Alphalytics
Tearing up the Rules on Active Management
Alphalytics: Tearing up the rules on active management

This report marks the launch of Alphalytics – a new database and fund analytics application which measures and analyses the idiosyncratic return generated by active portfolio managers. We define and motivate the concept of Idiosyncratic Alpha and show that it is both more predictive of future active return and more persistent than past performance. As such, it gives asset owners a better way to select funds, and can help asset managers to prove their skill and defend themselves against passive substitution.

Idiosyncratic Alpha (IA) is the Alpha that is ‘left over’ after adjusting active return for common factor exposures. With key factor returns being passivized and available for free, and the vast cost and fee pressures faced by the whole industry, an active manager needs to demonstrate IA in order to justify charging an active fee. In a low return world, this non-replicable return will also be even more valuable to asset owners, who will need more than long-only Betas to cover their liabilities. As the industry evolves, IA is set to become a key determinant of which active managers survive.

We show that Idiosyncratic Alpha is a superior tool for manager assessment and selection, for 2 key reasons. First, it is more persistent than active return, and so gives a more reliable guide to future skill. Second, it is also more predictive of future active return, with high IA managers significantly more likely to beat their benchmarks in the future than high past return managers. IA thus delivers returns of ‘better quality’…and more of them.

IA is a key input into creating fund portfolios. We show that asset owners can create more effective fund combinations by focusing on the aggregate IA, rather than past return. High IA funds beat high return funds; but high IA fund portfolios add further value. We also show that ensuring IA diversification in a portfolio of funds, and controlling the aggregate factor exposures helps boost the overall return even further. Thus being able to properly measure IA, separate it out from factor exposures and manage both at the fund portfolio level gives asset owners a powerful toolkit for achieving a superior outcome for the end investor.

Who is generating IA now? We are able to track the aggregate IA generated by managers with different geo focus, style, process, etc. US Growth managers currently look to be the strongest space across the globe in terms of IA. Among global mandates, Blended strategies are in the lead, and systematic approaches have also seen a sharp improvement in their alpha. Global managers are generating the highest (and positive) Stock Picking Alpha at the moment, unlike their counterparts with US and European benchmarks.

Concentration, TE and Turnover can all matter from the IA generation standpoint, at least for fundamental managers. Our data suggest that the relatively concentrated, higher TE and lower turnover managers have the best shot at being at the top of the IA rankings, although of course there are many nuances to this. We will be exploring the various internal (related to investment behaviour and process) and external (market structure) drivers of Idiosyncratic Alpha in future Alphalytics publications.
DETAILS
This note marks the launch of Alphalytics – our fund analytics application which measures and analyses the idiosyncratic return generated by active portfolio managers. In this inaugural report under the Alphalytics umbrella, we explain and motivate the concept of Idiosyncratic Alpha for use in manager selection (for asset owners) and as a way for asset managers to show how ‘truly’ active they are, thus defending themselves against passive substitution.

Using the Alphalytics database, which currently covers c.10000 long only active equity funds across the globe, we partition funds according to the size of their Idiosyncratic Alpha (IA) - i.e. the alpha that is ‘left over’ after adjusting for common factor exposures (to be defined in detail below) - and look at what this implies about their probabilities of future success. We show that IA is a powerful filter that helps us identify future ‘winners’ in terms of both forward active return and forward idiosyncratic return, and is superior to using trailing return alone to select and reward managers. As such, idiosyncratic alpha can be a big help for asset owners and fund selectors in finding those managers that are truly ‘worth the fee’, as well as for asset managers to prove skill and address problems.

Specifically, we find that:

+ Managers with high Idiosyncratic Alpha go on to beat their benchmarks with very high hit rates over the following 3-5 years; whereas those that are in the bottom quartile of Idiosyncratic Alpha vs peers are most likely to generate negative active return. These results hold even on a net-of-fee basis, and can be a crucial defence for active managers against passive substitution.

+ Importantly, high IA managers also go on to outperform high trailing excess return managers. This is both in terms of hit rates (i.e. the % of managers in the top quartile by IA and excess return respectively that go on to beat their benchmarks) and in terms of the average and median levels of forward relative return that the two groups deliver. IA is thus more predictive of future active return than past performance is.

+ Idiosyncratic Alpha is also more ‘persistent’ than active return. We measure persistency as the statistical relationship between future and past IA, and find that it is considerably stronger than that between future and past return, with the latter relationship either non-existent, or mean-reverting. This is important as it makes this way of assessing managers more reliable than past returns, which are famously hard to hold on to.

+ Managers who have generated both high and persistent Idiosyncratic Alpha outperform those managers who have high but less persistent IA, and deliver higher active return over the following 3-5 years. We can thus achieve even better results in terms of picking successful managers ex ante by adding IA persistency as a filter. We can also show that managers with persistent IA generate forward returns that are smoother, further boosting expected Information Ratios.

Crucially, many of these findings also hold for portfolios of funds, and we show that creating portfolios of funds which have a high aggregate IA achieves consistently positive active returns that are superior to those of ‘the best’ (in terms of IA or active return) individual funds over the following 5 years. High aggregate IA portfolios also beat (significantly) the portfolios of funds which have a high aggregate trailing excess return. That is, idiosyncratic return can not only help asset owners select the best individual managers, but combine them together in a way that further boosts expected return from their overall holdings to be greater than ‘the sum of the parts’. We show below that the average 5-fund portfolio (drawn from a sample of 2000 global managers) which has a high (top quartile) aggregate idiosyncratic alpha delivers a 5yr forward excess return of 1.30% pa, with high hit rates. This compares with a 5yr forward excess return of -1.25% from a 5-fund portfolio which has a high (top quartile) aggregate trailing return. It also beats the average individual fund in the sample (-0.07%) and the average top IA fund in the sample (0.68%).

We also show that when we construct the portfolios of funds in a way that ensures, in addition to high aggregate IA, low aggregate factor exposures and low correlation between the funds’ individual Idiosyncratic Return streams, future returns are boosted even further. These are powerful arguments for using IA not just for assessing individual managers, but also at the overall fund holdings level /in portfolio construction by asset owners. It also underlies the importance of understanding the funds’ individual and combined true factor exposures, and the power of IA diversification. We present all these findings in more detail in this report.

We are frequently asked whether there are any particular patterns in terms of regions, or types of fund or mandate or investment behaviour, that tend to be associated with higher Idiosyncratic Alpha. Alphalytics allows us to answer these
questions. In this report we group managers by style, region, investment process, concentration and holding period and assess their skill and past and future returns. We get some very interesting results.

+ In terms of geo focus, for global, US and European managers, the IA based on the most recent 3 years is currently negative. Europe is the region where the IA is the least negative, while globally benchmarked managers have delivered the lowest IA. The global PMs have generated the highest Stock Picking Alpha (which we are able to estimate separately from Factor Timing Alpha), but are considerably behind both Europe and the US in terms of the Timing Alpha. We will monitor these trends on an ongoing basis.

