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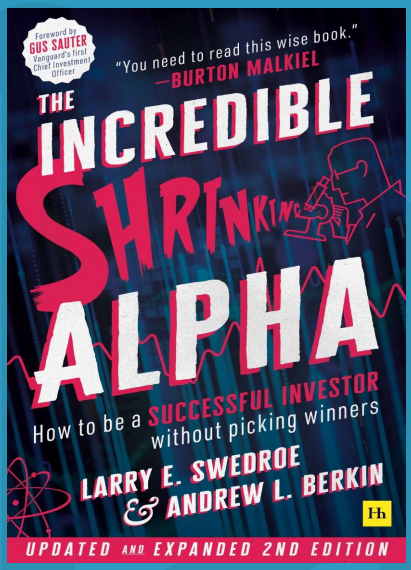
The Incredible Shrinking Alpha

Larry Swedroe
Chief Research Officer



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Four Themes

- Academic research has been converting what was once alpha into beta
- The pool of victims that can be exploited has been shrinking
- The competition has been getting tougher
- The supply of dollars chasing alpha has increased

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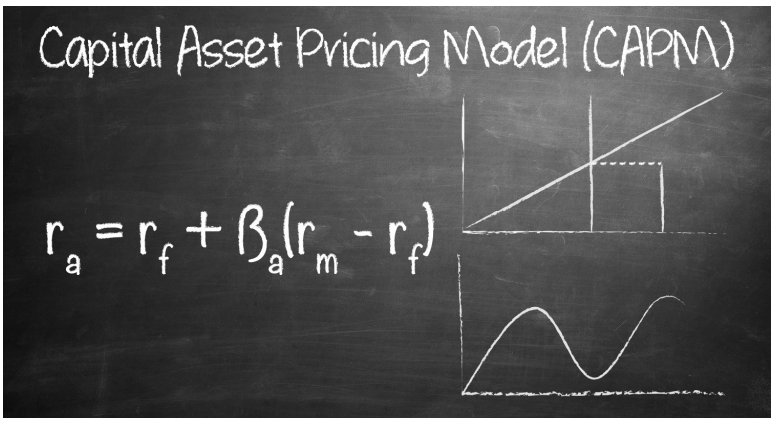
The First Asset Pricing Model



Source: Jon Mossin, Equilibrium in a Capital Asset Market. Econometrica, October 1966.

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Anomalies to the CAPM

THE RELATIONSHIP BETWEEN RETURN AND MARKET VALUE OF COMMON STOCKS*

Rolf W. BANZ

THE RELATIONSHIP BETWEEN EARNINGS' YIELD MARKET VALUE AND RETURN FOR NYSE COMMON STOCKS

Further Evidence*

Sanjoy BASU**

Persuasive evidence of market inefficiency

A bookprice strategy and a "specific-return-reversal" strategy, subject to careful tests, lead to the "inescapable conclusion" that prices on the NYSE are inefficient.

Barr Rosenberg, Kenneth Reid, and Ronald Lanstein

[1] Rolf R. Banz, The Relationship Between Return and Market Value of Common Stocks. Journal of Financial Economics, 1981.
[2] Sanjoy Basu, The Relationship Between Earnings' Yield, Market Value and Return for NYSE Common Stocks. Journal of Financial Economics, 1983.
[3] Barr Rosenburg, Kenneth Reid and Ronald Lanstein, Persuasive Evidence of Market Inefficiency. Journal of Portfolio Management, Spring 1985.

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The Fama-French Three-Factor Model

1927 - 2019

Value: 4.5%	Size: 3.1%
Beta: 8.6%	

Source: Ken French Data Library. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio nor do indices represent results of actual trading. Information from sources deemed reliable, but its accuracy cannot be guaranteed. Performance is historical and does not guarantee future results. Total return includes reinvestment of dividends.

