



Putting a price tag on talent

Capital Trading Group's **Neel Sloane** on paying for pure alpha products

In an environment of erratic returns and ultra-low yields, the debate around the value of paying for actively based excess performance (alpha), versus low cost passive investing has once again come to the forefront.

Financial giants such as Vanguard have grown exponentially over the years by promoting the mantra that markets are efficient and therefore consistent outperformance is impossible. If an investor accepts this assumption, it should lead them towards passive investments with the lowest expense ratio.

The other side of the debate claims that markets are not efficient and therefore recurrent pockets of pricing anomalies are available for arbitrage to the astute, and more expensive, manager.

As it always happens in life, the facts are not quite so black and white. Many of the assumptions of modern portfolio theory and the efficient market hypothesis have turned out to be too abstract and generally unrealistic. This realisation has allowed for a more genuine recognition that alpha can coexist with a market that is generally efficient but

not quite so effective as previously thought.

Alpha and its price carry one underlying issue: pure alpha is generally not too common and therefore it should be expensive. However, the cumulative weight of such cost may weaken, over the longer-term, many strategies that see their margins constantly compressed.

The answer to the active/passive dilemma rests on having a framework that helps an allocator or an investor determine which markets or market conditions may be more inefficient and therefore more adaptable to the hiring of services from alpha managers.

Additionally, one would need serious resources to pick the truly talented ones. This last point is a significant one. Ultimately, what really matters is being able to pick the really good alpha managers.

The cost issue may be more one of allocation of resources toward screening and monitoring, rather than management and incentive fees. Good performance will take care of fees.

Conversely, bad or at least unreliable performance combined with high fees delivers a

deadly blow to any portfolio. This is perfectly rational. The importance of identifying market contingencies and successful managers is underscored by any investment textbook.

Indeed, financial literature posits that out-performance is the result of one or a combination of the following two elements: market timing and security selection. The effect of fees, while substantial, is secondary.

From a CTA perspective, incentive fees are the lifeblood of the business. While there are theories on the passive risk premium associated with managed futures, i.e. from the roll yield to the insurance premium – the reality seems to validate the romantic idea that CTAs are pure alpha managers, whose success or failure is directly correlated to their ability to tame financial markets.

Naturally, in a low return environment, and with increasing competition from different fronts, fee compression for all alternative investments is a reality that must be confronted.

Perhaps the answer is not to just bow and engage in constant competitive undercutting or to refuse to face reality but to formulate more nuanced and longer term deals, which may eventually favour all parties.

Fundamentally, it is not in the interest of investors to negotiate fees so low it will make R&D unsustainable or indeed drive talent to other solutions. In the formulation of fee agreements, it should also be maintained that transparency has a key role. Alternative investments have often been attacked for the opacity of their cost structures.

Private equity is a prime example of an industry which is significantly in need of a general overhaul of its fee framework.

Managed Futures, especially in the form of funds, have also been the recipient of some criticism in the past. Bad packaging and poor products hurt everyone and they should be re-assessed and polished.

The new SEC rule that is about to be finalised, where financial advisers will have to abide to new fiduciary standards rather than the more generous suitability standard, will undoubtedly inject a new variable into the relationship between intermediaries, fund managers and clients.

Within this new regulatory context, questionable products should find it more difficult to be marketed. This however should result in additional opportunities for those who structure their investment vehicles according to high quality parameters.

The investing world needs talent; global portfolios need pure alpha and investors deserve good products and brains at their service. And indeed, brainpower also needs to be well rewarded. ■