April 30th, 2020

What drives returns?

The financial industry is obsessed with "alpha"

The main goal of portfolio management is to maximize returns relative to a targeted risk tolerance. Typically, portfolio returns can be broken down into alpha and beta. Beta generally measures the portion of returns that is attributable to the directional moves of the overall market, while alpha is everything else —generally a function of company- or industry-specific dynamics and/or market timing. The financial industry is obsessed with *seeking* alpha because it generally reflects portfolio managers' ability to pick specific stocks.

But investing for alpha has been synonymous with fees and underperformance

But consider our oft-cited adage: "Returns are greatest when capital is scarce" and renowned stock-picker Charlie Munger's comment: "For years and years and years, what we did was shoot fish in a barrel…It was so easy. It's gotten harder and harder and harder." The vast majority of the assets and resources dedicated to active management (consider most active mutual funds, hedge funds and research firms for starters) are primarily focused on picking stocks. There are currently 54 Wall Street analysts listed as actively covering Apple's stock, and one could reasonably conclude it will be difficult to achieve alpha when the stock gets so much attention. Munger is correct. Bank of America recently highlighted only 11% of actively managed large cap mutual funds outperformed their benchmark during the bull market from 2009 – 2019[1] (Chart 1). In addition, managers tend to hold too many stocks and "diversify away" potential alpha.

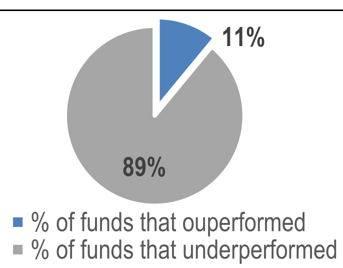
Asset allocation (beta management) is the dominant driver of returns

A well-known study of pension returns from 1977-1987 suggests that asset allocation was the "dominant contributor to total return," with asset allocation driving over 91% of the quarterly return variability[2]. Stocks, with their higher returns and greater volatility, have tended to be the primary driver of returns (Chart 2), but an allocation to stocks is NOT stock picking. Equity beta, not alpha, has been the biggest driver of portfolio returns, yet far fewer resources seem to be dedicated to the active management of beta.

Why actively manage beta?

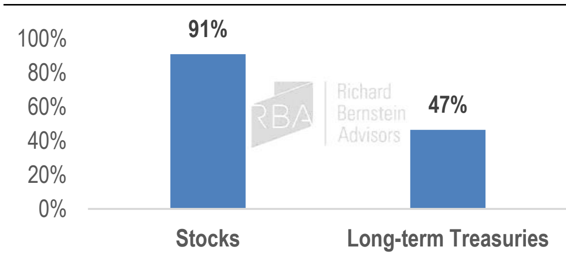
There are clear historical relationships between equity market risk/return and fundamental factors such as profits, liquidity and sentiment. It seems obvious the risk of auto accidents is lower on less crowded straightaways on sunny days. Similarly, the risk of significant market declines is lower when profits are accelerating, liquidity is improving, and nobody wants to own stocks. Those are periods where it makes sense to step on the gas pedal a bit harder.

Chart 1: Share of outperforming US active mutual funds 2009-2019



Source: BofA Global Research, Lipper Analytical Services
Note: This chart shows the percentage of actively managed US large cap mutual funds that outperformed their benchmark since December 2009 through December 2019.

Chart 2: Correlation of 50/50 stock/bond portfolio with underlying stock and bond components



Source: Richard Bernstein Advisors LLC, Ibbotson
Note: Based on monthly rebalanced returns of 50% US large cap stocks and 50% 15+ year Treasuries since January 1926 through March 2020.

Dan Suzuki, CFA
Deputy Chief Investment Officer

Please feel free to contact your regional portfolio specialist with any questions:
Phone: 212 692 4088
Email: sales@rbadvisors.com

Footnotes

[1] La Roche, J. (2017, February 15). Charlie Munger explains why he and Buffett have changed their minds about tech and airlines. *Yahoo Finance*. Retrieved from http://www.finance.yahoo.com

[2] Gary P. Brinson, Brian D. Singer & Gilbert L. Beebower (1991) Determinants of Portfolio Performance II: An Update, *Financial Analysts Journal*, 47:3, 40-48, DOI: 10.2469/faj.v47.n3.40

For more information About Dan Suzuki, please click here.

Recent & Related articles:

Sometimes defense is the best offense
Health Care for All
Cheap cyclicals may be a warning sign
Everything is awesome
Recession, recession, recession!
Perception vs. Reality: Valuations
Anatomy of a Bear Market
Don't Panic. Be Patient