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The Four-Factor Model

1927 - 2019

Value: 4.5%	Size: 3.1%
Beta: 8.6%	Momentum: 9.1%

[1]Mark Carhart, *On Persistence of Mutual Fund Performance.* Journal of Finance, March 1997.
[2]Ken French Data Library. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio nor do indices represent results of actual trading. Information from sources deemed reliable, but its accuracy cannot be guaranteed. Performance is historical and does not guarantee future results. Total return includes reinvestment of dividends.

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The Profitability/Quality Factor

- Stable
- Growing
- High Payout Ratio

The Other Side of Value:
The Gross Profitability Premium*

Robert Novy-Marx†

June, 2012

Abstract

Profitability, measured by gross profits-to-assets, has roughly the same power as book-to-market predicting the cross-section of average returns. Profitable firms generate significantly higher returns than unprofitable firms, despite having significantly higher valuation ratios. Controlling for profitability also dramatically increases the performance of value strategies, especially among the largest, most liquid stocks. These results are difficult to reconcile with popular explanations of the value premium, as profitable firms are less prone to distress, have longer cash flow durations, and have lower levels of operating leverage. Controlling for gross profitability explains most earnings related anomalies, and a wide range of seemingly unrelated profitable trading strategies.

Keywords: Profitability, value premium, factor models, asset pricing.
JEL Classification: G12.

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Buffett's Alpha

"Safe, Cheap, High-Quality, Large "

Andrea Frazzini, David Kabiller and Lasse Heje Pedersen, **Buffett's Alpha**. Working paper, November 2013.
Photo courtesy of https://twitter.com/WarrenBuffett

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Buffett's Alpha

Characteristics of High-Quality Stocks

- Low earnings volatility
- High margins
- High asset turnover
- Low financial leverage
- Low operating leverage
- Low specific stock risk

Andrea Frazzini, David Kabiller and Lasse Heje Pedersen, Buffett's Alpha. Working paper, November 2013.

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Factors in the Performance of Bond Portfolios

Average Annual Premium 1927 - 2019

Term:	Default:
1.9%	0.4%

Source: Dimensional Fund Advisors. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio nor do indices represent results of actual trading. Information from sources deemed reliable, but its accuracy cannot be guaranteed. Performance is historical and does not guarantee future results. Total return includes reinvestment of dividends.

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The Arithmetic of Active Management

Source: William Sharpe, The Arithmetic of Active Management. Financial Analysts Journal, January–February 1991.

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The Pool of Victims Is Shrinking

Equities Held by Households

1945: **90%**

Source: Robert Stambaugh, Investment Noise and Trends. Presidential address to the American Finance Association, Philadelphia, Pennsylvania, January 2014.

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The Pool of Victims Is Shrinking

Equities Held by Households

2008: **20%**

Source: Robert Stambaugh, Investment Noise and Trends. Presidential address to the American Finance Association, Philadelphia, Pennsylvania, January 2014.

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TODAY: 50% of Institutional Assets in Passive Strategies

Source: Robert Stambaugh, **Investment Noise and Trends**. Presidential address to the American Finance Association, Philadelphia, Pennsylvania, January 2014.

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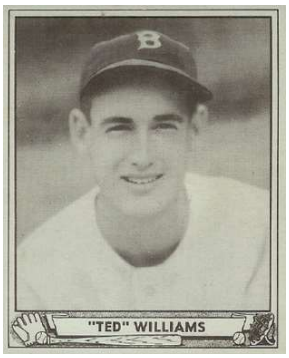
Competition Is Increasing

