NEW AGE ALPHA
avoid the losers®

Factor investing, smart beta, or the new age alpha approach

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Every day a new investment firm claims they are trailblazing the area that lies between passive management and active management. Seeing themselves as cowboys who are discovering the Grand Canyon for the first time, they ride in with all kinds of new overlays or secret filters to spot stock market winners.

What they don't realize, however, is that the Grand Canyon is both very old and very wide. So chances are good that their discovery is not quite as "new" as they think. In order to discover something new, one needs to take an entirely different approach—such as not attempting to pick winners in the first place!

Out with the Old. In with the...Old?

It's said that, if approached correctly, investors can attain some of the key advantages of active management while also garnering some of the benefits of passive management. Some call such an approach factor-driven investing, others call it Smart Beta, and still others use very specific overlay approaches to reap these benefits. Defining the advantages and benefits of the respective spectrum ends is easy. A unified definition of this area between the two, however, remains elusive.

We believe this gulf has proven to be a boon for factor-based investment managers expressly due to the area's ill-defined nature. Eugene Fama and Kenneth French's initial three factor regression model was academic and precise. Let's be clear on that. In practice on the Street, however, it—and other factor and/or Smart Beta applications—has resulted in an excess of stock picking models, each more arcane than the last. Yet, seemingly, virtually nothing changes. Investors and plan sponsors are left to read tea leaves like a medieval seer to deduce if a portfolio manager's methods are revolutionary or merely lucky.

New Investment Approach for a New Age

The respective benefits of active and passive management are well known. Active management—also known as direct stock picking—claims to offer better performance, particularly when the market swoons. Whereas passive management—also known as index investing—offers comparable market exposure but with lower fees. Many firms claim to harness the best of both worlds by creating rules-based products that, nonetheless, still pick stock market winners.

We might argue, however, that this is the worst of both worlds.

You see, we believe that any of these approaches still rely on picking winners. However, this requires the ability to forecast the future, which is impossible. And firms are charging greater fees than their passively-managed counterparts despite persistent underperformance.

At New Age Alpha, we believe all risk originates with human behavior. When humans interpret vague and ambiguous information in a systematically incorrect way, it gets impounded into a company's stock price. This creates a type of idiosyncratic risk distinct from traditional "firm specific" risk, that may impact stock prices and we believe cannot be diversified away. Specifically, this type of idiosyncratic risk is unique to the stock itself, as opposed to the firm as a whole. To mitigate this risk, we calculate the Human Factor, the likelihood that a company will fail to deliver the growth implied by the stock price. We don't attempt to pick winners, we simply aim to avoid the losers. And unlike a traditional portfolio manager, we take an actuarial-based approach to managing risk. We focus only on known, rather than unknown.

Avoid the Losers

New Age Alpha, through use of the Human Factor, seeks to outperform without increasing exposure to widely recognized risk factors such as size, value or momentum. This is because, if one defines factor-based investing or Smart Beta as enhanced passive management, we are decidedly not that. By measuring and avoiding human behavior, we are not handcuffed by the rigidity of a benchmark. In most portfolio mangers' attempts to create outperformance, they select the same stocks as the benchmark but simply weight them differently. Our approach isn't nearly so limited. This results in portfolio options that have not only historically outperformed but have done so without significant correlation to the components of other widely used benchmarks.

Compare this to an old-world marinara sauce. Many, if not most, red sauces use tomatoes as their central component—not unlike most investment products that originate from the same indexes. But, while a well-made red sauce is exquisite, some sauces are little more than ketchup. We're not here to cast aspersions on a time-tested, classic dish. But rather, we'll point out a pesto sauce can provide a rich, luxuriant dinner whose source ingredient is unique.

Taking this one step further: New Age Alpha isn't concerned with beta, like so many Smart Beta shops. And we certainly don't target a beta of 1. We view beta as simply another age-old metric that is, itself, rooted in human behavior. After all, beta is a reflection of market price movement, and our position is that market prices are ultimately determined by humans. Also, implicit in traditional Smart Beta strategies is the notion that the beta of a portfolio will be no different than that of the universe and outperformance will result from successful stock selection. In contrast, however, our portfolios may have a beta less than 1 even as they may outperform on a relative basis.

Another key way in which New Age Alpha's approach is distinct from Smart Beta or factor-driven strategies is our relationship with specific factors. Of the commonly used factors, those that best explain performance are Profitability (return on equity) and Quality (debt-to-equity). Yet these are calculated exclusively from financial statements—the exact process we use to avoid the risk of human behavior. Meanwhile, we believe factors such as Volatility and Value are least predictive of performance and, not coincidentally, rooted in human behavior.

Fundamentally, we believe that any of these strategies falter because—above and beyond the impracticality of picking stock market winners—they're focusing on metrics that are merely symptoms of the overall risk of human behavior. Factors, beta, volatility…any of these are simply different manifestations of the same problem.

It's similar to that old parable about the blind men describing an elephant based on their sense of touch. One man feels the elephant's tail and proclaims the elephant is exactly like a snake. Another grasps its leg and compares it to a tree. A third touches the ear and says an elephant is a giant leaf. None of the men are wrong, precisely. But they're most certainly not correct. And it all comes back to perception.

The Aggregate Effect of all Behaviors

History can be the greatest guide of all. As so often said, those who can't remember it are doomed to repeat it. So why do so many portfolio managers continue to enact strategies—factor-based, Smart Beta or otherwise—that rely on picking stock market winners when they should simply avoid the losers?

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Disclosures

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