+ In terms of style tilts, there has been a large divergence between Growth and Value managers, both within our global and US samples. **US Growth managers have been generating some of the best alpha 'out there'**. Around 40% of all US large cap Growth managers in our database have generated IA that places them in the top quartile (by idiosyncratic return) vs the broad universe (of 2500 US large cap managers). That is the highest proportion ever. US Value managers have seen the opposite trend, with their aggregate IA declining sharply, to -1.30% per annum, and only a tiny minority (around 10%) of all Value managers showing up in the top IA quartile for the broad investment universe. Globally the picture has been similar over the past couple of years, though less extreme, but more recently Growth managers have seen their IA deteriorate, driven by a negative contribution from their aggregate Timing ability. Globally, it is Blended style managers that are generating the least negative idiosyncratic return relative to the rest of the universe. All this raises interesting questions about the relationship between Idiosyncratic Alpha and the various Betas (and, by extension, the cycle and market environment) and whether they can be truly 'unstitched'. The cyclicality of the PM's aggregate ability to generate IA, and the relationship between IA and factor (and market) returns is a fascinating area for further study that we can pursue using the Alphalytics proprietary dataset.

+ We have seen a sharp gain in the IA generated by global managers running systematic approaches but the US quants and 'quantamental' managers have seen their presence among the top IA generators decline for several years. Fundamental managers investing in the US have been gaining steadily (a US fundamental manager is three times as likely to be in the top quartile by IA as a US quant manager at the moment) but those with a global focus have recently seen a drop in their idiosyncratic efficacy. We will explore what drives these differences and trends in forthcoming research.

+ **Turnover** seems to make a difference from the point of view of IA generation. The highest IA managers tend to have lower turnover, and vice versa. This speaks to our long-held concerns about too much churn in the industry inflicting an ultimate cost on the end investor.

+ **Concentration** is another variable that matters. We find that almost a third of top IA managers have the fewest number of holdings compared with the rest of the universe (< 50 holdings), and those who have very diversified portfolios have the smallest presence in the top IA quartile. However, concentration can also 'backfire' and go wrong – concentrated portfolios are also well represented among managers who have the worst IA. Diversifying a portfolio makes a manager less likely to find him/herself at either extreme in terms of IA rankings - so it may be a 'safer' approach but also one that makes one relatively unlikely to 'shoot the lights out' in terms of idiosyncratic return. High conviction, concentrated idiosyncratic bets work best...for those managers who have true underlying skill to get it right.

+ **Higher IA funds also tend to have higher Tracking Error**. 41% of the top IA generators have high (top quartile) TE, and only 11% have low TE. The picture is considerably more mixed among the 'worst' IA managers but the data do seem to suggest that one's chances of generating high Idiosyncratic Alpha are greater if one's approach deviates significantly from the benchmark, and vice versa.

+ We caveat by noting that our US and global samples of long only managers are dominated by fundamental approaches, but with that noted, the typical profile that emerges of a manager who has generated high IA in recent years is that of a manager who runs a relatively concentrated, high Tracking Error and low turnover portfolio. In the US and globally, it is, respectively, fundamental PMs with a Growth tilt, and systematic PMs with a blend of styles having been the most effective in generating Idiosyncratic return recently. Of course this changes over time, and we will be monitoring these trends, and their drivers, going forward. But there is also a stickiness to IA which is greater than that to 'normal' return - which means that these trends can be relied on to persist in the near future.
WHAT IS IDIOSYNCRATIC RETURN AND WHY DOES IT MATTER?

We have written extensively in the past about the importance of idiosyncratic return as a measure of ‘true value’ added by an active manager, or indeed of how active a manager is. In a world where factor returns are accessible at passive rates – i.e. close to zero or even below zero in many cases – via smart beta products, the common factor exposures that make up an important part of a manager’s active return can and should be priced differently. In effect they should be treated as benchmarks that a manager needs to beat in addition to the traditional market or sector ones. The smaller part of active return, depicted in Exhibit 2, which is idiosyncratic, i.e. 'survives' after common factor risk is taken into account, becomes a key measure of non-replicable activity and added value, and one that 'deserves' an active fee. Idiosyncratic return becomes even more important going forward given the more challenging outlook for returns on traditional asset classes implied by the current low yields and high equity valuations, which means that asset owners won’t be able to rely on the 60:40 to get the return they need to cover their liabilities. Asset managers will need to show the ability to deliver the return to help make up for the short fall, in a non-replicable (by passive) way.

EXHIBIT 1: Factors Available for (Less Than?) Free: The Lower Boundary for Smart Beta Fees Could Drop Below Zero

As summarized in Exhibit 2, idiosyncratic alpha can be generated in many different ways. The first thing that most people will think of in this context is security selection - or, within equities, Stock Picking. A skilled fund manager who generates high conviction investment ideas based on in-depth research and understanding of the highly nuanced characteristics of the company drivers, fundamentals and management should be able to demonstrate that the alpha they generate is not replicable by investing in a static combination of factor ETFs.

EXHIBIT 2: The Need for a New Definition of Alpha: What Counts as ‘Alpha’ is Shrinking–Idiosyncratic Alpha Is the New Way Forward

Note: We have created this time series of smart beta fees from data on the pricing of some of the most popular smart beta products for large cap US equities.

Source: Bernstein analysis

See Fund Management Strategy: Zero fee future - Is anything NOT going to zero fee in fund management? for sources of all funds used.

Source: Financial Times and Bernstein analysis
Another important source of skill is Timing. Whether it is explicit or implicit in one’s investment process, the timing of buying and selling decisions can result in timing the market, exposures to regions, countries, sectors, factors (including both style and macro ones), asset classes and so on. A decision to allocate to a particular asset class or beta is always an active one – and managers who do this well should be rewarded for that skill. In the next section we will show how we are able to isolate and measure the contribution to total idiosyncratic alpha and active return that comes from Stock Picking and Timing – two distinct and important sources of skill.

How do we measure idiosyncratic return?

We use regression analysis which allows us to avoid needing access to manager holdings, although holdings-based approaches are clearly also valid and have been used by academics and practitioners to measure and decompose Idiosyncratic Alpha. We have described our methodology extensively in papers referenced below. In the long only equities space we regress the fund active returns on the active (vs market) returns of the key investable (i.e. cheap and liquid) factors. The investability point is key – our aim is not to give a full theoretical attribution of a given manager’s performance but to measure the extent to which they can be replicated or replaced by static exposures to available products. Our angle is commercial rather than theoretical as we are trying to establish, quite simply, if a given manager is ‘worth paying for’ from an asset owner’s point of view.

