

What do investors want from active managers?



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The trinity of Alpha: Positive, Reliable, Uncorrelated

Investors want Alpha that is: 1) positive, 2) reliable and 3) preferably uncorrelated to underlying benchmarks and other active strategies. Pure Alpha must be achieved without any persistent risk factor tilts, such as Beta above one or a small size or value tilt vs. benchmark. Investors know that producing such Alpha is challenging and that it takes specialized skills to achieve. Thus, they expect rigor in the investment process and transparency in the objectives, including targets for the Alpha and risks (Tracking Error) of the active strategy overall and each segment or layer of the strategy. Knowing how much Alpha and risk should come from stock picking vs. sector tilts or market timing, or anything else, helps investors build a portfolio of active strategies.

Alpha is more valuable when reliable, so sophisticated investors focus on the Information Ratio. The Information Ratio is Alpha divided by Tracking Error. Thus, it gauges Alpha vs. reliability. As Tracking Error is the standard deviation or reliability of Alpha. An Information Ratio above the long-term Sharpe Ratio of the underlying benchmark is very valuable. Note that low Tracking Error doesn't mean that Alpha is normally low. It just indicates the active risk via Alpha volatility.

A rigorous investment process: Macro + Micro and Fundamental + Quantitative

We think active equity strategies should be based on fundamental analysis of macro and micro issues that determine value and influence total return potential in a conceptually robust way. We do not rely on technical or just empirical analysis. We believe that fundamental analysis is most effective and efficient when implemented in a well-organized research framework and decision making process. A process that includes quantitative tools that organize data to help identify and forecast the drivers of value. Such quantitative tools include many information databases and metrics organized for screening purposes, factor based ranking, DCF models, etc.

Every deviation from benchmark should be for a well justified fundamental reason

Every deviation from benchmark should be for a well justified fundamental reason that aligns with where that deviation occurs from the top to bottom. Beta deviations for macro reasons and relative asset class preferences, sector deviations for sector level reasons and relative sector preferences, and securities weight deviations for micro and relative stock specific preferences. Every overweight comes with an underweight, so both sides of any deviation must be justified.

Micro reasons include industry trends and company specific operating and financial forecasts. Macro reasons include views on the economy, inflation, interest rates, currencies, commodities, capital expenditure (capex) and credit conditions, etc. Macro considerations, including the relative valuations of other asset classes and key asset class sub-segments, tend to determine desired asset class or Beta exposure and also equity sector and other macro factor tilts in the portfolio. Micro considerations, including the relative valuation of securities, tend to determine the stocks selected within sectors and within other macro factor clusters. We refrain from sector or macro factor tilts for bottom-up reasons, but this can be justified if the micro assessment of large weight companies warrants it.

Portfolio risk attribution tools help to identify and optimize the risks in a portfolio

Bottom-up and top-down methods work best in their respective areas of benchmark deviation and will complement each other when they meet in the middle. Understand all risks in a portfolio from both its top-down and bottom-up architecture. Quantitative portfolio construction tools help ensure that all tilts from the top to bottom of benchmark are as intended and within risk budgets.

Systematic vs. Discretionary active strategies: Not so dissimilar when done well

Both Systematic and Discretionary active strategies seek Alpha vs. benchmarks. Like our Discretionary strategies, our Systematic strategies are based on fundamental frameworks. Systematic investing can be thought of as the codification of a fundamental portfolio manager's (PM) decision making process. Systematic strategies can be well suited for investing in Core and Value categories, whereas more PM discretion is often required with Growth stocks. Systematic strategies are usually better suited for well diversified portfolios from large eligible investment universes of mature industry stocks with long operating and valuation histories. More concentrated portfolios tend to require more PM discretion. Discretionary strategies are usually better suited with smaller and newer companies with short operating and valuation histories.

Active Share and Concentration are descriptive, but not performance or risk metrics

Active Share is not a reliable indication of likely Alpha or even active risk, in our view. We believe where different from benchmark is more important than how much different. Different in the right places counts. Active management should be selective and deliberate in its deviations from benchmark. The two ways to raise Active Share are to underweight big benchmark weight stocks or to be concentrated. But underweighting big weight stocks must be fundamentally justified, not automatic. Concentration is a two-edged sword. It also usually adds volatility to performance and makes it harder for investors to distinguish luck from skill. It makes sense to budget tilt sizes vs. benchmark weights on conviction, but it is wise to balance concentration and contrarianism.

