The Cyclicality of Manager Alpha

| Stan Miranda |

Active managers go through cycles of under and outperformance over time can be explained by certain environmental factors ('moving parts') and their immediate impact on dispersion and market volatility which results in more alpha opportunities. We think 2016 represented a turn in this cycle and, barring any major event shocks, we expect 2018 to be a good year for alpha, particularly for strategies looking to exploit increasing stock dispersion and rising interest rates.

2016 represented a year by which active investors had crowded into virtually every corner of the investment world, exhausting any remaining pockets of inefficiency and saw more managers underperforming their benchmarks than we can recall in our 16 year history. As expected, we saw a capitulation by many capital owners who moved more of their capital from active to passive managers. You may recall we devoted significant intellectual resource in 2016 to dig into the drivers of the disappearance of alpha and presented our conclusions to an assembled audience of over 100 of our clients in London in October 2016. Our conclusions were the following:

There will always remain a small minority of managers capable of persistently generating outperformance over the long term, with the greatest opportunities in strategies where the managers: 1) add value to the assets they manage, 2) are early investors in new emerging investment sectors and 3) bring a distinct skill or cost advantage to a specific investment arena. However, the magnitude of such alpha will vary over time as investors overcrowd certain areas of opportunity or inefficiency, seeing levels of alpha fall and eventually leave that investment space. It then follows that the inefficiency returns for those who never left or who can time their re-entry in line with the alpha cycles. Over the long term, we believe in a state of equilibrium market efficiency where markets are both inefficient enough for active investors to be compensated for their costs, but efficient enough to discourage additional active investors.

This cyclical behaviour of alpha is captured in the following chart (Figure 1) which shows the percentage of active equity managers outperforming their benchmarks on a rolling 5-year basis. You can see there have been periods of fairly violent swings in under and outperformance by active equity managers. The chart also shows that 2017 was a better year for active management, something we witnessed across our client portfolios. In 2016, just over 50% of the active managers in the Partners Capital Master Portfolio C beat their benchmarks, resulting in negligible manager alpha for the year. By contrast, 2017 saw 67% of managers outperforming their benchmarks registering more than 2% manager alpha, in line with our long-term expectations for outperformance.

Looking ahead, the question is whether 2017 representsed the start of a cyclical upturn in manager alpha expectations. To answer this, we have re-examined the environmental factors that lead to stronger alpha generation. Our research shows there are five such factors ('moving parts') that result in greater dispersion as well as volatility, thereby creating an environment in which active management thrives. The moving parts or factors most closely associated with manager alpha include the following:

1. Return to conventional monetary policy (e.g., tapering of quantitative easing)

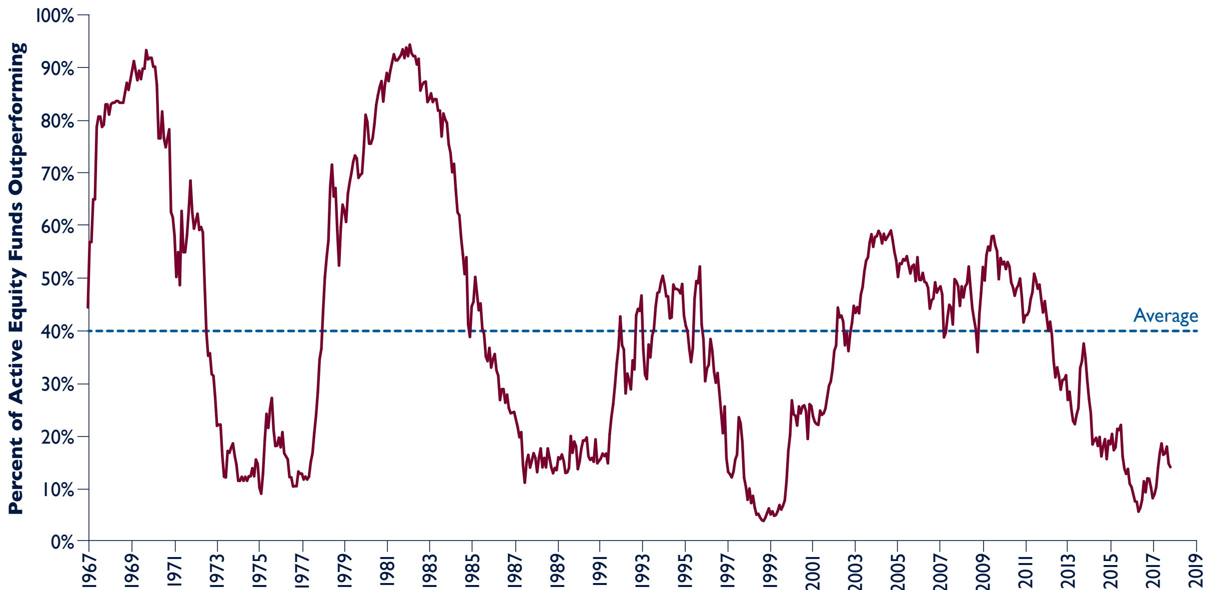
2. Steady rise in interest rates

3. Steepening yield curve

4. Large fund flow movement (whether in or out of active risk markets)

5. Absence of major market reversals or shocks (these tend to interrupt the natural alpha cycle driven by the factors above)

Figure 1: Percentage of active equity managers outperforming their benchmarks shows a highly cyclical pattern

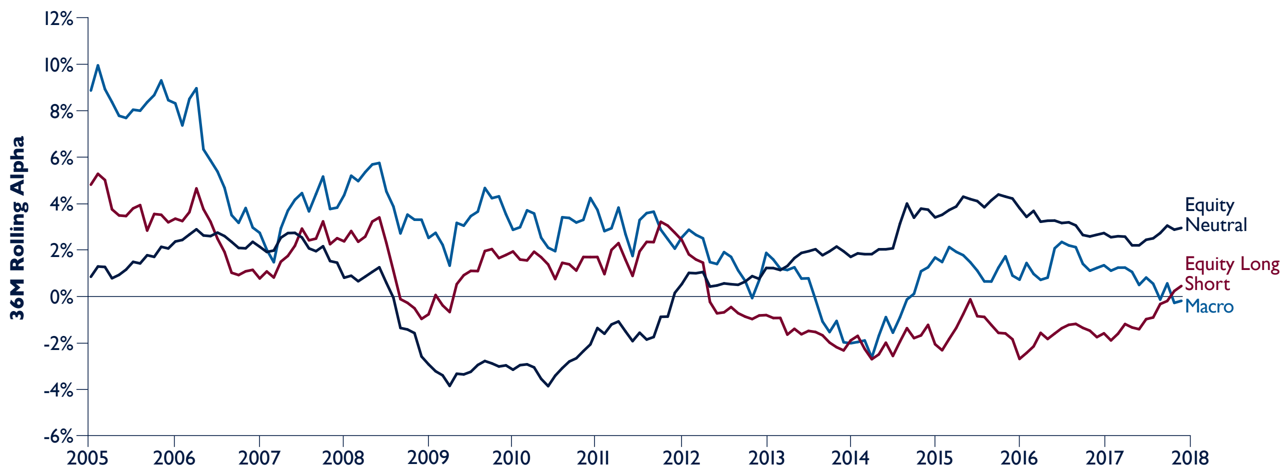


Source: Nomura, Centre of Research in Security Prices (CSRP)

Based on our analysis, we think 2018 should be a good year for alpha generation as four out of the five factors are directionally aligned. While there are geopolitical risks on the horizon which could effectively swamp these factors, on balance we are quite optimistic about active management in 2018. Within strategies, we are focusing on those looking to exploit higher stock dispersion (equity long short, equity market neutral) as well as those looking to benefit from diverging central bank policies and rising interest rates. We believe that our roster of high quality managers across asset classes should be well positioned to use the environment to good effect and deliver strong outperformance for our clients.

Over the long-term, hedge fund strategies such as equity long short, equity market neutral and macro strategies have undergone periods of out and underperformance versus their respective benchmarks, as shown in Figure 2.

