Mind the Qualitative/Quantitative Gap

Stay disciplined and active to yield absolute returns

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"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 results 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; as Thomas Carlyle said, "A judicious man uses statistics, not to get knowledge, but to save himself from having ignorance foisted upon him." The 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 they are in fact 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 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 consultants appropriately 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 to add constant alpha to a reference benchmark, and the means being the generation of absolute returns. As George Bernard Shaw cautions, "Beware of false knowledge; it is more dangerous than ignorance." The attributes leading to the failure of portable alpha mandates are strangely found in its nomenclature alone.

Absolute returns versus alpha

A portable alpha programme simply consists in overlaying a passive equity or fixed income allocation with a stream of reliable and stable sources 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 construction 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., 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 or her 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 of skill being demonstrated in the period of idea generation and research, or prior to 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 returns 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 constructed 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, on simply generating returns. They effectively navigate in the markets' ever-evolving perception of reality, or the collective emotions. They respect the overwhelming forces of these perceptions and understand that these forces can alienate market price well away from intrinsic valuation 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 remains solvent.

Absolute return versus hedge funds

It is well documented that the genesis of hedge fund strategies dates back to Mr. Alfred Winslow Jones's 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 institutionalised as global banking organisations 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 were 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 monetise 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 of 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 or her 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 is 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," says Aaron Levenstein, "What they reveal is suggestive, but what they conceal is vital."

Stanley Druckenmiller explains it best in saying, "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." Discipline is a core competency of absolute return; it is a behavioural characteristic that is best understood through qualitative analysis. How a manager behaves when faced with winning and losing positions and how a portfolio reacts in the ever-evolving market regimes is best understood through the identification of any behavioural biases expressed by the manager in the deployment of the strategy, as well as the implicit and explicit volatility (Vega) and gap-risk (Gamma) postures embedded in the portfolio.

When asked about the behavioural and personality characteristics of successful traders, Jack Schwager, author of several books on Market Wizards, answers with the following: "People who are successful traders will have the ability to quickly admit that they're wrong… discipline is also important."

An adequate evaluation of the manager's behavioural biases is paramount to the effective identification of absolute return strategies within the hedge fund universe. As well, a comprehensive inventory of the strategy's embedded implicit and explicit volatility (Vega) and gap-risk (Gamma) postures are also important in the assessment of a manager's propensity to generate absolute returns.

Active risk management and behavioural 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 toolbox 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. As recent history demonstrated, none of the risk mitigation tools offer a guarantee of absolute returns.

The propensity of absolute return is immensely superior through a framework better described as "active risk management" rather than risk mitigation. This is because active risk management allows one to conquer two destructive behavioural biases: overconfidence and the disposition effect.

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Overconfidence is typically revealed by the deep due-diligence investors' unwillingness to discount widely available information. They tend to overestimate 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 the direction of price movement of securities.

The market forces, fueled by collective perceptions of reality, generally exceed those of the valuation gaps identified through deep proprietary research and analysis. 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, leveraged portfolios and underlying positions come under price pressure. Managers are at times forced to dispose positions at a loss to honour 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 refers to a very human but irrational behavioural 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 realising 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 from withdrawing capital among these ideas further contributes to the deterioration on the return profile and the manager's ability to protect capital and follow Will Rogers's advice: "When you find yourself in a hole, stop digging."

The propensity to generate absolute returns and protecting capital is greatly enhanced as the manager suppresses the destructive behavioural biases. 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. The manager dwelling on 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. Risk mitigation tends to further subsidise the behavioural biases such as overconfidence and the disposition effect, whereas an effective risk management framework will tend to suppress these behavioural biases.

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 position implementation and sizing, and the portfolio construction process. 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.

Generally, 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 the investor is willing to assume to eventually monetise 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; i.e., the destructive behavioural biases are then dictating the portfolio management process.

Volatility and gap risk

Obviously, to harness volatility and gap risks in your favour will increase the propensity of generating absolute returns. However, it is most imperative and paramount that one should avoid any elements of explicit and implicit short Vega and short Gamma exposures as well.

Vega and Gamma are both friend and foe in the context of generating absolute returns and protecting precious capital. Any implicit or explicit exposure to negative Vega or Gamma risks should be construed as an alienation or impediment to a higher propensity to deriving absolute returns.

As simple as it is to replicate or derive a forward currency contract through an inter-listed stock, it is also possible to embed therein a short Gamma exposure if passively held in a portfolio. The lesson was painfully learned by non-US institutional investors who overlaid their portable alpha programme with a linear currency hedge. Although done with the right intentions, the hedge embedded implied a short Gamma exposure that single-handedly dismantled all hopes of absolute returns, let alone alienating the overall portfolio from the then broad and severe drawdown.

Things are not always as they seem. Essentially, linear positions in plain vanilla instruments can in some cases implicitly generate significant and potentially damaging non-linear relationships.

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, may effectively replicate a short option pay-off profile. The concern is particularly applicable to any investor allocating to hedge funds with the objective of absolute returns, protection of capital, and providing a de-correlation to the broad market drawdown risks already assumed in the traditional long-only allocations.

If there is a certainty about volatility, it is the fact that it is persistent and most of all "volatile". The quest for absolute return is better achieved by keeping volatility on your side, rather than allowing it to work against your portfolio.

The almost ideal absolute return strategy is a perpetual "straddle" on the market: i.e., long an at-the-money call option and long an at-the-money put option. Consider the hedge fund fee structure as the premium paid, as in options, to hold a perpetual straddle and reap the benefits of both the upward and downward moves in asset prices.

Unfortunately, the strategy type that usually represents the first step forward in the hedge fund space to institutional investors does effectively replicate the exact opposite of the above-described ideal absolute return strategy, i.e. replicating a perpetual short straddle or short strangle profile. This strategy is the equity market neutral, and most particularly those dwelling on statistical or other quantitative parameters, and including quantitative fundamental data points. Portfolio diversification allows these strategies to tolerate short Vega and Gamma risk at the position level. However, these strategies are not able to withstand Gamma at the systemic or overall market level without significant impact or ultimate demise.

As a warning to the hedge fund investor considering some form of leveraged market-neutral, carry, credit, relative value, merger arbitrage, volatility arbitrage, mean-reversion, spread-based, long-term trend-following, liquidity premium, or long small-cap versus short large-cap strategies: some could embed elements of implied short Vega and Gamma exposures if these risks are not addressed properly and can therefore be considered as potentially riskier than traditional long-only mandates when the increasingly frequent and violent second order volatility episodes arise. In reality, they function relatively well in benign environments but bleed or blow up in volatile and crisis episodes, the opposite to Dr. Michael Ong's definition of what they should be doing: "Good Risk Management fosters vigilance in times of calm and instils discipline in times of crisis."

Only skilled qualitative hedge fund analysis resources should be deployed to properly execute diagnostics to identify strategies managed within a disciplined and active risk management framework, while also avoiding the ones embedding implied short volatility and gap risks. **THFJ**

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ABOUT THE AUTHOR

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