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Glossary

Active Share: Active Share measures the percentage of stock holdings in a manager's portfolio that differ from the benchmark index. Active Share is calculated by taking the sum of the absolute value of the differences of the weight of each holding in a portfolio versus the weight of each holding in the benchmark index and dividing by two

Alpha: Alpha measures risk-adjusted return of a security or portfolio vs. its benchmark. Alpha is typically calculated as return minus benchmark return. Statistically, Alpha is the excess return by regressing the security/portfolio return versus the benchmark return. Alpha is the y-intercept of the regression line and Beta is the line's slope coefficient.

Beta: Beta is a measure of the systematic risk of a security or a portfolio based on its sensitivity to the market as a whole. Beta is the slope coefficient of the regression of security/portfolio return versus the benchmark return.

Capital expenditure (CAPEX) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.

Capital Asset Pricing Model (CAPM): CAPM is an asset pricing model based on the theory that a fair expected return of a security/portfolio should equal its risk-adjusted opportunity cost of capital. The model entails that investors should be compensated for: 1) time value of money (risk free rate), and 2) systematic risk. Expected Return = Risk Free Rate + Beta * (Expected Market Return – Risk Free Rate). CAPM helps estimate cost of equity. Absolute performance metrics and intrinsic valuation methods are the two sides of the same CAPM coin.

Concentration: Portfolio concentration measures single stock exposures of a portfolio. There are different metrics to measure concentration. A few examples are:

(1) Concentration ratios, calculated as aggregate weight of a given number (3, 5, 10, etc.) of stocks in the portfolio;
(2) Acar-Bhatnagar concentration index is a measure of market concentration. It has two alternative approaches: (i) A calibrated summation of the absolute departures from the uniform distribution case (A1); and (ii) A summation of the absolute differences among segment shares P_i and P_j (A2).

$$A1 = \frac{\sum_i |P_i - \frac{1}{n}|^2}{2(n-1)/n}; \quad A2 = \frac{\sum_{i=1}^{n-1} \sum_{j=1+i}^n |P_i - P_j|}{(n-1)}$$

(3) The Herfindhal-Hirschman Index (HHI) is a measure of market concentration by summing up the square of each stock's weight in a portfolio. The HHI index is always below 1 and a number close to 1 indicates high concentration.

Contrarianism Of a position or belief of an investment style that goes against prevailing market trends by buying poorly performing assets and then selling when they perform well

Information Ratio: Information Ratio is excess return (Alpha) divided by Tracking Error. It is a measure of a portfolio manager's ability to generate excess returns and the consistency of such.

Jensen's Alpha: Jensen's Alpha is used to measure the risk-adjusted return of a security or a portfolio in relation to the expected market return, which is based on the Capital Assets Pricing Model (CAPM). Jensen's alpha = Portfolio Return – [Risk Free Rate + Portfolio Beta * (Market Return – Risk Free Rate)].

Risk of Loss: Risk of loss is used to determine the likelihood of a specified loss over an investment horizon. It uses the expected distribution of returns to estimate the likelihood of a portfolio incurring a specified amount of loss.

Standard deviation is often used to represent the volatility of an investment. It depicts how widely an investment's returns vary from the investment's average return over a certain period.

Sharpe Ratio: The Sharpe ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. Sharpe Ratio = (Expected Portfolio Return – Risk Free Rate) / Portfolio Standard Deviation. Sharpe ratio uses Treasury bill yields as Risk Free Rate, CAPM uses Treasury bond yields to separate duration from Beta risk.

Tracking Error: Tracking Error is the standard deviation of portfolio returns minus benchmark return (i.e. volatility of Alpha). Tracking error shows performance consistency vs. benchmark over a given time period. It's a measure of investment strategy risk, which is a non-systematic risk. Alpha can be isolated from Beta with long/short portfolios, when Alpha strategies are isolated from Beta they offer an alternative to conventional assets in asset allocation.

Treynor Ratio: The Treynor ratio is the average return earned in excess of the risk-free per unit of systematic risk (market risk). Treynor Ratio = (Expected Portfolio Return – Risk Free Rate) / Portfolio Beta.

Value at Risk (VaR): Value at Risk is a measure to assess the probability of occurrence of a specified amount of potential loss and a specified time frame. VaR is based on the same concepts and calculations as Risk of Loss, but the time period in VaR calculations is usually a year or less as investors want to quantify the near term risk to their current capital levels, not risk to capital gains earned in years past.

Volatility: Volatility is the standard deviation of security/portfolio returns. It's a measure of the dispersion of the returns of a security/portfolio over a specified period of time.

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