Can Active Management Capture the *Alpha* Your Clients Seek?

The ink on the first iterations of the capital markets theory was barely dry before academics began debating whether passive or active management works better for investors. This paper will examine one theory of how active investment management can be the superior alternative, providing *alpha*-generating results.

A 40-Year-Old Debate

At the heart of the dispute is efficient market theory (EMT). In its purest form, EMT presumes that all information relevant to future returns is processed quickly and efficiently by investors, resulting in "fairly" priced securities at all times. Because all information is embedded immediately in prices, there can be no significant or lasting mispricing of securities, all investors will achieve similar results, and investors cannot add *alpha* through active management. Some managers will outperform, others will underperform, but it will be solely a matter of luck.

Opponents of EMT respond that, empirically speaking, markets are *not* completely efficient. An oft-cited example asks: How could a dot com stock have been fairly priced at $100 per share in February 2000 and also fairly priced at $20 per share three months later, given that the company's fundamentals and macro trends had not changed noticeably in the interim? To EMT skeptics, the theory does not adequately explain why investors leave their senses from time to time, creating extreme or excess volatility at the market or individual stock level. Nor does it illuminate why Peter Lynch, Warren Buffett and other notable investors outpace the markets with considerable frequency.

Champions of active management argue that "asset prices are not always driven by rational expectations of future returns"[2] because of so-called "inefficiencies" in the marketplace. These inefficiencies fall into two distinct types:

- Information does not flow evenly to all investors, so price changes are not always reflective of genuine information.
- Factors other than pure rational economic analysis regularly enter into the decision-making process.

Their conclusion: Because these inefficiencies or inconsistencies exist, managers *can* systematically generate excess return by exploiting them.

And the Winner Is...

Which side is correct? For the answer, we turned to experts on both sides of the aisle. Active management advocates Richard C. Grinold, Ph.D., and Ronald N. Kahn, Ph.D., are the authors of the highly regarded *Active Portfolio Management*. Burton Malkiel, Ph.D., is the author of *A Random Walk Down Wall Street,* a classic EMT text. We sampled interviews and articles in recent years, in which each expressed views based on decades of performance analysis. While they remain sharply divided over whether markets are efficient or not, both camps acknowledge that:

- In a minority of instances, a given manager or investment style can repeat above-market performance.[3,4]
- Past outperformance by itself is not a reliable predictor of future outperformance.[5,6]

Although their conclusions do not form an overwhelmingly positive endorsement of active management, we believe it would be wrong to dismiss the active approach, since it is indisputable fact that the Lynches and Buffetts exist — that is, that some percentage of active managers *do* best the market with notable consistency. The financial advisor who can identify those managers will have an edge in meeting client objectives and maintaining solid relationships, particularly when the client's investment mandate is to surpass (or otherwise deviate) from the market's results.

The salient question, then, is: What characteristics *are* predictive?

Who Can Unlock *Alpha*?

One set of answers is emerging among a different group of academics: the scientists behind the rapidly developing field of behavioral finance. Martin Leibowitz, William Jahnke, Robert Arnott, Peter Bernstein and others examine human financial decision-making behavior, which they find predictably *ir*rational.

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Bernstein studied "the great investors," those who have produced "extraordinary performance over a span of many years." His conclusion: "The investors share the common feature of not being in the mainstream (i.e., they are all contrarians in one way or another)... [and] share a number of characteristics — focus, patience, a clear-cut philosophy, a willingness to accept risks, [and] an innovation-prone attitude..."[7]

Leibowitz asserts that these investors have generated *alpha* from exploiting what he labels "chronic inefficiencies" — that is, gaps between market pricing and intrinsic value that "arise from structural and behavioral sources."[8] Resistant to rapid resolution from available market forces, these inefficiencies are persistent and, often, ambiguous and hard to discern. However, to observant investors who learn to recognize them and how they impact security pricing at different times, chronic inefficiencies may be actionable opportunities.

A Sampling of Behavioral Inefficiencies

The behavioralists have identified a number of irrational and generally counterproductive traits that are common among investors — even, we might add, professional investment managers and institutional investors. Among them are:

- **The "herding" effect**: The practice of following the crowd, often in the belief that, if an investor can find no way to outperform the crowd, at least he or she will not widely underperform it.
- **Compulsive confirmation seeking**: The tendency to seek opinions that will confirm one's own views rather than cause him or her to re-examine them.
- **Market ebullience cycle** or "unopened envelope" syndrome: Refers to excessive pessimism and optimism. In disappointing market conditions, people tend to ignore unpleasant news and may hold onto losing positions beyond any rationally explainable point. Conversely, when the "good times roll," investors tend to become euphoric and, consequently, let winning stocks ride well past their true value, or to invest more aggressively than their personal risk tolerance warrants.

