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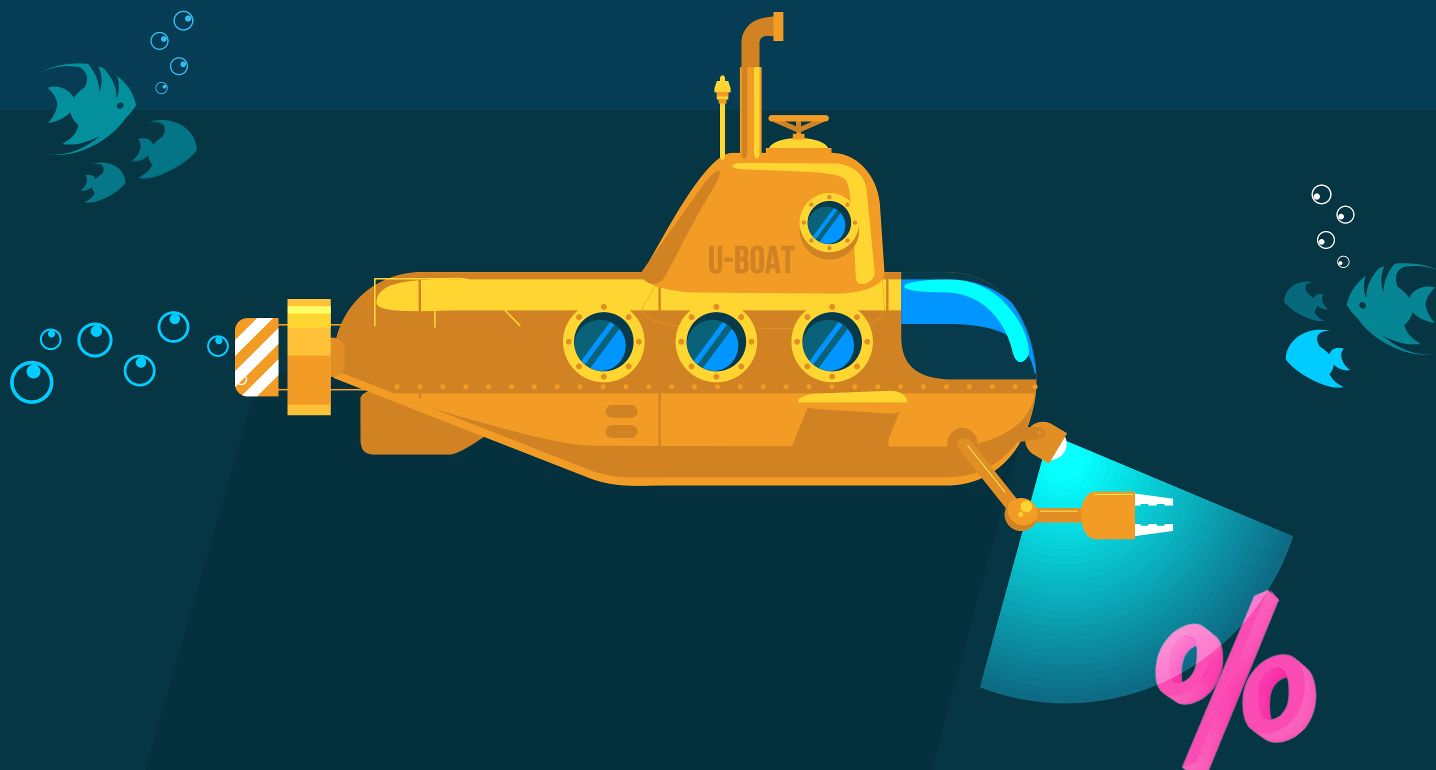
How low can we go?



INTERVIEW

Anthony R. Malloy
Executive Vice President & Chief Investment Officer,
New York Life Insurance Company

Thought Leadership for the Insurance Investment Community

Solving the Mysteries of Alpha

6

Northern Trust Asset Management

Michael Hunstad, PhD
Head of Quantitative Strategies
Northern Trust Asset Management

As evidenced by their high fees, stock pickers still are coveted in investing. Conventional wisdom attributes much of alpha to the skill of investment managers finding the best businesses at the right price. However, the mysteries of what creates positive alpha — or outperformance — have been chipped away over time. And not in the favor of conventional wisdom.