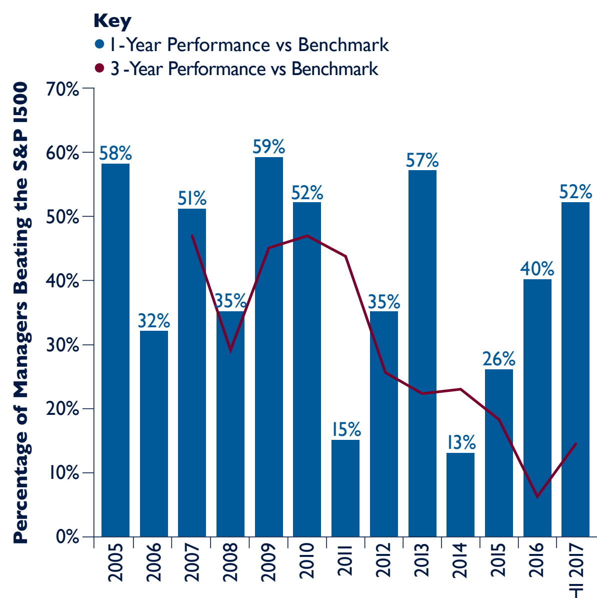
Figure 2: Investment strategies tend to undergo cycles of out and underperformance



Note: 36m rolling alpha of HFRI Equity Hedge Index (benchmark 50/50 equity/cash), HFRI Equity Market Neutral index (benchmark cash) and HFRI Macro Index (benchmark cash) over respective benchmarks.
Source: Bloomberg, Partners Capital Analysis.

This long term trend is also visible when looking at the percentage of managers outperforming their benchmarks, a metric we feel is more important than the average level of outperformance for any given strategy. Figure 3 below shows the percentage of mutual funds that have outperformed since 2005 on a 1-year and 3-year basis (in contrast to Figure 1, which shows rolling 5-years outperformance). There is significant variability in the proportion of alpha generating managers over the years, with H1 2017 marking a recovery after a number of below par years.

Figure 3: Percentage of US mutual fund managers outperforming the benchmark on a 1 and 3-year basis: 2014 represented the bottom in alpha generation, with a steady recovery through to 2017



Source: SPIVA

What has driven these changes in manager outperformance? We have put together a conceptual model, based on certain observable macro factors which we believe to be markers for improved alpha opportunities. These factors directly result in increased dispersion, low cross-asset correlations and higher volatility in the markets, which are all favourable for active management.

These alpha drivers and their first order effects factors are defined in Figure 4 and Figure 5.

Figure 4: A conceptual model to define a favourable active management environment

Alpha Drivers ('Moving Parts')	First Order Effects (favourable to alpha)	Alpha Measures
1. Return to conventional monetary policy 2. Steady rise in interest rates 3. Steepening yield curve 4. Large fund flow movement (whether in or out of active risk markets) 5. Absence of major market reversals or shocks	1. Higher market volatility 2. Lower asset class correlations 3. Lower inter-stock correlation	1. Greater percentage of managers outperforming the benchmark 2. Higher average manager alpha across strategies a. US Large cap funds b. Equity long short c. Equity market neutral d. Macro funds

An example of first order impact would be looking at rising interest rates and falling inter-stock correlations, as shown in Figure 6. This is because different sectors of the markets respond differently to changes in interest rates, and within sectors, companies react differently to higher costs of capital based on factors such as their leverage levels.

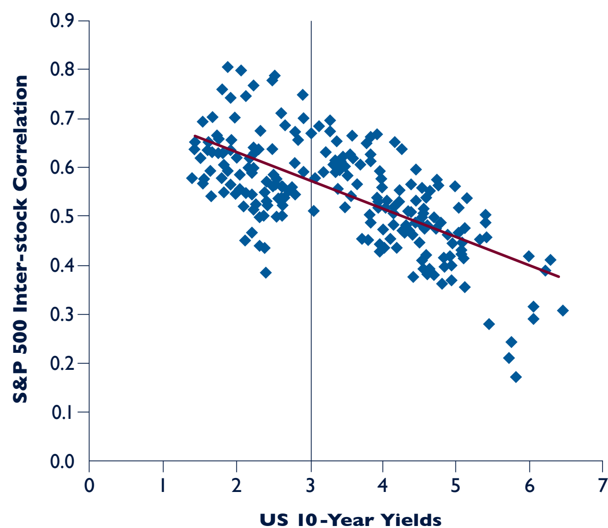
The relationship between a steepening yield curve and rising volatility is visible in Figure 7, although it is quite noisy because volatility will spike if there has been a market or economic shock.

