



QUALITATIVE OR QUANTITATIVE

by Rene Levesque - Montjoy Capital

"Past Performance Is No Guarantee Of Future Results!!" The studies are well documented on the fact that manager selection based on trailing performance metrics is a losing proposition. Chasing return profiles ultimately result in disappointments for the investor. New research now suggests a mean-reversion theory: outperforming and underperforming fund managers across the world showed the idea of mean reversion to be factually correct, suggesting that strong periods of outperformance can be followed by less attractive results and that frequently strong periods of underperformance can be followed by improved returns.

Qualitative versus Quantitative
Quantitative tools do in fact help in building a case to justify manager selection decisions with evidence of hard data under the scrutiny of the investment committee members. "A judicious man uses statistics, not to get knowledge, but to save himself from having ignorance foisted upon him." (Thomas Carlyle) The institutional process has evolved into a culture that imposes quantitative filters on a discipline better referred to as an art rather than a science. Plainly, the justification process has somehow drifted as the core of the evaluation and decision-

making process; while the two being two very distinct activities. The problem is acutely applicable in the evaluation and selection of absolute return strategies operating within a contaminated universe we all refer to as "hedge funds".

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.

The large consultants previously prescribed but failed in the execution of Portable Alpha mandates. Perhaps their failure stems from the fact that the term "Portable Alpha" is a misnomer or, at least, a source of confusion between the intention and the means; the intention being adding a constant Alpha to a reference benchmark, and the means being the generation of absolute returns. The attributes leading to the failure of Portable Alpha mandates are strangely

found in its nomenclature alone. "Beware of false knowledge; it is more dangerous than ignorance." (George Bernard Shaw)

Absolute Returns versus Alpha

A Portable Alpha program simply consists in overlaying a passive equity or fixed income allocation with a stream of a reliable and stable source of positive returns to supplement the index returns hence the word "Alpha". The key words are "reliable and stable"; whatever the market environment, direction, and volatility regime. The all-weather and absolute return investment solution is a pivotal element to a successful Portable Alpha mandate. The concept, although sound and well-intended, unfortunately failed miserably because of ineffective and ill-qualified execution.

The term embeds a paradox; a successful Portable Alpha mandate simply does not dwell on Alpha. What good is a leveraged negative 14% when the market is down 22%? The key to the construct of a successful Portable Alpha mandate is an effective understanding and identification of absolute return strategies.

Recent research from a consulting group shows that even top-



performing Alpha-seeking managers eventually underperform. They claim that the industry should revisit the idea of treating Alpha as if it were a regularly observable phenomenon, when in reality, Alpha is not stable. They also observe that Alpha is not necessarily "earned" in the period in which it is measured. True skill might be demonstrated in the period of idea generation and analysis, i.e. before 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. After all, the market, not the manager, ultimately determines prices. Dwelling on the emotions of other investors, or Alpha, is incoherent with the expectations of a reliable and stable source of absolute returns.

The concept about skill being demonstrated in the period of idea generation and research, or before portfolio implementation, is interesting. Once implemented, a portfolio of expressed ideas is subjected to the emotions of other investors rather than the manager's skill. However, it is at this juncture that the absolute return framework can significantly be distinguished from traditional Alpha-seeking asset management. Absolute return is more akin to the concept of discipline in the active management of expressed ideas already in a portfolio.

The process framework leading to the generation of absolute return is very much entrenched with the activities that coincide with and

follow portfolio inclusion. The process is intimately relevant to, for example, the timing of entry and exits, the sizing of positions, the trade construct to express an idea, as well as the deliberate calibration of the net and gross portfolio exposures. Each of these active decisions is undertaken within the context of the collective emotions of other investors. Right or wrong, the collective perception of the market ultimately decides direction and price.

Effective absolute return managers are not-at-all focused on "beating the market" or generating Alpha. But rather, they are focused simply on generating returns. They effectively navigate in the markets' ever-evolving perception of reality or the collective emotions that are ultimately dictating price. They respect these overwhelming forces and understand that they can alienate market price well away from intrinsic valuation, and for an uncertain timeframe. The traditional asset manager may be "right" in expressing his research skills through positions sized/scaled to the underlying conviction level. However, in a leveraged portfolio context, he may be right longer than he may remain solvent. Absolute Return versus Hedge Funds

It is well documented that the genesis of hedge fund strategies dates back to Mr. Alfred Winslow Jones' investment framework, i.e. The Jones Model, where he added the concept of leverage to buy more shares and short-selling to mitigate/reduce market risk.

However, this does not coincide with the concept of absolute return. As a matter of fact, and as history demonstrates, none of the basic hedge fund tools offer a guarantee of absolute return. Hedging, market neutrality, diversification, and pairing of positions, only serve as a means to reduce the volatility of returns. Contrary to conventional wisdom, absolute return is possible without the use of any of the above-mentioned tools.

Although difficult to pinpoint its genesis, absolute return strategies became significantly more prominent and institutionalized as global banking organizations with leveraged balance sheets started taking on an increasing amount of capital market risk. In the midst of the deregulation of the financial markets, the "Big Bang" enacted in 1986 by the UK government can best be described as a pivotal event.

By virtue of the fact that these large banks where highly leveraged, the heightened sensitivity to the tolerance of loss was clearly communicated to the risk-takers, i.e. the proprietary traders. There was very low tolerance in allocating leveraged capital among ideas while waiting for the market to monetize these positions. Thus, the emergence of the absolute return and protection of capital framework became commonplace. These risk-takers (or risk managers) were hired, compensated and dismissed on the sole basis of generating absolute returns; not on generating "Alpha" or beating the markets. By virtue of the imposed



rules of engagement, absolute return became an active and disciplined process: "active" being the dynamic allocation capital to ideas then receptive to the market and "disciplined" in retrieving capital no longer being rewarded by the market. In contrast to the traditional asset manager spending most of his time researching ideas and building conviction, much of the absolute return manager attention and energy is focused on the portfolio implementation and ongoing risk allocation process.

The evaluation of investment strategies should go well beyond the means of quantitative justifications. An effective qualitative evaluation and understanding of investment strategies are paramount to the

manager selection process, and particularly pertaining to absolute return strategies. The hedge fund universe is heterogeneous in nature. Applying the same metrics and filters throughout will systematically fail to correctly identify managers embedding the highest propensity of delivering absolute returns. "Statistics are like a bikini. What they reveal is suggestive, but what they conceal is vital." (Aaron Levenstein)

The core element in the quest for absolute return is a matter of discipline and humbleness. This is very difficult, if not impossible, to capture through statistics and quantitative analysis.

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." When asked about the behavioral and personality characteristics of the successful traders, Mr. Schwager, author of several books on Market Wizards, answers with the following two elements: These are (1) "People who are successful traders will have the ability to quickly admit that they're wrong." and (2) "Discipline is also important."

These core competencies and behavioral characteristic are obviously best understood through a robust qualitative analysis framework.

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