This document is intended for investment professionals and eligible counterparties only.

8AM Insights – 'Alpha Decay'

The 5 Year Rule

0203 327 3277

portfolios@8amglobal.com

Contents

Introduction 3
Forecasting is Hard 4
  Assumption is the Mother of All... 5
  Human Bias ....
The Facts: Alpha Decays 8
  The Trend is to Hold 9
The Solution: Reliably Identifying This Decay 10
The AQ Process 11
About 8AM Global 12

This document is intended for investment professionals
and eligible counterparties only.

Introduction

We, being those concerned in the management of investments, have known for a long time that the average fund does not outperform the market. If the average fund manager (Homo Collectivus?) had due and appropriate longevity, performance persistence would be significant, and we'd have higher than benchmark returns across the board!

Instead, what we have is a 3/4 chance that an investor will end up in a fund that, over a decade, will not outperform the index for equities, according to a 2022 study by Morningstar.

Those figures don't tend to improve much over shorter periods, either. The best an investor could hope for on selection of any individual fund, was effectively shown as a 1/3 chance of picking a winner (as defined by index-beating performance – alpha) over a one-year period. One year. A nanosecond, in the world of investment.

Quite interestingly, this same Morningstar study whilst wide-ranging and detailed, didn't include any US fund analysis. Perhaps because it's so widely accepted that sustained alpha among US equity money-runners is rarer than a political apology? One of those permanent truisms, along with death, taxes, and English batting collapses...

We have made it our business to find out why, despite the efforts of Nobel Laureates, esteemed financiers, mathematical savants and every taxi driver within the M25; very few managers can produce consistent market-beating returns.

We also believe that there's little point trying to find a "perfect" long term fund manager, because you can have the benefits without the disappointment.

This document is intended for investment professionals
and eligible counterparties only.

Forecasting is Hard

"Forecasting is hard, especially when it's about the future" Many famous people

But investors - professional and private - still believe in their ability either to outperform markets, either by direct investment selection, or by finding managers who will on their behalf.

Very cognisant of this becoming a doomsday scroll, we will bring it round to more optimistic territory, we promise – bear with us.

The inability to find consistent positive performance is down to so many factors it legitimately makes us wonder why most people bother! In a Consumer Duty world, it takes on a more serious connotation – that of client outcomes.

The problems with prediction come largely (though not exclusively) down to issues of assumption and bias.

8

This document is intended for investment professionals
and eligible counterparties only.

Assumption is the Mother of All...

Now, it's important to know that what we're dealing with here are profoundly complex, dynamic, and largely abstract assets, markets, and economic and political forces. So, it does follow that trying to forecast them using a model that doesn't allow for irrationality is a fool's errand.

Ladies and gentlemen, we present to you:

- The Capital Asset Pricing Model, and...
- Homo Economicus (The Economist)

The former is the traditionally accepted means of pricing a risk asset, and the latter the preeminent way of profiling the behaviour of the people who do it. Both assume rationality. Let's also throw in the Efficient Markets Hypothesis and its slightly nonsensical assumption of both prompt information flow and accurate price discovery.

We feel the average investor, when researching their next position, is trying to predict next week's weather by putting their hand out of the window.

Human Bias

I know, we hear you. You've heard it before. You've seen the data and you feel confident that your process is robust...

...and that's the core issue. Many people have a story. An experience. A rebuttal. Usually related to Anthony Bolton. That one instance where it was proven that alpha could be both a) reliable and b) long-standing.

Which is an interesting aspect of the debate. Because there's no disputing the fact that some investors do experience additional, manager-driven returns. Anyone holding Berkshire Hathaway for decades will attest to that.

