Investments: Evaluating for Absolute Return or Alpha?

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It's one or the other. You cannot have both. The quest for one comes at the expense of the other.

There may be a legitimate place for both in an overall portfolio. One is seeking to outperform a reference benchmark such as an index or a peer group. The other is actively and dynamically allocating capital to pre-defined but liquid asset classes and steps aside when the market environment is not conducive to generating returns for the strategy; i.e. when protecting capital becomes the priority. When a manager is hanging on to his/her highest conviction positions, and perhaps also increasing the allocation when the market has yet to (or fails to) acknowledge the underlying valuation gap, protection of capital goes out the window.

The search, interviewing, evaluation and selection process should be differently applied to the two camps.

Track record analysis has become a favorite in the evaluation of Alpha-seeking managers. This is in large part explained by the fact that there is a clearly defined and measurable yardstick, i.e. the benchmark. The quantitative methodology has developed into a science. However, in the case of Absolute Return strategies where the benchmark and peer group is subject to interpretation, the qualitative evaluation process may be more suitable and appropriate.

Thus far, the hedge fund industry has mostly applied the quantitative tools to evaluate and select managers. As a matter of fact, if you Google "qualitative hedge fund analysis," the word "qualitative" is underlined in red, as if to indicate a spelling mistake, and you will be prompted with the statement "Did you mean: quantitative hedge fund analysis." This is obviously symptomatic of the industry's predisposition to apply and dwell on metrics rather than qualitative elements in the assessment and recommendation of hedge funds.

Industry practice and academic body of knowledge have obsessed investors towards the quest for Alpha. It is inscribed and prescribed in the investment policies. It is the metric dictating manager hiring, compensation and dismissal. However, Alpha is not a regularly observable or stable phenomenon. It is not necessarily earned in the period in which it is measured. True skill is demonstrated prior to portfolio inclusion rather than in that security's subsequent outperformance.

Essentially, a manager's ability to add Alpha is dependent on forces beyond his control, such as the emotions of other investors. The market, not the manager, ultimately determines prices. It is precisely at this juncture that Absolute Return can be distinguished from the Alpha-driven framework.

The successful Absolute Return manager allows the market to ultimately dictate portfolio inclusion, sizing, as well as net and gross exposure calibration. Whereas in Alpha, portfolio inclusion is merely sequential to the idea generation process; sizing is a derivative of conviction, magnitude of assessed valuation gap (and benchmark membership/weight).

Absolute Return represents a very small portion of the much contaminated hedge fund universe. The crucial attributes can be grouped among the following elements: active risk management, abstinence from two behavioral biases, and long volatility posture.

Active Risk Management

Not to be confused with "risk mitigation" such as hedging, diversification, pairing or market-neutrality. These only contribute to reducing the volatility of returns.

There should be little, if any, tolerance to allocating portfolio capital to ideas while waiting for the market to finally acknowledge their underlying thesis. Plainly, the propensity of absolute return is greatest as one allocates portfolio capital among ideas that are currently receptive to the market, and later reclaims the capital when the market is no longer receptive.

Active risk management directly impacts portfolio entry and leaving points, and positions sizing. It should determine the net exposure of the portfolio alon`g with the prevailing market trend and sentiment, as well as impacting the portfolio gross exposure that should generally be inversely proportional to the prevailing market volatility regime.

Behavioral Biases

Absolute Return is an active and disciplined undertaking. The discipline pertains to avoiding two destructive behavioral biases.

Overconfidence is typically exhibited by the Alpha-driven investors' unwillingness to discount widely available information and overestimating the value of proprietary and hard-earned superior inventory of publicly-disclosed data points to identify and formulate non-consensus and high-conviction investment ideas. However, it is the "widely available information" that dictates market prices. The focus on Alpha and "beating the market" only alienates the mandate from absolute return. Successful absolute return managers effectively navigate in the markets' ever-evolving collective perception of reality and emotions. The traditional asset manager may be "right" in expressing his research skills through positions sized to the conviction level. However, in a leveraged portfolio context, he may be right longer than he may remain solvent.
The Disposition Effect refers to a very human but irrational behavioral trait whereby individuals are unwilling to experience the pain of realizing loss of capital through disposition.

"Risk-mitigation" subsidizes whereas "active risk-management" suppresses the destructive behavioral biases.

Volatility

To harness volatility and episodes of market dislocations in your favor enhances the propensity of Absolute Returns, particularly in stressed events and market cycle. However, it is most imperative that any elements of explicit and implicit short volatility exposures should be avoided.
In some cases, linear positions in plain vanilla instruments can implicitly generate significant and potentially damaging non-linear relationships and exposures. The issue is relevant to the investment committees that institute a ban on the selling of options in the investment policy but allows the inclusion of a strategy that, although at face value does not engage in option transactions, but effectively may replicate a short option pay-off profile.

The investor should be keenly aware of strategy elements with embedded concerns such as: yield for carry, price mean-reversion, illiquidity, dwelling on longer term economic or price parameters, buy-and-hold, contrarian investing, and doubling-down.

Only competent and qualitative hedge fund diagnostics can effectively identify true Absolute Return strategies and distinguish from Alpha-focused managers.

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