EXPLANATORY POWER

It may be helpful for some to recall that the strange but common use of Greek letters in investing — in particular beta and alpha — comes from the capital asset pricing model (CAPM) theory developed by William Sharpe in the 1960s, which provided the foundation for modern finance. The theory goes that beta, related to volatility, explains variation in stock returns. Higher beta means higher expected returns, and vice versa. Except that beta didn't explain everything. The unexplained part of Sharpe's model is referred to as alpha, commonly meant performance versus a benchmark.

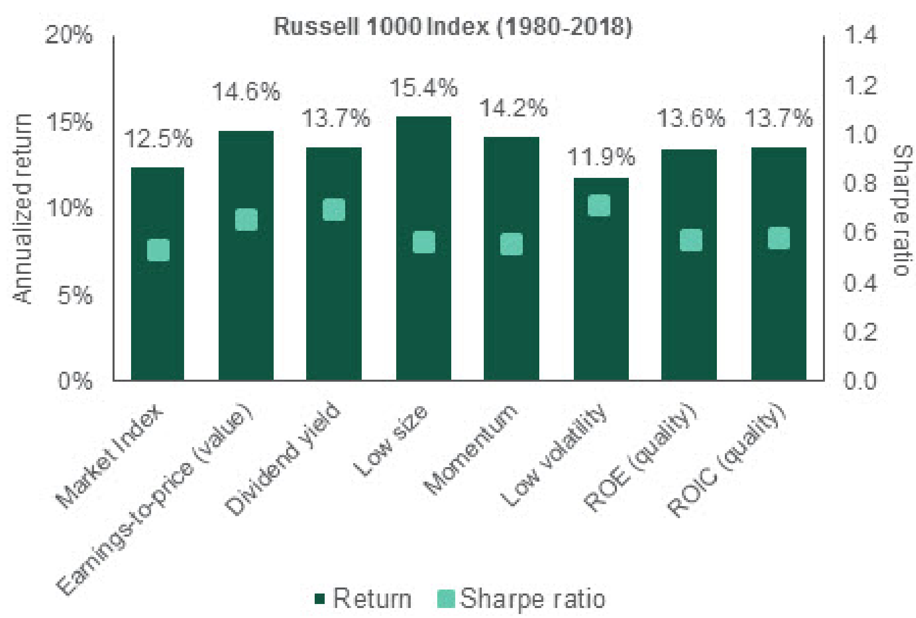
While the model offers no insight into the source of alpha, conventional wisdom has attributed it to the ability of the portfolio manager. Managers who consistently generated positive alpha were thought to have superior stock-picking abilities.

However, the advent of multi-factor pricing models has changed this dynamic. As the explanatory power of multi-factor models increased, unexplained active manager alpha necessarily decreased. This introduced the possibility that manager skill could be explained by other systematic factors.

This topic was thoroughly explored in the landmark paper by Mark Carhart (1997), in which he examined the performance of more than 1,800 mutual funds between 1962 and 1992. Initially he found strong persistence in active returns, supporting the notion that managers with superior insights can consistently generate positive alpha. However, after the returns were subsequently adjusted for style factors, the persistence disappeared. More importantly, after adjusting for style factors, alpha was found to be negative, indicating that manager "skill" actually decreased returns on average.

Carhart is by no means the only academic to find persistence in manager returns, nor was he the first (or last) to attribute persistence to style factors. Bollen and Busse (2001) confirmed all

Exhibit 1: Hypothetical Performance of Factors vs. Market
Portfolios that represent equity factors outperformed the market index, based on Russell 1000 Index data from 1980 to 2018.



SOURCE: Northern Trust Asset Management, Russell. Hypothetical factor performance represents the top 30% of stocks sorted by each individual factor (bottom 30% for low size and low volatility). Portfolios are capitalization weighted and rebalanced quarterly. For illustrative purposes only. Please see important information on hypothetical returns at the end of this presentation. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

the findings of Carhart, as did Daniel, Grinblatt, Titman and Wermers (1997). A number of other studies that were published during this time period drew similar conclusions.

RELIABLE AND COST-EFFECTIVE

The interest in style factor investing should not be surprising given its appeal to both passive and active investors. Style factors offer a systematic, diversified and transparent source of return, but with the added benefit of higher Sharpe ratios. Like traditional active investing, style factors offer the ability to outperform the market, but in a more reliable and cost-effective manner.

Read Northern Trust Asset Management's new paper ***Foundations in Factors*** for a detailed analysis on the evolution of factors, implications for investors, the perils of cyclicality, and diversity within and across factors.

Thought Leadership for the Insurance Investment Community

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insuranceaum.com
journal@insuranceaum.com
847.868.0044