Having seen the impact of some of these factors on dispersion and volatility, we now look at their relationship with active management alpha. Figure 1 maps the percentage of active equity managers outperforming the S&P 1500 every year as well as their average level of outperformance, against inter-stock correlation and net new assets into active managers. While the linkages to stock correlations and inflows tend to be quite clear in most years, market shock years such as 2001 and 2007-08 are exceptions where macro events swamp any stock specific information that active management relies on.

Figure 5: Five observable factors and their first order effects which are favourable for active management

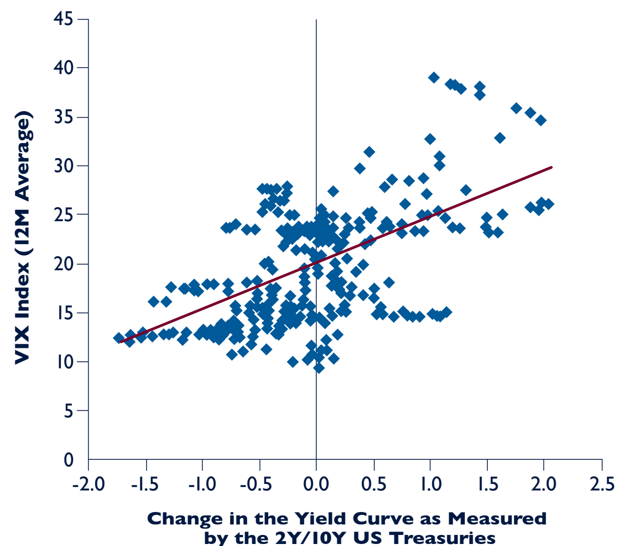
Alpha Driving Factors ('Moving Parts')	Why it leads to an improved environment for active management?
1. Return to conventional monetary policy	Represents a return to normality where central bank asset purchases do not swamp the micro factors driving asset class/stock returns.
2. Steady rise in interest rates	Different segments of the markets respond differently to changes in interest rates. However steady change is better because a sudden increase in interest rates is generally a response to some macroeconomic shock.
3. Steepening yield curve	Empirically we have seen greater volatility as the yield curve steepens. A steepening yield curve also benefits skilled traders who understand the impact of rates at various parts of the curve on various asset classes.
4. Large fund flow movement (whether in or out of active risk markets)	This indicates there is less competition for active investors.
5. Absence of major market reversals or shocks	All of the bets above are off when there are large sudden shocks that lead to swift market reversals, with the exception of volatility.
First order effects	Why it leads to higher alpha generation?
1. High volatility of securities price movement	More extreme price movements combined with relatively rationale markets provide traders with mean-reversion based alpha opportunities.
2. Lower cross asset class correlations	This is a first order effect of tapering QE and central bank policies becoming increasingly desynchronised. Benefits asset allocators and macro investors. Company and sector specific drivers take over.
3. High dispersion of securities price movement (low inter-security correlation)	Low inter-stock correlation implies prices of stocks move due to idiosyncratic reasons, by far the most important factor for active bottom up fundamental research based active managers. All boats are not rising or falling with the tide. Research matters.

Figure 6: Higher interest rates typically lead to falling inter-stock correlations