The regression takes the general form of:

\[
    r_{it} = \alpha_i + \beta_{1,i}V_t + \beta_{2,i}Q_t + \beta_{3,i}M_t + \beta_{4,i}R_t + \epsilon_{i,t}
\]

The intercept becomes the measure of Idiosyncratic Alpha; we can also look at 1-R² from the regression as an alternative or additional measure of the extent to which the manager’s returns can be explained/replicated by factor exposures, and of what is left over.

We can extend the above equation in order to separate out the portion of the Idiosyncratic Alpha that is attributable to Stock Picking vs that coming from factor Timing. To do that we introduce dummy variables - one for each factor - which take the values of 1 and 0 respectively at times when the corresponding factor returns are positive and negative. The sum of the coefficients attached to these dummy variables becomes the measure of the Timing skill, and the intercept measures the Stock picking alpha in this formulation, as follows.

\[
    r_{iT} = \alpha_I + \beta_{1,I}V_t + \beta_{2,I}Q_t + \beta_{3,I}M_t + \beta_{4,I}R_t + \epsilon_{I,t}
\]

The sum of the Timing and Stock Picking alpha is the total idiosyncratic alpha, and is approximately equal in magnitude to the intercept in the simple regression in Equation 1 which does not separate out the two.

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2 Please see What is worth paying for in an asset manager? and Fund Management Strategy: How active is a fund manager? The robustness of idiosyncratic returns
How much idiosyncratic alpha is 'out there', and what drives it?

Our database assesses Idiosyncratic Alpha for nearly 10000 long only equity funds – equally split between mutual funds and institutional products – across the globe. We are working on adding Fixed Income, Multi-asset and Alternatives to our coverage.

We have aggregated our estimates of Idiosyncratic Alpha by region as well as by type of alpha, and the results are displayed in Exhibits 3–6. Note that our regressions use monthly historic data so these estimates give monthly, annualized Idiosyncratic Alpha. Exhibit 3 shows the IA for the latest trailing 3yr period, while the times series show the results of the regressions using a 3yr rolling window. The returns used here are gross of fees.

EXHIBIT 3: Aggregate Idiosyncratic Alpha by Region (%pa)

The IA is estimated based on the most recent three years using gross returns. We use a sample of 2000 long only equity managers benchmarked to MSCI World and MSCI ACWI for the ‘global’ group; 2500 managers benchmarked to S&P indices, Russell indices and MSCI USA for ‘US’, and 1000 managers benchmarked to MSCI Europe, MSCI EMU and Euro STOXX for ‘Europe’.

Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis
The IA is estimated based on the rolling 3yr regression window using gross returns. We use a sample of 2000 long only equity managers benchmarked to MSCI World and MSCI ACWI for the 'global' group; 2500 managers benchmarked to S&P indices, Russell indices and MSCI USA for 'US', and 1000 managers benchmarked to MSCI Europe, MSCI EMU and Euro STOXX for 'Europe'.


We see from the above exhibits that the Total IA is negative across the three investment universes, although its composition is different. Global managers are adding impressive value through Stock Picking, but this has unfortunately been offset by poor Timing decisions (explicit or implicit), resulting in the negative total alpha. In Europe, it’s the other way around — managers have actually added value through Timing but Stock Picking Alpha has been negative, having seen a very sharp decline since late 2017. In the US, Stock Picking has been improving over the past couple of years, but not enough to cross over into positive territory. Exhibits 4–6 illustrate the ‘cyclicality’ of the alpha which we will explore in more detail in our future research.

In Europe, the extremely sharp decline in the Stock Picking Alpha since late 2017 and the rapid rise in the Timing Alpha over the same period, which have not been matched by other regions, seem to have coincided with the sharp rise in factor correlations in Europe since 2017, which was also much more extreme here than in the US (Exhibit 7 and Exhibit 8), Stocks moving in large factor cohorts, instead of individually, has meant that generating alpha through Stock Picking has been harder, effectively implying fewer independent opportunities in accordance with Grinold’s so-called Fundamental Law of Active Portfolio Management. By contrast, as factors have been co-moving to an unusually high degree, portfolio managers appear to have been relatively more effective in timing their factor exposures, as evidenced by the improving Timing Alpha. ‘Getting the factor call right’ has been important for portfolio performance, and the factor call has been very ‘binary’ in the sense that getting one of them right made it easier to also time the others correctly. Specifically, at least until very recently, being long Growth and Momentum at the expense of Value would have been the right timing decision. Unfortunately, the ability to be exposed to the right factor has not been sufficient to make up for the harder environment for Stock Picking and the total of the two alphas has been negative, as elsewhere.
The correlations are based on the average absolute pairwise correlations of daily signed long-short factor returns for US composite value, US composite quality, US long term growth and US price momentum. The correlations are calculated over a rolling 6 month window.

Source: MSCI, FactSet, IBES, Bernstein analysis

In Exhibits 9 - 13 we look more explicitly at the breakdown of the active returns generated by PMs through the lens of factors and idiosyncratic return. We show, for our MSCI World-benchmarked sample, how much return has been coming from IA vs factors and how that has related to overall portfolio risk. The analysis below includes both institutional and retail products and is on a net return basis.

On average, over the past few years managers have generated positive active return coming from factors while Idiosyncratic Alpha has been an increasingly negative contributor to benchmark-relative performance (Exhibits 9 and 10). For this particular sample of funds, Idiosyncratic Alpha has been a negative, or at best zero, contributor to excess return for the best part of the past 15 years – the excess return has come almost entirely from factors. Even less flattering has been the shift that occurred around 2012, when Idiosyncratic Alpha became an increasingly large negative contributor to relative return.
Exhibits 11 and 12 allow us to drill further down and see how individual factor exposures have contributed to or detracted from returns. It looks as though, in aggregate, our global managers have been ‘on the right side’ of each key factor – Value, Momentum, Min Vol and Quality have each contributed positively to returns. Exhibit 11 shows the actual aggregate factor exposures – as measured by the factor coefficients from our Idiosyncratic Alpha regressions detailed in equations 1 and 2 above – while Exhibit 12 shows the corresponding factor excess returns. We can see that managers have rightly been under-exposed to Value (with the aggregate Beta to Value having been negative) over the past few years, which has contributed positively to relative return given that Value has been underperforming over the same time period.
Finally, Exhibit 13 below looks at the trends in the aggregate realized Tracking Error (TE) of the funds in our sample vs the spread between the active return from Idiosyncratic Alpha and the active return from factors. It appears that the two tend to move together – i.e. the times when more of the return is derived from idiosyncratic sources rather than common factors are also the times when realized TE is higher. This makes sense – by definition, idiosyncratic return is the return that is generated from sources that are unrelated to the various benchmarks and common risk factors, so when a greater share of return (and risk) comes from Idiosyncratic Alpha, TE is likely to be higher. Given the low market volatility over the past few years, many of our asset manager clients have struggled to maintain or increase their TE – and we can indeed see from the Exhibit that the aggregate TE has been low over the past few years, along with the contribution to return from Idiosyncratic Alpha. It is likely that the two trends have common drivers in market structure and the macro environment, and we will address these in more depth in the future.
**EXHIBIT 13: Tracking Error and Alpha to Factor Return Spread**

The relationship between the tracking error and spread between alpha and factor return across a 3yr horizon for a sample of 2000 ‘Global’ managers
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

Exhibit 14 below shows the distribution of idiosyncratic return for our sample of globally-benchmarked managers, with the monthly IA plotted on the left-hand side axis, and the associated t-stat on the right-hand side. What we want is, of course, for the alpha to be positive AND statistically significant, i.e. for the t-stat to exceed a threshold value (in this case, we use 1.29 – critical at a 80% confidence level – which is marked by the dashed line on the chart).