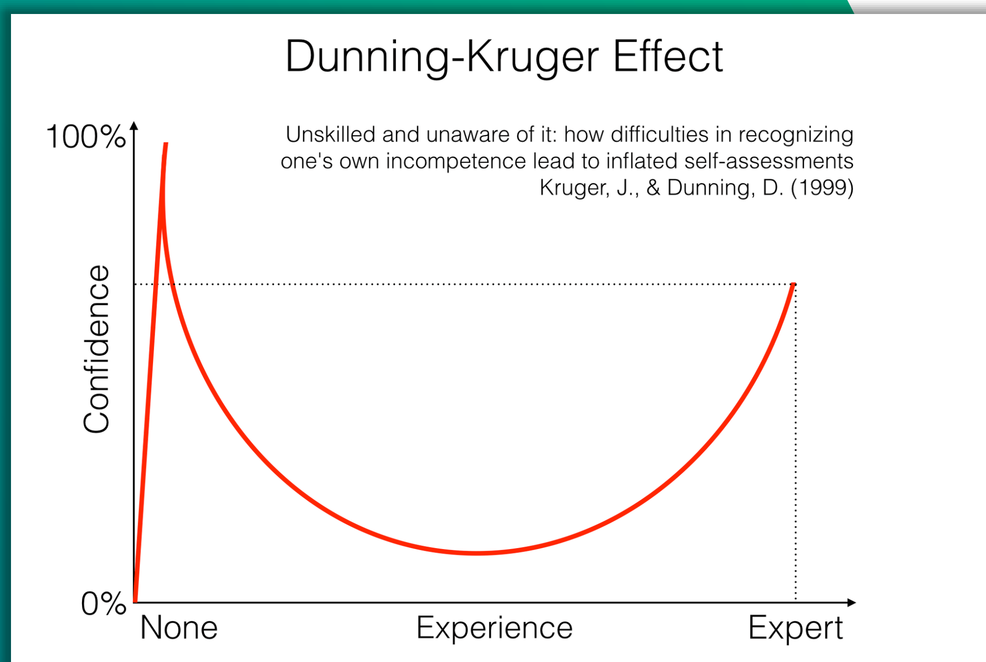
Our position is that they are supremely hard to identify, and that the majority of the investor community can't enjoy them without the benefits being arbitraged away.

This document is intended for investment professionals
and eligible counterparties only.

Just imagine for a second you *or your investment manager*, to some degree, embody one of these biases which can (and do) impact investment decisions:

1. Confirmation Bias
2. Anchoring Bias
3. Overconfidence Bias
4. Hindsight Bias
5. Herding Behaviour
6. Loss Aversion
7. Availability Heuristic
8. Recency Bias
9. Self-Attribution Bias
10. Status quo Bias
11. Regret Aversion
12. Endowment Effect
13. Representativeness Bias
14. Sunk Cost Fallacy
15. Illusion of Control
16. Familiarity Bias
17. Home Bias
18. Anchoring Bias
19. Cognitive Dissonance
20. Dunning-Kruger Effect

We stopped counting at 20, and we did have to look up the Dunning-Kruger effect.



Biases result in fundamental misunderstandings about investment management or personal skill, and therefore investment decisions are often based on faulty logic.

For just one example, those of us with a predilection for believing we possess the ability to outperform (in spite of the evidence to the contrary) could be exhibiting **overconfidence**. The foundation of the **overconfidence** could be because you know the person, business, or strategy from previous experience, that's an instance of **familiarity bias** at work.

This document is intended for investment professionals
and eligible counterparties only.

Overconfidence in who or what we know is the basis for many a baseless strategy or comment. "My child would never do such a thing!". And the same attitudes resulted huge numbers of investors holding onto Woodford (other examples are available) for too long.

> **"It ain't what you don't know that gets you in trouble. It's what you know for sure that just ain't so".** Mark Twain

What other biases or skews are there, relating to investment selection?

Return-chasing investors focus only on top-performing funds for investment choices. *This results in selection bias.* Partially connected with the prior points, it's common to simply select the very best performing funds over a single period. The reasons why it's generally ineffective as a long-term strategy are a thesis in itself, but the basic explanation is woven throughout this piece.

Fund selectors often overlook fund volatility and other cross-sectional and concentration data when assessing managerial skill. Looking at time-based data is useful. Performance does matter, after all.

