Destructive Behavioral Biases: Obstacles to Absolute Returns

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In my previous article, Hooked on Alpha: The Failure of Portable Alpha and Absolute Return Mandates, it made reference to the destructive behavioral biases, i.e. overconfidence and disposition effect, that represent significant obstacles to absolute returns. This article elaborates on these behavioral biases.

The Hedge Fund universe's constituents generally exhibit an impressive arsenal of idea generation and research talent. This, overlaid with position-specific and/or portfolio-level risk mitigation, represents what most Hedge Funds are all about. The risk mitigation overlay toolbox often includes, for example: diversification, paired positions, systemic and/or sector hedges, market neutrality, and targeted risk calibration. Hedge Fund managers and investors have sought comfort in these risk mitigation tools in their quest for absolute returns and thereby alienate at least part of their portfolio allocation from broad market drawdowns and dislocations. Unfortunately, and as recent history demonstrated, none of the risk mitigation tools offer a guarantee to absolute returns.

Essentially, dwelling on a risk mitigation overlay to construct Hedge Fund portfolios, coupled with two key missing ingredients, only further alienates the Hedge Fund mandate from the concept of absolute returns and the protection of precious capital.

The Key Ingredients

The first key ingredient is to abstain from surrendering to two particular behavioral biases, i.e. overconfidence and the disposition effect. The second key ingredient consists in the failure to distinguish between Risk Management from Risk Mitigation.

Overconfidence tends to be most prevalent among managers who deploy an impressive amount of time and resources to conduct private equity style deep due-diligence research to generate and validate ideas. This involves, for example, leveraging elaborate contact networks to source and validate data points, conducting channels checks and cross-referencing data points with management, current and former employees, suppliers, customers and competitors, and conducting proprietary surveys, to cite a few examples.

The research process leads to a superior inventory of publicly disclosed data points that are not readily available to the typical investor and thus enables the portfolio manager to identify significant intrinsic valuation gaps and formulate and express high-conviction and non-consensus themes and ideas in a portfolio.

Overconfidence is typically revealed by the deep due-diligence and the investor's unwillingness to discount widely available information while overestimating their proprietary and hard-earned superior information. Most often, the "widely available information" will dictate the direction of price movement of securities. The market is a collective perception of reality. Right or wrong, this perception dictates price movement. Its forces will generally exceed those of the embedded valuation gaps identified through deep proprietary research and analysis not readily available to all.

As a matter of fact, the deeper the due-diligence the most time required for the rest of the investor universe to uncover, digest and discount the information, and only then drive asset price. And until this chain reaction actually takes place, both the individual security and the overall markets are subject to changes and events that will further widen the price spread from its true intrinsic valuation. At these junctures, portfolios and underlying positions come under price pressure. Managers are at times forced to dispose positions at a loss to honor redemptions that all too often coincide with overall market dislocations. Overconfidence is an enemy, rather than an ally, in the generation of absolute return and the protection of capital.

The Disposition Effect

The Disposition Effect refers to a very human but irrational behavioral trait whereby individuals are inclined to be more eager to sell securities of value but tend to be willing to hold securities that have lost value. Essentially, we are pre-disposed and unwilling to experience the pain of realizing loss of capital through disposition.

As market perceptions and volatility regimes further alienate securities' prices from fair valuation and the manager's portfolio entry points, refraining to withdraw capital among these ideas further contributes to the deterioration on the return profile and the manager's ability to protect capital.

The propensity to generate absolute returns and protecting capital is greatly enhanced as the manager allocates capital to long and short ideas that are receptive to the market, and then retrieving in whole or in part that capital as the market is no longer receptive to these long and short ideas. One cannot expect each and every portfolio position to be receptive by the market but it is not unreasonable to dynamically calibrate its size or risk allocation to the degree of receptiveness by the market. This is what risk management is all about: dynamically allocate portfolio capital risk among ideas to generate returns, and most specifically actively attending to losing positions, i.e. reducing or removing capital from ideas not being rewarded by the market.

If the objective is to generate absolute returns, there should be very little, if any, tolerance to allocating capital among ideas while waiting for the market to eventually agree that they are right. This calls for a process that is specific to the timing of portfolio implementation, position sizing and trade construction, as well as portfolio net and gross exposure calibration. Not that there is anything wrong with hard-earned research and due-diligence in the formulation of an investment thesis; however, it should not dictate the portfolio implementation, construction and management process.

Two Very Distinct Activities

Idea generation and portfolio implementation, per se, are two very distinct activities in the management of absolute return strategies. They are unfortunately, and too often, confused and applied sequentially.

In the evaluation of a hedge fund manager, the investor must acknowledge the importance in recognizing the manager's priorities. Is he spending all or most of his time generating and investigating ideas? Or, is he actively attending to his portfolio positions? The investor must be able to assess the manager's likely behavioral patterns and level of complacency or tolerance when faced with losing positions. How does he react when the market does not agree or has yet to discount his hard-earned ideas? Generally (and unfortunately), the time and effort spent in the formulation of high-conviction ideas tends to be highly correlated with (1) the amount of capital allocated to the idea, (2) the investment horizon willing to assume to eventually monetize the hard-earned idea, (3) the marked-to-market loss tolerance allowed within the required investment horizon, and (4) the willingness to gross-up or double-down on the position undergoing negative price pressure within the intended holding period. At this point, the manager is emotionally attached to his hard-earned ideas and claims superior knowledge to the market. One can remain right much longer than solvent in portfolio management, particularly when leverage is applied and liquidity is scarce.

The risk mitigation toolbox mentioned earlier only serves as a means to reducing the volatility of portfolio returns rather than protecting capital. When risk mitigation is confused as risk management, a false sense of security is being assumed. Risk mitigation tools dwell on relatively static relationships such as volatility and price correlation metrics to remain effective in reducing volatility of returns. Unfortunately, these relationships are systematically breached when we most rely on them remain stable, and in most cases rather violently.

The manager applying a risk mitigation overlay through paired positions, diversification, or hedges, will tend to accept a higher loss tolerance at the position and portfolio levels for the benefit of longer term results. As a matter of fact, risk mitigation tends to further subsidize the behavioral biases such as overconfidence and the disposition effect. In contrast, an effective and disciplined application of a risk management overlay will tend to suppress these behavioral biases.

Portfolio Management Framework

The process to abstain from the behavioral biases requires an active and dynamic portfolio management framework. The manager promptly accepts that the market ultimately dictates when ideas and themes are right or wrong. This framework requires discipline, a respect for the market's overwhelming forces, nimbleness, and humbleness in admitting being wrong; i.e. to suppress the behavioral biases rather than subsidizing them. Only then, will the hedge fund portfolio manager expose his investors to a higher propensity of absolute returns and protection of capital.

Mr. Stanley Druckenmiller explains it best with "It's not whether you're right or wrong, but how much money you make when you're right and how much you lose when you're wrong."

The quest for absolute returns does not rely on being consistently right, but how you react when right and behave when wrong; that is, when the market decides when you are right and when you are wrong.

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