For this particular sample, we see that it is only a handful of managers on the top left who add value through idiosyncratic return with statistical significance. The majority of managers have generated negative alpha, or alpha that is positive but not significant. This distribution is representative and is similar for other regions.
EXHIBIT 14: **The Need for Idiosyncratic Returns: How Do Funds Compare? Global Funds: Idiosyncratic Alpha**

Note: The chart shows results from the regression of relative fund returns versus relative returns of Value, Momentum, Quality and Min Vol factors for the period of March 2016–March 2019. The returns are gross in total return USD terms for a sample of 2000 global funds.

Source: Morningstar, eVestment, MSCI and Bernstein analysis

If such a small number of funds deliver idiosyncratic return, does that mean that it is not ‘worth bothering’ with seeking it? We think that, on the contrary, the high bar presents a key opportunity for managers who can show true skill to defend themselves against passive and justify their fees. The seemingly small portion of active return that is idiosyncratic is going to be even more valuable going forward when the return from asset class exposures is set to be lower, as we discussed above. In Exhibit 15 below we show the breakdown of the total return for the 30 best performing US equity funds since 1988, into market, factor and idiosyncratic components; and then project it 10yrs forward assuming the same level of Idiosyncratic Alpha and factor returns but using the forecast for the market based on the current Schiller PE, i.e. 3.5% pa. The idiosyncratic return of 1.4% looks a lot more significant in this context, and certainly worth having. Despite the fact only a relatively small proportion of active managers generate it consistently, it is worthwhile for asset owners to try and identify those who do. The good news is that this can be done.
EXHIBIT 15: Idiosyncratic Return Matters More in a Low Return World (Percent)

The analysis looks at the performance of 30 US funds that had the best performance since June 1988. The "before" column shows the sum of US market performance, factor returns (Value, Momentum, Quality and Min Vol) and average idiosyncratic alpha. For "after" we assume 3.5% market returns implied by current Shiller PE and we are keeping the factor returns and idiosyncratic alpha constant.

Source: Morningstar, MSCI and Bernstein analysis

In the sections below we show that Idiosyncratic Alpha is both more persistent than active return - meaning that we can reliably identify managers who are likely to generate idiosyncratic return in the future using their past Idiosyncratic Alpha as a guide – and also, importantly, more predictive of future active return than past active return. At the very least, it is therefore an extremely useful metric to use alongside past performance to assess, select and reward managers.

HOW (AND WHY) CAN IDIOSYNCRATIC ALPHA HELP ASSET OWNERS SELECT MANAGERS?

The problems with selecting managers based on past performance are only too well known. Chasing performance is just as damaging and costly at the fund level as it is at the security level, with an estimated 26bps dead weight loss to the industry resulting from excessive manager churn, in the form of a spread between the actual return achieved by funds, and the average return experienced by the end investors in those funds. Exhibits 16 and 17 show that, on average, there is a 3-year hiring and firing cycle with managers getting hired at the 3-year performance peak, and fired at the 3-year trough.

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3 Please see Morningstar - 'Mind the Gap', June 2018
The issue is that there is little persistence in fund returns. In more quantitative terms, we can show that the relationship between past and future return for a given manager is, in aggregate, weak or negative (ie mean reverting) and so the approach that is so embedded in the industry of selecting managers based on performance has very obvious limitations.

**Idiosyncratic Alpha is persistent**

By contrast, a key advantage of idiosyncratic return as a measure of manager skill/success - in addition to the fact that it isolates the part of the return that is genuinely non-replicable and can’t be passivized – is that it can be shown to be more persistent. That is, if a manager demonstrates high IA at period t, they are more likely to remain a high IA manager at t+1 compared to a manager with high return at t delivering high return at t+1. Intuitively, this makes sense as the measure isolates the portion of return that 'survives' after we strip out factor exposures, which can be highly cyclical. As such we remove a lot of the (good or bad) 'luck' from being exposed to the right or wrong factor, and are left with the measure of return that is more closely related to skill – and should therefore be more persistent (note that this also includes the alpha attributable to the skill to time factors, which we are able to distinguish from pure Stock Picking skill as detailed above).

How do we show this empirically? One way to demonstrate the persistence of Idiosyncratic Alpha is to run a panel or pooled regression of forward on trailing idiosyncratic alpha across the universe of funds and across time periods. The size and statistical significance of the coefficient in the regression will give an indication as to the persistency of alpha. We do this for our samples of US and global funds, using data from 1998 with 3yr and 5yr rolling windows to calculate the alphas (thus regressing 3yr forward on 3yr trailing alpha, etc.). We also run the same regression but for the standard definition of excess return, i.e. relative to benchmark return (regressing forward on trailing relative return) to compare the persistency of the two performance measures. The results are shown in Exhibits 18 to Exhibit 21. We see that coefficient in the regression is considerably larger for

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**EXHIBIT 16: Average mutual fund holding periods**

<table>
<thead>
<tr>
<th>Holding period in years</th>
<th>Equity Funds</th>
<th>Bond Funds</th>
<th>Balanced Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.3</td>
<td></td>
<td>3.2</td>
<td>4.3</td>
</tr>
</tbody>
</table>

Source: Dalbar 2012, Bernstein analysis

**EXHIBIT 17: Managers tend to be hired after outperforming for 3 yrs, and go on to underperform thereafter**

<table>
<thead>
<tr>
<th>Institutional investment management hire/fire decision, 1996-2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess return of hired manager vs fired manager</td>
</tr>
<tr>
<td>Before manager</td>
</tr>
<tr>
<td>After manager change</td>
</tr>
<tr>
<td>3 years</td>
</tr>
<tr>
<td>2 years</td>
</tr>
<tr>
<td>1 year</td>
</tr>
<tr>
<td>-2</td>
</tr>
<tr>
<td>1 year</td>
</tr>
<tr>
<td>2 years</td>
</tr>
<tr>
<td>3 years</td>
</tr>
</tbody>
</table>

idiosyncratic alpha than for excess return (where it is close to zero or negative); statistical significance is also much higher. This suggests that Idiosyncratic Alpha is indeed more persistent than excess return. These results were also corroborated in the earlier research by Chin et al\textsuperscript{4}.