Source: Bloomberg, Partners Capital Analysis based on data from 1990-2017

Figure 7: A steepening yield curve typically leads to higher market volatility

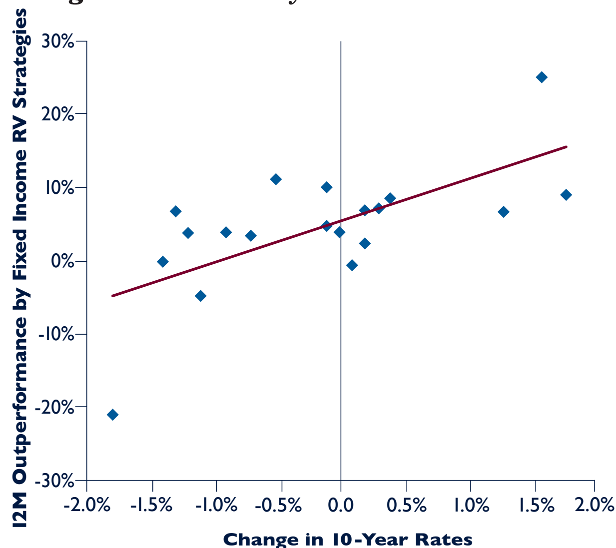


Source: Bloomberg, Partners Capital Analysis based on data from 1990-2017

Similarly for non-equity related absolute return strategies, such as fixed income arbitrage, we see that they benefit from rising rates across the yield curve as shown in Figure 8.

So what does this analysis bode for 2018 and beyond? We expect interest rates to rise over the course of the next couple of years, accompanied by a normalisation of monetary policy across the US. As global central bank policies become increasingly desynchronised (e.g., the Federal Reserve unwinding its monetary easing, while stimulus continues from the Bank of Japan and the ECB), linkages across asset classes, regions and stocks are giving way to more asset class and sector specific drivers. We are already seeing the impact of this with an increase in volatility and falling inter-stock and cross asset class correlations (Figure 10-12).

Figure 8: Fixed income arbitrage benefits from rising rates across the yield curve



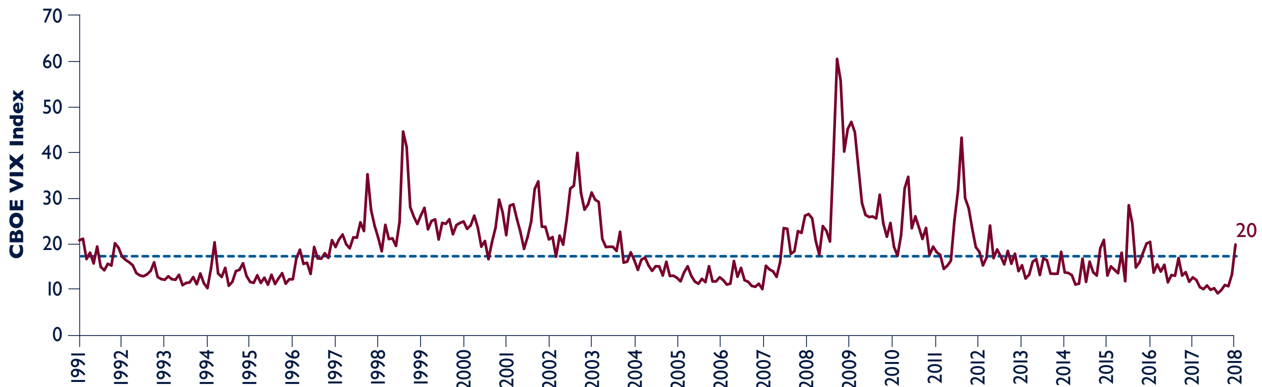
Source: HFRI, Bloomberg, Partners Capital Analysis based on data from 2000-2017

Figure 9: Equity manager outperformance tends to increase during times of lower inter-stock correlations and greater outflows from active management

	% of Domestic Managers Beating the S&P 1500	Annualised Alpha in US Large Cap Mutual Funds (%)	Inter-stock Correlations in the S&P 500	Inflows into active management (T-1 year, US$B)
2000	59.5%	9.3%	0.31	-99.4
2001	45.5%	3.9%	0.46	-151.5
2002	41.0%	1.6%	0.55	-27.8
2003	52.3%	0.5%	0.58	2.7
2004	48.6%	0.2%	0.50	-120.0
2005	57.7%	2.0%	0.50	-127.7
2006	32.0%	-1.1%	0.46	-86.1
2007	51.1%	1.3%	0.46	-100.8
2008	35.1%	0.1%	0.52	-60.0
2009	59.3%	2.2%	0.63	-110.0
2010	51.7%	-0.8%	0.68	-50.0
2011	15.4%	-2.8%	0.67	-19.5
2012	35.1%	-0.8%	0.67	-29.4
2013	56.7%	-0.4%	0.55	-85.6
2014	13.1%	-2.7%	0.57	63.7
2015	26.0%	-2.5%	0.57	-3.6
2016	39.5%	-2.0%	0.61	-116.2
2017	52.5%	-1.7%	0.47	-310.1

