THE INSIDE TRACK ON ALPHA

Alpha is an investment buzzword but it doesn't always stand up to scrutiny. In the race to find it, fund selectors need to consider how it fits into their overall aims and how much it is worth paying for, says Athymis Gestion's **Tristan Delaunay**

Fund selection can be viewed as a search for absolute performance, but this is too narrow a focus. We choose a fund for how its potential alpha complements the aims of our portfolio. In this way a strategy is selected as a building block within an overall structure rather than as an end in itself.

However, the notion of alpha is meaningless without a relevant benchmark. For instance, if the fund manager selects stocks which operate outside a specific asset universe, the alpha can become a random factor that is almost completely determined by the performance of these 'off-piste' investments. In this way, for example, European equity funds often have exposure to Russian or US stocks. Once this principle is accepted, alpha computing is easy and equates to the sum of the relative weighting of every stock.

OPERATING IN A FINITE WORLD

The market universe may contain hundreds or thousands of stocks, but it is not infinite. However, most statistical financial models are based on linear mathematical theories, which imply an infinite choice. This flaw has consequences: in a limited universe, statistics do not provide an accurate picture, because of the weights of outliers and idiosyncratic cases. As a consequence, the structure of the investment universe drives the investment process. In a concentrated group of stocks, such as emerging government debt, the only real decisions taken by the portfolio manager concern the relative weightings of the countries. In this sort of case, alpha is rare. In a very large and homogenous investment universe such as small caps, the portfolio manager has a tendency to focus on the same companies, because research is scarce, trades are costly and volatility can be high, which means the wrong bet can be punished harshly. In this scenario, investment processes focus more on stock picking and often neglect sector analysis or macro monitoring.

The make-up of the chosen benchmark directly shapes the alpha, according to the weightings of the main stocks. Traditional indices weight equities according to their market capitalisation, or in the case of bonds, the size of their issuance. Some country indices may add a few positions that account for more than 10%, which the portfolio manager will not be authorised to replicate. For this reason, MSCI introduced 10/40 indices to cap the weightings and improve the index characteristics. Bond indices highlight the most indebted companies or countries, that is to say the riskiest ones.

WHAT DRIVES ALPHA?

Alpha is often held up as the holy grail in asset management, bringing fame and success for the fund manager, so it is worth considering the factors that may or may not underpin it.

Style biases, such as value and growth, are often neglected in alpha analysis, and are usually viewed as intrinsic to the manager. Style indices may integrate this bias, but these are essentially a US phenomenon. In Europe, style portfolios are characterised by sector bets and these are the main sources for alpha, transferring considerations of style and how to balance different approaches to the fund selector.

The share of mid and small caps can also play a key role in equity alpha. A high level of small caps can often explain much of the underperformance in active management during years of large-cap outperformance, such as 2014.

Certain types of market can undermine the average level of potential alpha. A calm market, for instance, in which the stocks are closely correlated prevents any portfolio manager from beating the index. In this case, manager selection is an empty exercise .

Another factor driving alpha is the level of active management. A fund's tracking error is a quick way to determine this – we regard anything under a 2.5% tracking error as passive management in an equity fund.

However, these sorts of measurements cannot always be trusted to identify a reliable source of alpha, because at an extreme point, a fund that is too different from its benchmark cannot be compared to it.

Perhaps the most important and yet most difficult driver to gauge when it comes to alpha is the manager himself. An active manager must have convictions and challenge them. This double-edged approach needs to be blended with qualities such as humility, intellect and endurance.

To detect this kind of temper, we conduct in-depth interviews in which we confront the manager with his past mistakes and his currents problems. We also ask him about his analysis of global events connected to his positions, and if we perceive a concealed style bias, we question him on this too.

However, we don't ask about any personal investment a manager may have in his fund. To think that a professional will be more efficient with 'skin in the game' rests on specific hypotheses which cannot be verified.

THE COST OF ALPHA

Once you've identified a source of alpha, how much should you pay? The more I pay a manager, the less I get what I want: management fees directly reduce alpha. Institutional investors understand this point well and their selection process often focuses on reducing management fees. In this way they provide instantaneous alpha. To pay 1% to earn 2% may seem acceptable, but to pay 0.5% to earn 2.5% is proportionally 2.5 times more interesting.

***Tristan Delaunay** is CEO at Athymis Gestion in Paris*

WORKSPACE

Fund selectors reveal the tools and good luck charms they use to navigate the markets

TRISTAN DELAUNAY
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FAMILY PHOTOS
These are pictures of my daughter and my nephews. They help me to stay focused and calm.

MOTORCYCLE GEAR
I have been riding a motorbike for 13 years and it is a great way to forget the place you've come from and be ready for the one you're approaching.

COFFEE MACHINE
Without this, there's no hope of being efficient 11 hours a day.

Career in a nutshell

- Started out as a computer and maths engineer and gained the CFA qualification.
- Spent six years at BNP Paribas Investment Partners working in IT, research, and as a portfolio manager where I focused on international equities, convertible bonds, ESG equities, and corporate pension funds.
- Then moved to Edmond de Rothschild Asset Management where I worked for three years as a portfolio manager on convertible bonds. I also spent a year as a European long/short portfolio manager.
- **Currently at Athymis Gestion where I've worked for seven years as CEO and senior portfolio manager.**

Hobbies

- Outside of work I find time for riding my motorcycle and playing squash. I also enjoy reading, music and the movies.