EXHIBIT 18: 3 Year rolling Regressions of forward on trailing return and forward on trailing idiosyncratic alpha – US funds

<table>
<thead>
<tr>
<th>3 Year Regressions</th>
<th>Coefficient</th>
<th>T stat</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess Return Persistence</td>
<td>0.04</td>
<td>2.20</td>
</tr>
<tr>
<td>Idiosyncratic Alpha Persistence</td>
<td>0.15</td>
<td>7.10</td>
</tr>
</tbody>
</table>

Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

Table shows the results of regressing 3yr forward on 3yr trailing IA for a sample of 500 S&P 500 benchmarked funds since 1998. The Beta coefficient in the regression is our measure of the persistency of IA and excess return.

EXHIBIT 19: Top Alpha Quartile, 3 Year rolling regressions of forward on trailing return and forward on trailing idiosyncratic alpha – US funds

<table>
<thead>
<tr>
<th>Top Alpha Quartile 3 Year Regressions</th>
<th>Coefficient</th>
<th>T stat</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess Return Persistence</td>
<td>0.07</td>
<td>2.79</td>
</tr>
<tr>
<td>Idiosyncratic Alpha Persistence</td>
<td>0.17</td>
<td>4.96</td>
</tr>
</tbody>
</table>

Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

Another way to show persistency is to note that the managers who have generated the biggest IA today are also most likely to be delivering the top IA in the future using conditional probabilities. In Exhibit 22 - Exhibit 25 we show the probabilities of managers being in each quartile by IA 1 and 3 years out, conditional on their IA ranking today. We can see that on both time horizons, the most likely position for a top-ranking IA manager is to remain at the top, and for a laggard to remain at the bottom. This supports using IA as a robust and persistent metric for fund selectors.

EXHIBIT 22: **Top Skill Managers: Conditional Probabilities of Being in Each Quartile by Skill One Year Later (Percent)**

<table>
<thead>
<tr>
<th>Quartile</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top Quartile</td>
<td>48.7</td>
</tr>
<tr>
<td>2nd Quartile</td>
<td>24.8</td>
</tr>
<tr>
<td>3rd Quartile</td>
<td>11.6</td>
</tr>
<tr>
<td>Bottom Quartile</td>
<td>6.2</td>
</tr>
</tbody>
</table>

Data for 2003-2016 period; 3yr trailing idiosyncratic alpha; 'Global' sample net returns
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

EXHIBIT 23: **Bottom Skill Managers: Conditional Probabilities of Being in Each Quartile by Skill One Year Later (Percent)**

<table>
<thead>
<tr>
<th>Quartile</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bottom Quartile</td>
<td>52.5</td>
</tr>
<tr>
<td>3rd Quartile</td>
<td>24.3</td>
</tr>
<tr>
<td>2nd Quartile</td>
<td>10.9</td>
</tr>
<tr>
<td>Top Quartile</td>
<td>6.4</td>
</tr>
</tbody>
</table>

Data for 2003-2016 period; 3yr trailing idiosyncratic alpha; 'Global' sample net returns
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

EXHIBIT 24: **Top Skill Managers: Conditional Probabilities of Being in Each Quartile by Skill 3 Years Later (Percent)**

<table>
<thead>
<tr>
<th>Quartile</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top Quartile</td>
<td>32.6</td>
</tr>
<tr>
<td>2nd Quartile</td>
<td>22.6</td>
</tr>
<tr>
<td>3rd Quartile</td>
<td>20.3</td>
</tr>
<tr>
<td>Bottom Quartile</td>
<td>24.6</td>
</tr>
</tbody>
</table>

Data for 2003-2016 period; 3yr trailing idiosyncratic alpha; 'Global' sample net returns
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

EXHIBIT 25: **Bottom Skill Managers: Conditional Probabilities of Being in Each Quartile by Skill 3 Years Later (Percent)**

<table>
<thead>
<tr>
<th>Quartile</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bottom Quartile</td>
<td>30.7</td>
</tr>
<tr>
<td>3rd Quartile</td>
<td>24.2</td>
</tr>
<tr>
<td>2nd Quartile</td>
<td>20.7</td>
</tr>
<tr>
<td>Top Quartile</td>
<td>24.3</td>
</tr>
</tbody>
</table>

Data for 2003-2016 period; 3yr trailing idiosyncratic alpha; 'Global' sample net returns
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis
**Idiosyncratic return is more predictive of future active return than past returns**

The persistency of idiosyncratic return is good news, but clearly it is also important to ask what the level of idiosyncratic return that a fund has generated implies about its future active return if we are to propose this measure as a way of selecting managers. We perform fund-level analysis on the same global sample of managers, estimating their idiosyncratic alpha based on 10 years of history and the persistence of this alpha using a rolling 3yr and 5yr window. We then partition managers according to the level and persistency of their idiosyncratic alpha and see whether it can be useful at predicting how the fund manager will perform in the future.

The table below shows, for managers in the highest and lowest quartile by idiosyncratic alpha, the proportion of each group that generates positive and negative excess returns respectively over the following 3 years. We do this on the basis of both gross and net returns.

The results are striking. On a gross-of-fee basis, 75% of the top IA managers outperform the market over the following 3 years, and 61% do so on a net-of-fee basis – a much higher bar to beat. The opposite is true for the managers in the bottom IA quartile, which have a low probability of beating the market on a net-of-fee basis in particular. If we use trailing return as a predictor instead, the hit rates are considerably less impressive; for the top excess return funds, the probability of beating the benchmark over the following 3 years is about 50/50. Our ability to discriminate between future winners and losers is thus much improved using trailing IA as a guide.

**EXHIBIT 26: Idiosyncratic Alpha is predictive of future excess return, and gives asset owners better odds of picking future winners than past return alone**

<table>
<thead>
<tr>
<th>Gross 3 year forward excess return</th>
<th>&lt;=0</th>
<th>&gt;0</th>
<th>&lt;=0</th>
<th>&gt;0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top IA quartile</td>
<td>25%</td>
<td>75%</td>
<td>39%</td>
<td>61%</td>
</tr>
<tr>
<td>Top excess return quartile</td>
<td>35%</td>
<td>65%</td>
<td>50%</td>
<td>51%</td>
</tr>
<tr>
<td>Bottom IA quartile</td>
<td>50%</td>
<td>50%</td>
<td>77%</td>
<td>23%</td>
</tr>
<tr>
<td>Bottom excess return quartile</td>
<td>49%</td>
<td>51%</td>
<td>70%</td>
<td>30%</td>
</tr>
</tbody>
</table>

Note: Based on 2006 – 2016 period; sample of 2000 Globally benchmarked managers
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

Given the disappointment with the performance of active managers, and their apparent inability in aggregate to add value in excess of the market after fees, which has helped fuel the flight to passive over the past few years, this is perhaps a key way for active to fight back. Despite the disappointing aggregate numbers – which have also been contributed to by what we would argue are cyclical or at least temporary forces such as high correlations between stocks and factors, the perennially low yields weighing on the efficacy of Value as a strategy and seemingly impairing mean reversion etc. – there ARE managers who add genuine value, and they CAN be identified. Idiosyncratic Alpha may not be a perfect predictor of future return, but it is a strong filter which helps us to separate future winners from losers.