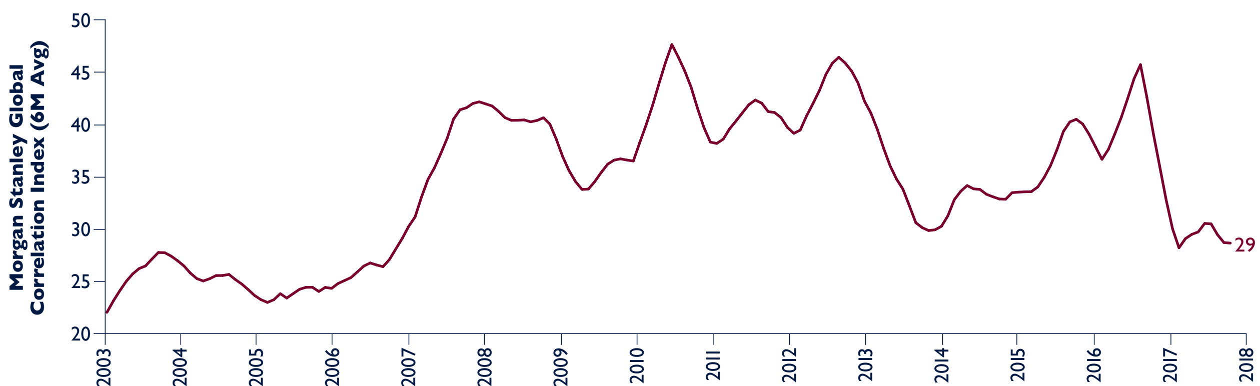
Notes: Colours of the cell denote how favourable each factor was for alpha generation, with Green being most favourable; (1) Source: Bloomberg, Morningstar, SPIVA and press reports; (2) US Large Cap Mutual fund data based on Morningstar's Active Large cap blend category (benchmark S&P 500); (3) Inter stock correlation measured by CBOE S&P 500 Implied Correlation Index; (5) Inflows into active management measured by Net new assets US active Mutual Funds and Hedge funds in the previous (T-1) year. For years prior to 2007, data is based on inflows into US Equity ETFs. It is assumed that 90% of all inflows into passives are driven by a concurrent outflows from active managers, which is in line with the trend we see 2007 onwards.

Figure10: The VIX has gone up from historically depressed levels and is now trading around its long-term median



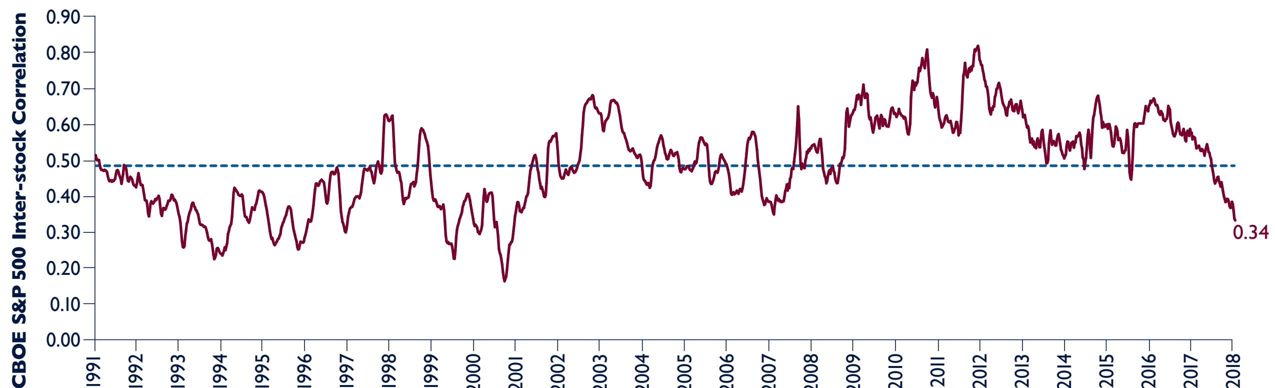
Source: Bloomberg

Figure 11: Cross asset correlations are back near post crisis lows



Note: Represents average pairwise correlation of all S&P 500 stock combinations
Source: Bloomberg

