

ABR Dynamic Funds' Portfolio Construction Series: Part 23

Alpha and various other MPT stats are often used to rationalize performance chasing

In the previous installments, we have constructed portfolios which were significantly better than “60/40.” What is noteworthy for this installment is that it was done with just 4 benchmark behaviors. These were not the best performing versions of strategies, with significant alpha and improved risk features. They were fairly commonly available benchmarks. In fact, nothing whatsoever in this series has used alpha at all. There’s a reason for that. At most, it barely matters. **Alpha may not exist, and, even if it does exist, it may be too hard to identify reliably. Diversification, on the other hand, has been identifiable and extremely helpful.**

Alpha

1. To the extent that alpha means something stock specific that can be teased out by skilled managers through careful research into individual stocks, plenty of evidence suggests it may not even exist. But, more importantly, even if it does exist, finding it has been extremely difficult. As most studies indicate, past performance has almost nothing to do with future results. [Installment 3](#) discussed how worthless performance rankings have been, and [installment 7](#) discussed part of the reason they have been so worthless: it takes a very long time to have an idea of what to expect from an investment based solely on its results.

Although many investors like to look at 5 years, the actual time frame needed to determine statistically significant alpha is more like 5 market cycles.

- When used over ~5-year periods, alpha is little more than a way to intellectually rationalize performance chasing.
 - A simple performance chaser invests in investment A, not investment B, because the return of A was greater than the return of B over the past ~5 years.
 - In other words, $(A) > (B)$.
 - It’s often little more than window dressing to benchmark investments A and B to benchmark X and select the best outperformer. This performance chaser invests in A, not B, because A beat X by more than B beat X over the past ~5 years.
 - In other words, $(A-X) > (B-X)$, or, for the most part, $(A) > (B)$.

However, even if an investor has more like 5 market cycles of data and uses that data to identify a statistically significant alpha, it might not mean much:

- *Some alphas would appear statistically significant just by random luck, even if all alphas were all 0 over the very long-term.*
- *Is the same investment team making the same decisions in the same situations over the next 20-50 years as over the last 20-50 years?*

2. To the extent that alpha means a “factor,” its long-term outperformance can be viewed as a behavior in itself. Factors and their past behavior are well-publicized and benchmarked.

3. To the extent that alpha means a better implementation of some factor or strategy, it may be worth considering. However, the reason for dubbing it better must be more than just recent outperformance, which has been unreliable. There exist many more versions of each strategy than there exist reasons for outperformance; caution is warranted.

Diversification

Depending on definitions, alpha may not exist, and, even if it does exist, the effort to find it may be endless and fruitless (or even counterproductive). Instead, **we think it makes sense to focus on diversification within each behavior just like it made sense to focus on diversification across behaviors** in previous installments. Once an investor has selected a behavior s/he wants in the portfolio, we think it makes sense to look for investments that take different approaches to that behavior. Stated another way, within each benchmark behavior, we think it's wise to **select investments on the basis of their differences, knowing full well that means some of them will not be the best recent performers.**

Diversification within each behavior may lead to a more robust portfolio that can better weather various market conditions. Additionally, this approach may provide a defense against the things that eventually go wrong, by reducing the largest possible exposure to them at any time. For example, companies will go bankrupt; funds will blow out; individuals will commit fraud; governments will change regulations and tax codes; and, on a more mundane level, all investments will have extended periods of loss.

Therefore, it may make sense to use several different managers in several different jurisdictions with several different approaches to a selected benchmark behavior in several different investment vehicles. In other words, use several different wrappers, *provided, of course, that they are wrappers on the desired benchmark behavior and not the disguise on expensive beta we've uncovered so many times already.*

Surprised that we finally said wrapper may matter, after all those "Fooled by the Wrapper" installments? That's only because wrapper may matter just a little bit more than what's likely to be an ultimately fruitless search for alpha.

The next installment is the conclusion.