This analysis also helps answer the concerns of those who think that picking managers on the basis of IA somehow sacrifices ‘normal’ alpha, i.e. excess return. This is not the case. Focusing on skill, one gets a higher probability of outperformance – and, furthermore, one gets a different kind of return – a ‘truly active’, non-replicable kind that is worth paying for.

We can further enhance these results by overlaying idiosyncratic alpha with alpha persistence and other criteria. Exhibit 27 does this by showing the gains in excess returns that one can obtain by filtering managers this way. We can see that for our global sample, a ‘random’ or average manager generates a 3-yr excess return of 0.2% pa before fees. If we first filter this sample by IA, and take the top quartile of managers, the average excess return goes up to 1.1% pa (compared with 0.5% pa for the top quartile of managers by trailing excess return). Then further refining the sample by looking for managers that are in the top quartile on the combination of IA and the persistency of the IA we get a group who deliver the average excess return of 1.5% pa; finally, combining these managers with those who have also delivered strong excess return in the past we get to an average excess return of 2.5% pa. The incremental value of using IA and IA persistence as criteria is even greater on a 5yr forward basis; here we can go from a negative expected excess return (-0.3% pa) for the group of top performing fund managers based on
trailing excess return to 1.0% pa and 1.3% pa outperformance respectively if we use IA and its persistence instead of, or in addition to trailing return.

EXHIBIT 27: Using IA and its persistence as filters for picking managers helps achieve a considerable boost in expected outperformance compared with return-based metrics

<table>
<thead>
<tr>
<th>Random Manager</th>
<th>Ave 3 yr fwd excess return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top quartile by:</td>
<td>Ave 3yr fwd excess return</td>
</tr>
<tr>
<td>IA</td>
<td>1.1%</td>
</tr>
<tr>
<td>Excess return</td>
<td>0.5%</td>
</tr>
<tr>
<td>IA + IA persistence</td>
<td>1.5%</td>
</tr>
<tr>
<td>IA+ IA persistence + Excess return</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

Average 3 yr forward excess return

<table>
<thead>
<tr>
<th>Random Manager</th>
<th>Ave 5 yr fwd excess return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top quartile by:</td>
<td>Ave 5yr fwd excess return</td>
</tr>
<tr>
<td>IA</td>
<td>0.1%</td>
</tr>
<tr>
<td>Excess return</td>
<td>-0.3%</td>
</tr>
<tr>
<td>IA + IA persistence</td>
<td>1.0%</td>
</tr>
<tr>
<td>IA+ IA persistence + Excess return</td>
<td>1.3%</td>
</tr>
</tbody>
</table>

Note: returns are gross of fees. Based on 2006 – 2014 period; sample of 2000 Globally benchmarked managers
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

In Exhibit 28 we show that, while the level of IA gives a good guide to future level of active return, IA persistency can give an insight into the future return volatility - specifically, managers with the most persistent IA are most likely to generate return that is less volatile than that of the rest of the universe.
Unsurprisingly given these relationships, we find that managers with higher IA are also those with higher IR and vice versa, as shown in Exhibit 30 below. This is a contemporaneous relationship, which shows that managers who have the highest IA also deliver the highest IR over the same period, and vice versa – again, the relationship is ‘neatly’ monotonic. The pattern also holds between IA and future IRs.

**EXHIBIT 30: IA and IR: the top-skilled managers tend to generate the highest IR over time; and vice versa**

<table>
<thead>
<tr>
<th>IA (t)</th>
<th>Bottom quartile</th>
<th>Q3</th>
<th>Q2</th>
<th>Top quartile</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bottom quartile</td>
<td>60.2%</td>
<td>26.5%</td>
<td>9.9%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Q3</td>
<td>29.5%</td>
<td>40.0%</td>
<td>24.0%</td>
<td>6.5%</td>
</tr>
<tr>
<td>Q2</td>
<td>7.1%</td>
<td>23.9%</td>
<td>40.9%</td>
<td>28.0%</td>
</tr>
<tr>
<td>Top quartile</td>
<td>3.6%</td>
<td>9.3%</td>
<td>24.8%</td>
<td>62.4%</td>
</tr>
</tbody>
</table>

Data for 2003-2016 period; 3yr trailing idiosyncratic alpha; net returns
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

THE POWER OF MANY – COMBINING FUNDS USING IA

Crucially for helping asset owners ‘do their job’ we find that Idiosyncratic Alpha can be an extremely useful input in creating portfolios of funds, and can add value beyond the incremental expected return it can help achieve at the individual level, as well as compared with other ways of creating portfolios. Exhibit 31 shows that a 5-fund portfolio with an aggregate positive trailing IA has a 73% probability of beating the benchmark over a 5yr horizon; this compares with a little over 50% chance of beating the benchmark for an average portfolio which has a positive trailing excess return. Results are even more striking if we look at fund combinations which are in the top quartile in terms of the aggregate IA – there is an 86% chance that such a combination
will beat the benchmark on an annualized 5yr forward basis. A fund portfolio which is in the top quartile by trailing excess return is only 52% likely to outperform.

**EXHIBIT 31: Combining funds: IA is also a better predictor of future excess return than past performance for portfolios of funds**

<table>
<thead>
<tr>
<th></th>
<th>5yr forward excess return</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&gt;=0</td>
</tr>
<tr>
<td>Fund portfolios with IA &gt;=0</td>
<td>73.1%</td>
</tr>
<tr>
<td>Fund portfolios with excess return &gt;=0</td>
<td>56.2%</td>
</tr>
<tr>
<td>Top quartile IA fund portfolios</td>
<td>85.6%</td>
</tr>
<tr>
<td>Top quartile Excess Return fund portfolios</td>
<td>52.4%</td>
</tr>
</tbody>
</table>

Results from testing thousands of 5-fund portfolio combinations of MSCI World benchmarked funds, over the period 2007-2014, using 5yr returns and 5yr IA estimates, based on gross returns.