But what about point-in-time data? Comparisons to peer group, investment style, prevailing sentiment, risk assessment. These are all essential in providing context for time-based performance, but they're often lost or overshadowed in the decision-making process due to the excitement of a few quarters' outperformance!

Surveys of sophisticated retail investors reveal a lack of understanding about chance (luck) in fund performance. They often mistake risk-taking for managerial skill and may over-allocate capital to fortunate past winners.

Furthermore, investors often mistake high alpha for high skill, overlooking volatility i.e. if volatility is high, then the statistical significance of alpha is lower. Alpha can be due to chance.

Alpha often *is* due to chance (and concentration)

lets talk about it...

This document is intended for investment professionals
and eligible counterparties only.

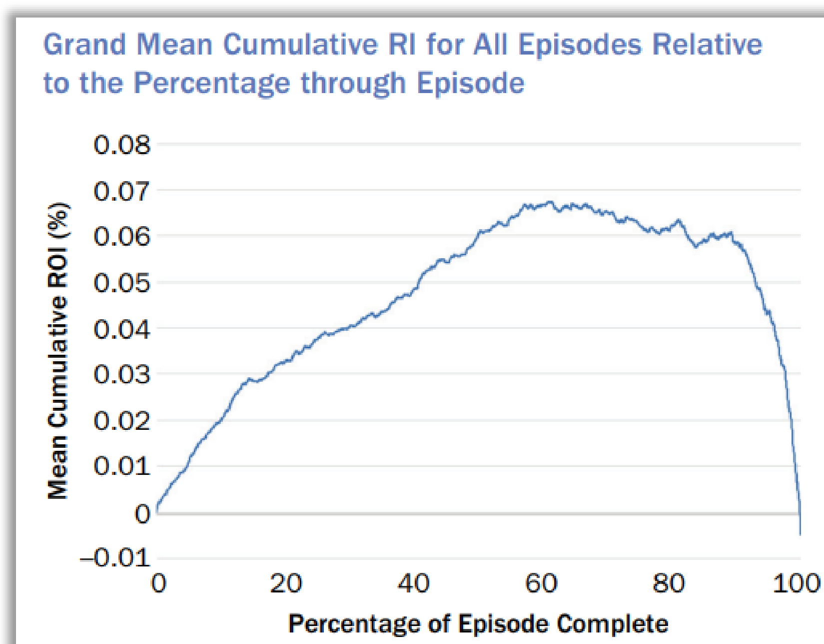
The Facts: Everything Decays – Especially Alpha

To this point, the thrust of this article so far has been to outline how difficult it is to repeatedly generate alpha or identify those who *can*.

The definition of '*can*' requires deeper understanding. Many professional money managers can generate additional returns attributable to their level of skill, especially at individual position levels.

Where it becomes unstuck, and therefore where investor outcomes become mean reverting or worse, is how long the position stays open.

You see, alpha has a lifecycle. Studies have shown it is often early in the holding period, but not always. This graph, from a 2022 study in the Journal of Investing highlights the concept perfectly.



Long story short: the 7% total average outperformance (ROI) is given back entirely over the whole period. More interesting is the fact that it seems to mostly happen within the final 20% of the average observed holding period.

In other words, alpha falls off a cliff, quickly.

This document is intended for investment professionals
and eligible counterparties only.

How responsive, though, is the average investment manager going to be to act accordingly? To answer this, we must bring to mind the various strategies and styles used within the industry. Is the 'buy and hold' manager going to be wired into this mindset at all? Pretty unlikely.

What about the 'fair value' aficionado? Again, we doubt it, unless the ROI peak by pure coincidence intersects their estimations of fair value. Estimations which are likely to be inaccurate anyway, given asset pricing models are (generally) rigid and unrealistic.

The Trend is to Hold

It's harder to justify active portfolios with high turnover.

Those higher transaction costs have to be justified by, you guessed it, additional alpha. So, it's challenging to find an investment house with the propensity to sell fast and do so with an investment rationale that stands up to scrutiny. Trading in and out should be done for the right reasons, not based on emotive debate or flawed bottom-up analysis.