Figure 12: Inter-stock correlation across US large cap stocks have fallen below its long-term median

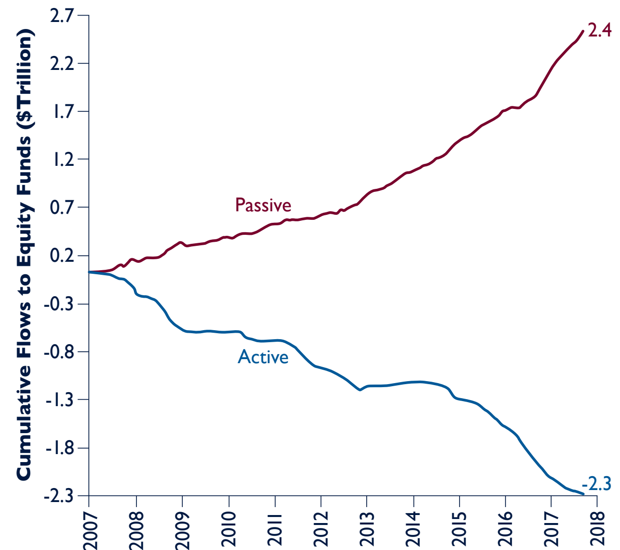


Source: Bloomberg, Morgan Stanley research

At the same time investors continue to allocate more capital to passive funds at the expense of active management as shown in Figure 13, something we expect to continue due to the increasing fee pressures in the asset management industry. In addition, our experience suggests that an environment of higher volatility across asset classes should provide a favourable backdrop for other absolute return strategies such as macro trading.

Therefore, while there are geopolitical risks on the horizon which could effectively swamp these factors, on balance we are optimistic about active management in 2018. A summary of our 2018 forecasts for each factor is detailed in Figure 14.

Figure 13: $2.4 trillion of assets have moved into passive equity funds, at the expense of active funds