Getting slightly more detailed, Exhibit 32 shows, for top quartile portfolios of funds by IA and by excess return, what the probability is of ending up in each quartile by excess return 5yrs forward (on an annualized basis). For IA, there is a clear and monotonic decrease in the probability of a top fund ending up in the progressively lower quartiles of return. Conversely, the worst IA funds are most likely to end up in the bottom excess return quartile, and progressively less likely to end up in the ranks.

The relationship between past and future excess return, however, is a lot less clear. The highest and lowest past return portfolios are basically equally likely to end up among the top or bottom performers vs benchmark on a 5yr forward basis. It seems that the conditional probabilities of future performance based on past performance are essentially random.

These are very simple stylized examples but nonetheless a powerful indication, in our view, that being guided by idiosyncratic return rather than the usual active return in creating fund portfolios (as well as selecting individual funds) could achieve much better outcomes for asset owners and end investors.
Exhibit 32: Top quartile fund portfolios by IA and excess return – conditional probability of being in each quartile by excess return 5yrs forward

Exhibit 33: Bottom quartile portfolios by IA and excess return – conditional probability of being in each quartile by excess return 5yrs forward

Results from testing thousands of 5-fund portfolio combinations of MSCI World benchmarked funds, over the period 2007-2014, using 5yr returns and 5yr IA estimates, based on gross returns.
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

Results from testing thousands of 5-fund portfolio combinations of MSCI World benchmarked funds, over the period 2007-2014, using 5yr returns and 5yr IA estimates, based on gross returns.
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

In Exhibit 34 we focus on the actual return that can be achieved if we create our fund portfolios based on a) the aggregate (fund portfolio) excess return; b) the aggregate idiosyncratic alpha and c) the high aggregate (i.e. fund portfolio level) IA combined with low aggregate factor exposures and low trailing IA correlation between the constituent portfolios. If we rank the fund portfolios based on each portfolio construction method and look at the forward returns achieved by each quartile, the results are striking. The top trailing return portfolios achieve by far the worst return in the future and lag the benchmark – with the relationship between past and future performance monotonically negative, i.e. mean reverting. Ranking the portfolios based on aggregate IA achieves a steady increase in future expected return, from negative for the worst IA portfolios to 1.3% pa for the top IA portfolios. Finally, neutralizing factor exposures and ensuring that the IA is not only high for the fund combination but also diversified (i.e. the correlation between the IAs of individual funds within the fund portfolio is low) adds value across the board and achieves the best outcome of a 1.64% pa active return over the following 5 years.
EXHIBIT 34: Annualised 5yr fwd Excess Return by quartile of fund combinations using different portfolio construction techniques

Results from testing thousands of 5-fund portfolio combinations of MSCI World benchmarked funds, over the period 2007-2014, using 5yr returns and 5yr IA estimates, based on Gross returns. Fund combinations where factor exposures are kept low, the IA correlations are low and the aggregate IA is high beat the ‘high trailing excess return’ portfolios over the following 5 years.


Finally, Exhibit 35 also brings results for individual funds into the comparison to illustrate the power of IA (and IA diversification) at both the individual and combined fund level. It shows that a ‘random’ (i.e. average) fund in our large sample has an annualized 5yr excess return of -0.07% before fees. The top trailing (over trailing 5 years) excess return fund goes on to lag the benchmark by 1.27% pa over the following 5 years; the top trailing return portfolio delivers similar underperformance. The top quartile fund as ranked by 5yr trailing IA beats the benchmark by nearly 70 bps. Combining funds on the basis of IA and using even as simple a risk management framework as keeping aggregate factor exposures AND constituent IA correlation low gives vastly superior results. In our follow-up work we will be introducing more sophisticated approaches to fund portfolio construction using IA as an input, but these initial results are extremely encouraging. Being able to separate idiosyncratic return from factor exposures and understanding and managing both at the fund portfolio level can be of powerful help to asset managers and asset owners.
EXHIBIT 35: Syr forward Excess Return for individual funds and different fund combinations

Results from testing thousands of fund portfolio combinations of MSCI World benchmarked funds, over the period 2007-2014, using 5yr returns and 5yr IA estimates, based on Gross returns. Chart compares the 5yr forward annualized returns for the average (‘random’) manager; for the average top quartile trailing excess return manager and top quartile IA manager; for the average top excess return and top IA fund portfolio and, finally, for the average fund portfolio with factor neutrality and low IA correlation. We show that the high IA combinations add value over the best performing and high IA individual funds as well as the best performing fund combinations. Further, controlling aggregate factor exposures and ensuring low IA correlations boosts future fund portfolio returns even further.

Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

WHO IS GENERATING IDIOSYNCRATIC RETURN?

Growth managers stand out in terms of IA generation; Value managers lagging

Our database of IA estimates for a large universe of managers allows us to look at aggregates and trends for different subsets of managers to see if any sectors, styles, product types or aspects of investment processes and investment behaviour tend to be associated with higher IA than others, and how that changes over time. This is of course an area for much further research, but could give invaluable insights on what 'works' and what doesn't as far as idiosyncratic alpha and non-replicable return generation is concerned.

Exhibit 36 - Exhibit 39 show the aggregate IA by manager style tilt as reported by either eVestment or Morningstar for our global sample. The most recent numbers show that Growth and ‘blended’ style managers have generated positive Stock Picking Alpha in aggregate in recent years, but the implicit or explicit decisions on timing have detracted from alpha in both cases. Global Value managers have been poor both at Stock Picking and Timing.
Interestingly it appears that recently the ability to time exposures has got sharply worse for global Growth managers in particular (Exhibit 38) which has dragged down their overall idiosyncratic return. The recent deterioration in the Growth managers’ IA is also evident from Exhibit 40 and Exhibit 41 where we look at how many managers within each style category rank in the top and bottom quartiles by IA vs the broad universe — i.e. how many top (and bottom) IA generators there are within each group. We note a large divergence between the proportion of Growth and Value managers in the top quartile by IA since...
January 2017, with the relevant spread between the two styles averaging 15% since then. More recently, the proportion of global Growth managers who were highly ranked on IA has fallen in lock-step with Value managers, from 45% to 30% and from 30% to 15%, respectively. At the same time, the proportion of Growth managers who lagged the rest of the global universe on IA has nearly doubled. From Exhibit 37 and Exhibit 38 below we know that it is Timing in particular that has been poor.