Interestingly, the tendency of a portfolio manager to hold onto positively performing positions too long flies in the face of one of the great biases – **riding losers too long and selling winners too soon**. This is countered by the endowment effect, which states that we place higher value on the things we already own (this, and a sprinkling of pure overconfidence, in our experience).

We preside over a landscape that doesn't reward most investors – professional or retail – when it comes to identifying consistent ROI, but we also, interestingly, know that many managers can generate alpha at individual holding level for a time, it's just that they miss the chance to sell before it fizzles. Consensus says, the best mental framework to apply to that period is five years, maximum.

"many managers can generate alpha at individual holding level for a time, it's just that they miss the chance to sell before it fizzles."

The Solution: Reliably Identifying This Decay

With the problems identified and the reasons analysed, we turn to the solutions.

We said we'd get there eventually! Welcome to all those who have simply scrolled to the bit called "Solution".

Though not all related, much comes down to the effect of momentum during both the upward leg and prior to the inflection point, before that precipitous downward stretch.

Momentum is a catch-all term. A convergence of several highly predictable human behaviours which govern the flow of capital to, from, and within risk assets. There is always an ongoing pattern of momentum shifts between different styles and categories of investments, such as value versus growth, cyclical versus non-cyclical assets, and more.

Of course, it's one thing to know and another to predict.

But the warning signs are always there, and this is one area in which a combination of the right data and algorithmic logic can signpost momentum shifts in a repeatable way.

There's an obvious connection between capital flows and momentum in asset prices.

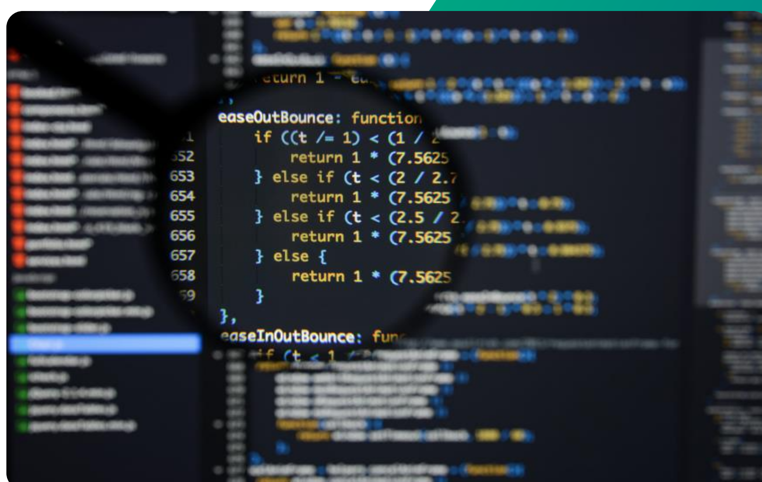
Flows of investor money, in and out, quite predictability influence returns in both shares and funds via price pressure. Herd-like behaviour is hard-wired into us as a species, and it would take an unrealistically large number of investors to alter their behaviour and act more rationally for this not to be the case.

At 8AM, we have therefore made it our business to develop our own unique, sophisticated, and repeatable screening methodology, which identifies (statistically) the appropriate, emotionless calls to make regarding the emergence and fading of fund manager alpha.

We rhythmically monitor the relative performance of all investment funds for early indications of momentum shifts.

No lengthy debate at which human bias is at play, just calculated action.

"We rhythmically monitor the relative performance of all investment funds for early indications of momentum shifts."

