERS

1. Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance", *The Financial Analysts Journal*, July/August (1986).
2. Markowitz, H. 1952. Portfolio Selection. *The Journal of Finance* 7 (1): 77-91.



Michael Furey is Managing Director of [Delta Research & Advisory](#), which specialises in providing independent, conflict-free investment research and asset consulting services to dealer groups (AFSLs), financial planners, and self-directed investors. He has worked in the financial planning industry since 1999, both in research and financial planning roles.