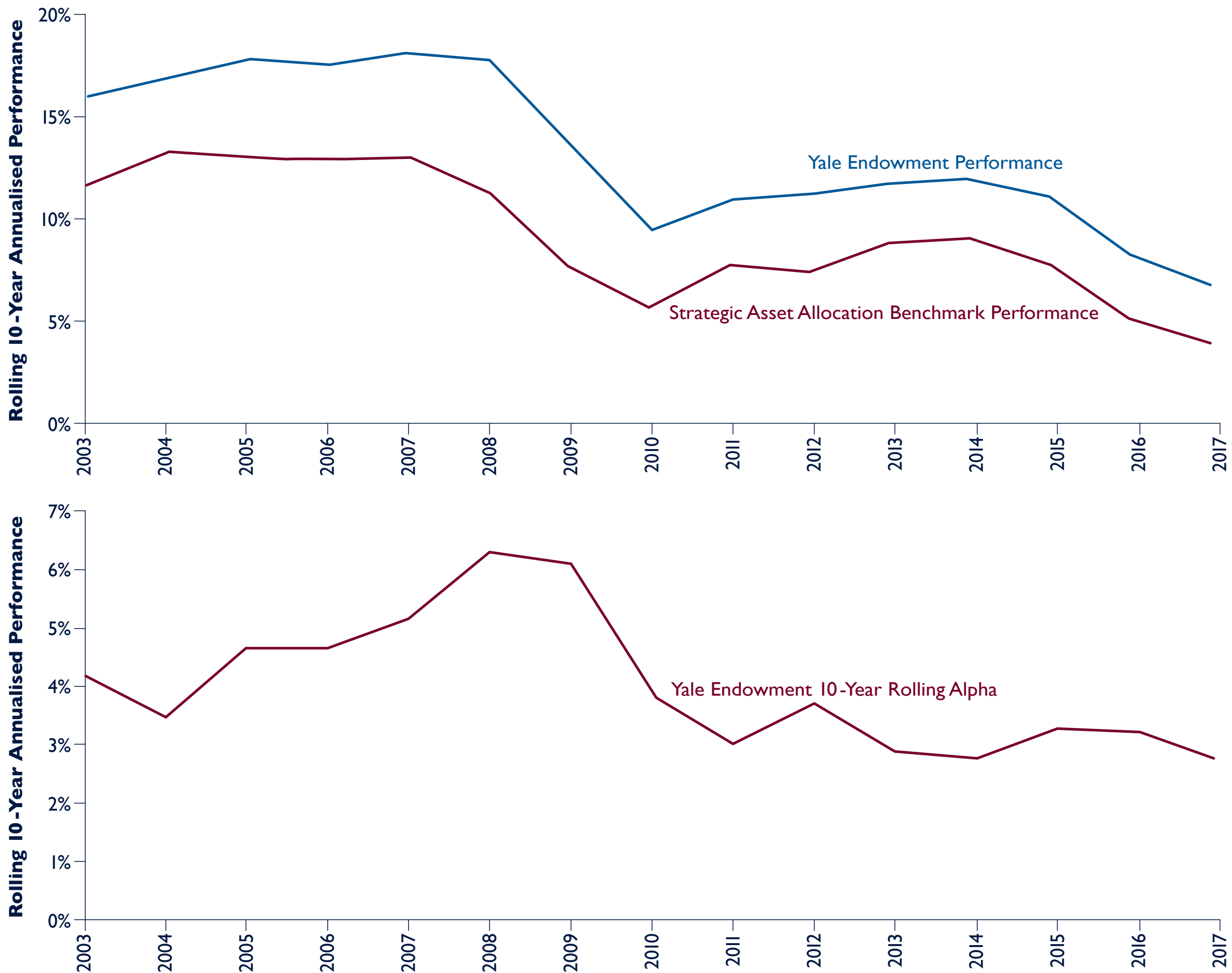


Source: BofAML Global Investment Strategy, EPFR Global

Figure 14: We expect 2018 to be strongly positive for active manager alpha, similar to what we have seen in 2017

Alpha Driving Factors ('Moving Parts')	2018 Forecast
1. Return to conventional monetary policy	Started in the US a year ago, and not yet started in EU or Japan. However this divergence in monetary policy should be positive for active managers
2. Steady rise in interest rates	Current US 10-year yields are at 2.8% and markets are expecting Fed funds rates to rise by 75bps by year end 2018. Very slow rate rises expected in the rest of the world
3. Steepening yield curve	US yield curve is relatively flat with asymmetric steepening risks
4. Large fund flow movement (whether in or out of active risk markets)	The recent trend is continuing with flows into passive instruments
5. Absence of major market reversals or shocks	There are many geo-political events on the horizon that could trigger a risk-off event, with major reversal
First order effects	**Why it leads to higher alpha generation?**
1. High volatility of securities price movement	VIX has only recently gone from historically depressed levels of around 10, and is currently trading around its long-term median level of 17
2. Lower cross asset class correlations	MS Global Cross-Asset Correlation Index is at its post-crisis lows of 29 as equities have become less correlated with rates, FX, oil and vice versa
3. High dispersion of securities price movement (low inter-security correlation)	Inter-stock correlations have fallen around 0.35 vs. the median range of 0.50
Overall Assessment	Overall moderately positive but focus on strategies which can benefit from inter-stock dispersion and normalisation of monetary policy

Figure 15: The Yale Endowment has consistently generated 300bps of alpha per annum



Note: The fiscal year 2016-17 performance for the Strategic Asset Allocation is estimated as 70% of the equity market performance, in line with the risk level.
Source: Yale Endowment annual reports.

We continue to believe that holding a portfolio of the highest quality managers who can ride through cycles of low and high alpha generation achieves the best results over the long-run. This is evident from the performance of investors such as the Yale Endowment which has consistently generated 300bps of alpha per annum over its history (Figure 15). Therefore we remain committed to replicating this performance by accessing rare, persistent alpha generating managers across the asset classes where active management thrives.

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