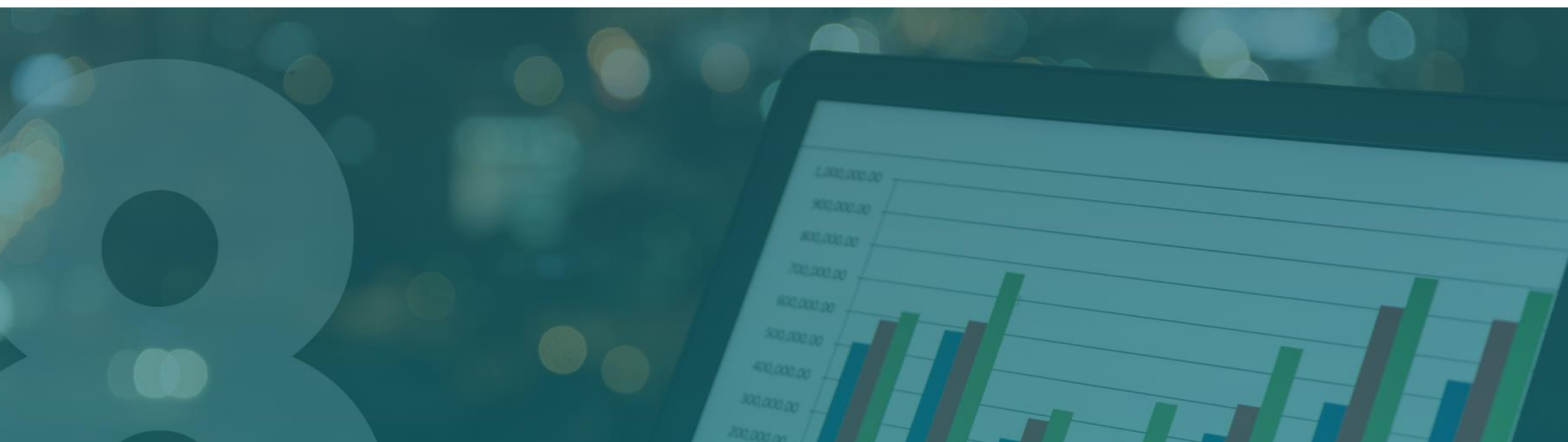


This document is intended for investment professionals
and eligible counterparties only.

The AQ Process

We have always worked from the standpoint that active OR passive is a false trade-off, and we hope, having got this far, you see at least partially why.

That passive/active paradigm requires reworking, so we have introduced a distinctive approach. Passives are a base for our portfolios, and a significant one. These are then layered with a minority of quantitatively screened active funds. The algorithm that identified the uptrend also calls the reversal, and we exit within the requisite window to capture that momentum and, thus, much of the alpha.



There are obvious additional benefits to holding significant exposure in passive investments. It helps mitigate the impact of higher management fees associated with active fund holdings, whilst providing the ideal environment to allow frictionless fund switching of our active AQ positions.

Whilst there is sophistication to the process and the algorithm – AQ – the approach is straightforward, simple, and easy to explain to clients.

A Brief Overview of AQ MPS Features

- Genuinely fairly priced discretionary MPS range at 0.15% ongoing.
- Sophisticated algorithmic investment intelligence.
- Emotionless, unbiased decision-making.
- The benefits of passive and active combined for maximum efficiency.
- The ability to adjust positioning in response to market shifts.
- Strategic asset allocation, with selective tactical allocation based on efficiency and data rather than human decision-making.
- Focused, concise investment committee meetings.
- Independent portfolio risk management.
- High liquidity.

This document is intended for investment professionals
and eligible counterparties only.

About 8AM Global

8AM Global is a boutique asset manager dedicated to crafting and delivering industry-leading Model Portfolio Service (MPS) solutions for the financial advice market. Established in 2006 and offering MPS since 2015, our team is composed of individuals selected for their specific expertise and experience garnered from across the entire retail advice value chain, from adviser firms, to platforms, and risk profilers. Every aspect of our service is adviser-centric, with a primary focus on creating value in all that we undertake.

The AQ Managed Portfolio Service is managed by 8AM Global Limited. 8AM Global Limited is authorised and regulated by the Financial Conduct Authority (937456). All data cited and contained has been sourced via FE Fundinfo, Morningstar and 8AM Global Limited. The information provided in this document has been provided from sources believed to be reliable and accurate and 8AM Global Limited does not accept any liability for the accuracy of the contents. Please note that past performance is not necessarily a guide to the future and investors may not get back the amount originally invested as the value of any investment and the income from it is not guaranteed. The information in this document is not intended to provide the basis for any investment advice or recommendation.