Risk management and the search for alpha

Janus Capital Group

Institutional investors today are facing a number of potential challenges. The high nominal return environment that characterised the equity markets for two decades has moderated substantially, risk budgets are being rationalised as institutions prepare for a potential market rotation away from recently "hot" asset classes and many plans are experiencing an under funding conundrum. Enhanced index or risk-managed strategies offer a potential solution. Properly evaluating the risk characteristics of a manager is crucial, particularly if a plan is attempting to replace a passive investment that carries virtually no relative risk. Metrics like t-statistic and information ratio can help plan sponsors understand the inherent risks of a certain strategy from a statistical and probabilistic standpoint.

The case for enhanced strategies

Plans face a choice: They can leave their passive allocations alone and hope that strong market returns combined with higher tracking error strategies will be sufficient to generate target returns in this new market reality, or they can look for alternative ways to squeeze incremental amounts of excess return from their passive allocation.

Enhanced products aim to provide consistent alpha and control downside risk. This allows a plan sponsor to participate in the market, as with a passive index strategy, but potentially realise excess returns with little additional risk. These types of products can be an attractive solution to the risk/reward challenge. However, some may find themselves under-whelmed by relatively conservative excess return goals of enhanced managers. After all, in exchange for the controlled risk profiles, most enhanced providers strive only to produce excess returns of 1% to 2% net of fees above the benchmark. But to write off such an amount as insubstantial, is to ignore the power of compounding.

To put this in perspective, a £100 million investment will grow to £1 billion if compounded at 8% for 30 years. Adding just 1% in excess return yields £1.3 billion at the end of 30 years; while 2% excess return yields £1.7 billion – a not-so insignificant £700 million in excess return over the 30-year period. Just 1% to 2% excess return net of fees can go a surprisingly long way toward helping a plan meet long-term goals.

The key is to identify a manager who has a high probability of providing consistent, repeatable returns.

Selecting an enhanced manager: Skill vs. luck

Statistical tools that enable an investor to gain greater confidence in the historical alpha generated by a given investment strategy do exist. Information ratio is a popular measure of how consistent a manager is at generating alpha. Statistically, an information ratio of 1.0 implies out-performance five out of every six years. The higher the information ratio, over the long term, the better.

Taking this analysis a step further, one can gauge the probability of a manager delivering similar results in the future by computing a t-statistic. This essentially tests the statistical reliability of a regression coefficient. In an investment management context, the t-statistic can be used to test whether a manager's performance is the result of skill or luck.

Using standard normal distribution tables and variables measuring the size of the distribution and degree of confidence, it's possible to use a manager's t-statistic to determine whether the manager is good or just lucky. To illustrate, we calculated five-year t-statistics for the universe of US enhanced index managers using information ratio data*. Of the 101 managers who screened, more than 83% did not have the statistical support to demonstrate that their results were likely a product of skillful security selection as opposed to mere luck.

Those considering enhanced products would therefore be wise to search for strategies that have produced high information ratios as well as having t-statistics indicating a high degree of skill. Quantitative analysis alone cannot guarantee success. Any statistical conclusions should be validated through a thorough qualitative assessment of a manager's investment process. If that process is understandable, theoretically sound, consistently applied and has produced results that closely track stated expectations, the sponsor may be comfortable placing even greater faith in these quantitative measures.

Enhanced index strategies: A partial solution

Enhanced index strategies may be a partial solution for plan sponsors facing today's challenges. Still, reallocating indexed assets toward alpha-seeking strategies implies an increase in relative risk. Plans should carefully evaluate the risks and consistency of excess returns of any enhanced strategy while trying to ascertain whether the results are a result of skill or luck. Information ratio and t-statistic are two ways sponsors can attempt to evaluate potential managers.

** Data from the InvestorForce database*

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