In the US we also see a divergence between the idiosyncratic return generation by Growth and Value managers, Exhibit 42 and Exhibit 43, but here it is more extreme. Although this share has ticked down recently, close to 40% of the Growth managers are in the top quartile by IA vs our broad US universe of 2500 managers, with the proportion having been rising steadily in recent years. By contrast, the incidence of top IA generators amongst Value managers has collapsed to as low as 10% in recent months - the lowest we have seen in at least a decade. Conversely the proportion of Value managers that lag the universe has continued to rise, and is now near a record high, while the Growth managers have the smallest presence amongst the laggards in many years. This of course had an impact on the aggregate level of the IA that is being generated, Exhibit 44 and Exhibit 45 - Exhibit 47. Unlike the trends for the global managers seen above, in the US Growth managers have managed to generate positive total IA through their strong Stock Picking, even though their Timing ability has also deteriorated recently.
EXHIBIT 42: % of US managers in each style bucket who are in the top quartile by IA

Data to September 2019; 3yr trailing idiosyncratic alpha; 2500 US managers; gross returns. Percentage of managers in the top IA quartile for a given investment style / total number of managers for a given investment style
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

EXHIBIT 43: % of US managers in each style bucket who are in the bottom quartile by IA

Data to September 2019; 3yr trailing idiosyncratic alpha; 2500 US managers; gross returns. Percentage of managers in the top IA quartile for a given investment style / total number of managers for a given investment style
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

EXHIBIT 44: Aggregate US Idiosyncratic Alpha by Manager Style (%pa)

Data to September 2019; 3yr trailing idiosyncratic alpha; 2500 US managers; gross returns
Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis
How can we explain this divergence in the IA trends between Value and Growth? We know of course that the long-only Growth factor has performed very well while the Value factor has obviously suffered, but the fact the performance of a factor beta appears to affect the ability of managers to generate idiosyncratic return in excess of it raises interesting questions about the relationship between the Idiosyncratic Alpha and the various Betas, and whether they can be truly ‘unstitched’. We will be exploring this further in the future.

**Quant vs fundamental – global Quants in the lead**

Our database also allows us to partition managers according their investment process, albeit broadly, into fundamental, quantitative or combined approaches as reported by eVestment and Morningstar. Exhibit 48 to Exhibit 51 show, for our samples of globally and US benchmarked managers, the % of each category who have been in the top and bottom quartile (vs broad universe) by IA, and how those shares have changed through time. One interesting thing that stands out is the relatively steady incidence of top and bottom IA managers in the fundamental group, where the share of both top and bottom quartile managers has been around 25%-30% since 2006. Both among global and US fundamental managers the share of top alpha generators has been rising for the past 5 years, but has dropped noticeably in the past year or so for the global group. From the charts we saw above it seems likely that this drop is driven by Growth managers within the group. In the US, where Growth managers have carried on doing well, our fundamental sample (where most Growth managers would reside) has also continued to do well in terms of IA – 30% of fundamental managers are now in the top quartile by IA among the US benchmarked universe, compared with just over 10% and 15% for the quantitative and ‘combined’ processes respectively.
EXHIBIT 48: % of Global managers in each investment strategy category who are in the top quartile by IA

![Graph showing the percentage of Global managers in the top quartile by IA from January 2006 to January 2019.](image)

Data to September 2019; 3yr trailing idiosyncratic alpha; 2000 Global managers; gross returns. Percentage of managers in the top IA quartile for a given strategy / total number of managers for a given strategy.

Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

EXHIBIT 49: % of Global managers in each investment strategy category who are in the bottom quartile by IA

![Graph showing the percentage of Global managers in the bottom quartile by IA from January 2006 to January 2019.](image)

Data to September 2019; 3yr trailing idiosyncratic alpha; 2000 Global managers; gross returns. Percentage of managers in the top IA quartile for a given strategy / total number of managers for a given strategy.

Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

EXHIBIT 50: % of US managers in each investment strategy category who are in the top quartile by IA

![Graph showing the percentage of US managers in the top quartile by IA from January 2006 to January 2019.](image)

Data to September 2019; 3yr trailing idiosyncratic alpha; 2500 US managers; gross returns. Percentage of managers in the top IA quartile for a given strategy / total number of managers for a given strategy.

Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis

EXHIBIT 51: % of US managers in each investment strategy category who are in the bottom quartile by IA

![Graph showing the percentage of US managers in the bottom quartile by IA from January 2006 to January 2019.](image)

Data to September 2019; 3yr trailing idiosyncratic alpha; 2500 US managers; gross returns. Percentage of managers in the top IA quartile for a given strategy / total number of managers for a given strategy.

Source: eVestment, Morningstar, MSCI, S&P, Factset, Bernstein analysis
The trends among the long only quant and 'quantamental' approaches have been startling. We note a sharp apparent recovery in the efficacy of the systematic approaches that are globally benchmarked, and also the long-term decline in the efficacy (in terms of IA) of US quants, where the proportion of top IA managers amongst the group is now the lowest it has been since the financial crisis (and the proportion of the worst IA products the highest since then). We will be investigating what has been driving these trends in future publications.

Idiosyncratic Alpha and turnover, Tracking Error and concentration levels

Our database also allows us to partition managers by turnover, TE and the number of holdings, and we also get some interesting results. In Exhibit 52 and Exhibit 53 we take the top/bottom quartile of managers by IA in the global sample and show the proportion of the group that is in each quartile (vs broad universe) by turnover. We can see that the majority (over a third) of all the top managers have the lowest (bottom quartile) turnover – on average for our universe that is 10% pa. This suggests that churn is bad – a message that holds both at the individual portfolio and manager level as we discussed above.

Exhibit 54 and Exhibit 55 show the breakdown of the top and bottom IA managers in the same sample by Tracking Error. 41% of the top IA generators have high TE, and only 11% have low TE. The picture is considerably more mixed among the 'worst' IA managers but it does seem fair to stipulate that one's chances of generating high Idiosyncratic Alpha are greater if one's approach deviates significantly from the benchmark, and vice versa.
Finally, we break down the best and worst IA managers into different buckets in terms of concentration. Exhibit 56 and Exhibit 57 show the % of the top and bottom quartile IA managers that are in each quartile by the number of holdings, with 'top quartile' signifying the least concentrated/most diversified funds and the 'bottom quartile' the most concentrated. The distribution is more even here, as we can see, although the highest proportion of the top IA managers do have the highest levels of concentration. The bottom of the IA spectrum is also dominated by managers with relatively concentrated portfolios – so it seems that being concentrated somewhat increases your chances of being a top alpha generator, but can also go very wrong.
Putting all this together it appears that the typical profile of a manager who generates high IA is that of a manager who runs a relatively concentrated, high Tracking Error and low turnover portfolio. This of course may change over time, with some regimes more or less favorable for concentrated managers, higher TE managers, etc. We will look at all this in future publications.

Currently the US fundamental managers with a Growth tilt are enjoying some serious limelight, whereas Value managers and quant/quantamental approaches are having a rough time in terms of their ability to generate non-replicable value over and above style exposures. Globally, it is, remarkably, Value and blended managers and Quant approaches that are generating idiosyncratic return relative to the rest of the universe of globally benchmarked products. Again, establishing drivers of these trends, delving deeper into the specifics of investment processes to understand what in particular hinders or helps IA generation and when, are all areas Alphalytics research will focus on going forward.
REQUIRED REGULATORY DISCLOSURES

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