Using Inefficiency, Efficiently

Certainly, Flippin, Bruce & Porter is not alone in seeing Leibowitz' position: capturing the potential in security price-value disconnects is at the heart of many an active manager's investment strategy. So, the final question is: if so many active managers recognize the omnipresence and importance of inefficiency, why do so few succeed in exploiting it? Perhaps it is because their investment approaches

generally address only half the sources of inefficiency.

As most any consultant can attest, a vast majority of active managers will claim that in-house research is the key to their performance results. In other words, they believe they do a superior job of capitalizing on the first type of the inefficiency; that is, uncovering and analyzing information, thus enabling them to make better-quality investment decisions. But if better research alone were sufficient to achieve this, could we not reasonably expect many more active managers with proprietary research to outperform?

After decades of selecting stocks (our own "empirical evidence"), we at Flippin, Bruce & Porter adhere to Leibowitz' view, which, again, holds that chronic inefficiencies, both structural and *behavioral* — and the price-vs.-value disconnects they create — are "very real, even if they are not always available or directionally consistent." [8]

> Many active managers fail to realize that more and "better" information (research) is only half the solution to capitalizing on inefficiency.

We view this lack of attention to the *behavioral* inefficiencies as the real "disconnect" in active investment management. If markets are inefficient due to imperfect information flow *and* human decision-making behavior, then improving information flow and analysis is only half the answer to benefiting from the situation. To regularly make better-quality decisions, an active investment manager should systematically address the human contributions to inefficiency, both within the market and within the investment manager.

Active management supporters Grinold and Kahn put it this way: "Successful active management will require cleverness and hard work: to uncover information ...and to *implement more efficiently* [emphasis ours] than other managers."[9]

How might that happen? Picking up where Leibowitz leaves off, we suggest that:

- **It is important to understand how the tendency to seek confirming opinions impacts financial decision-making**. It may be equally valuable to develop a strategy for avoiding that pitfall in the manager's own decision-making, by routinely subjecting in-house research and conclusions to contrary views from sharp-minded outsiders.
- **An active, *alpha*-seeking manager should be prepared to capitalize on excessive optimism and pessimism, panic and euphoria** — but without succumbing to either. This may require tools to carefully and consistently gauge investor sentiment, as well as internal policies and procedures to act as checks and balances to the emotional element in a manager's own buy and sell decisions. This is very important since, as Bernstein points, successful active managers must go against the tide as investment sentiment swings toward buoyant optimism or mulish pessimism.
- **Active managers may benefit from a systematic means of monitoring and understanding the activities of large investors** like hedge funds and pension plans, which are not immune to "herding" and other inefficiencies. They may single-handedly or as a group have undue influence on stock-price movements.

In Conclusion

Even efficient-market enthusiasts concede these days that the market is not always efficient; extremes and volatility are discernible and repetitive. In this age of mass communications, it is difficult to argue that imperfect information flow alone causes these

extremes, particularly in large, sophisticated markets. So, we find it doubtful that perfecting information flow — by itself — is sufficient to result in superior, *alpha*-generating active management.

What remains? The factor that is constant, with or without a plethora of facts and data, is the humans who process and act upon the information. Irrational behaviors, which the behavioralists have shown to be patterned and predictable in many ways, explain extremes and the opportunities thereby created. At Flippin, Bruce & Porter, we believe that by addressing both causes of inefficiency — that is, by integrating behavioral finance theories with rigorous information processing and analysis in a highly disciplined way — active managers may find themselves, like the "great investors," "out of the mainstream," often moving in opposition to the market consensus. They may also be better able to achieve the *alpha* advantage that they and financial advisors seek.

[1] Price, John, Ph.D. "Price on Value: Sherlock Holmes and the Science of Investing." September 2000.

[2] Shiller, Robert J. "From Efficient Markets Theory to Behavioral Finance," *Journal of Economic Perspectives*, Vol. 17, No. 1: 83-104.

[3,5] "Market Efficiency and Active Management: A Non-Random Talk with Burton G. Malkiel, Ph.D.," *The Journal of Investment Consulting*, Vol. 6, No 2: 11-19.

[4,6] Grinold, Richard C., Ph.D., and Khan, Ronald N., Ph.D. "The Historical Record for Active Management," The Journal of Investment Consulting, Vol 2. No. 1:1-7 (adapted from *Active Portfolio Management*).

[7] Bernstein, Peter L. "Alpha: The Real Thing, or Chimera?" *Economics and Portfolio Strategy*, March 15, 2005.

[8] Leibowitz, Martin L. "Reflections," Financial *Analysts Journal*, September/October 2005: 32-39.

[9] Grinold, Richard C., Ph.D., and Khan, Ronald N., Ph.D. "The Historical Record for Active Management," The Journal of Investment Consulting, Vol 2. No. 1:1-7 (adapted from *Active Portfolio Management*).

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