Why There Are No More .400 Hitters



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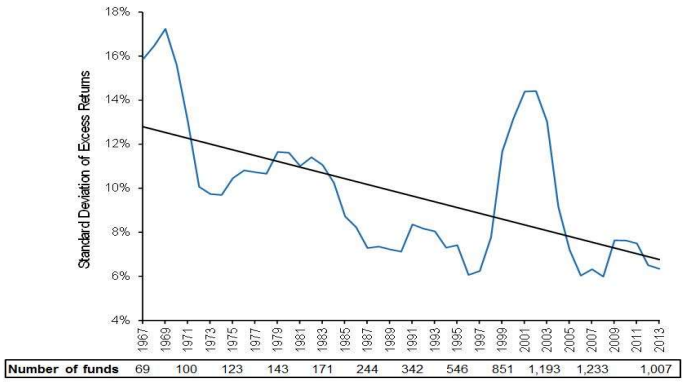
The Paradox of Skill

Decline in Standard Deviation of Excess Returns for U.S. Large Capitalization Funds



Source: Michael Mauboussin and Dan Callahan, Alpha and the Paradox of Skill. Credit Suisse, July 15, 2013.

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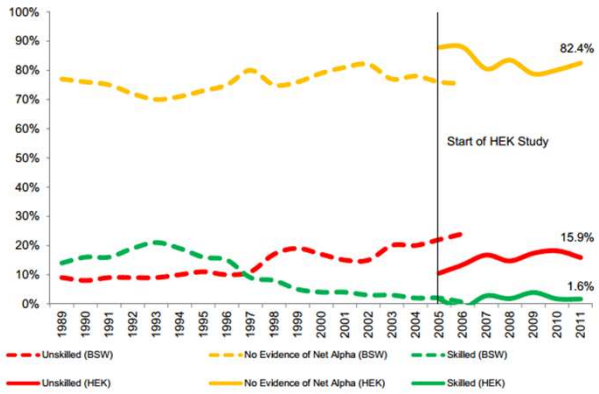
The Paradox of Skill

Manager Skill Over Increasing Cumulative Periods, 1975-2011



Source: Conviction in Equity Investing. Hewitt EnnisKnupp, An AON Company, 2012.

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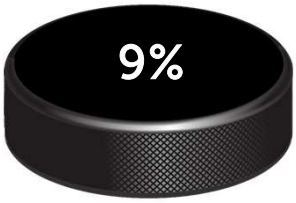
Skating Where the Puck Was

Hedge Fund Alpha

HFR Global Returns Index

1998–2002



Source: William J Bernstein, *Skating Where the Puck Was: The Correlation Game in a Flat World.* 2012.

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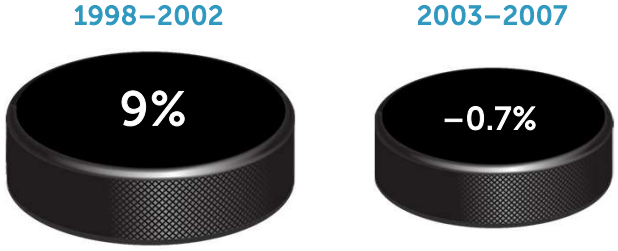
Skating Where the Puck Was

Hedge Fund Alpha

HFR Global Returns Index



Source: William J Bernstein, *Skating Where the Puck Was: The Correlation Game in a Flat World*. 2012.

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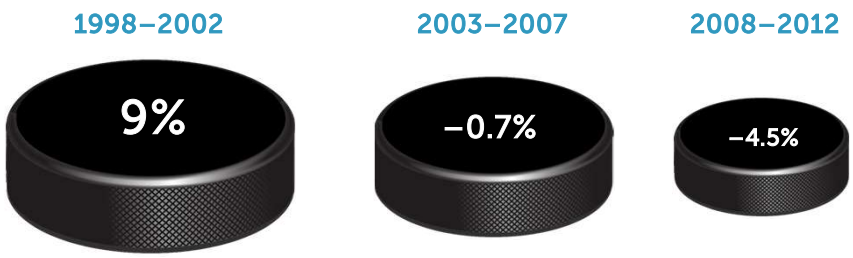
Skating Where the Puck Was

Hedge Fund Alpha

HFR Global Returns Index



Source: William J Bernstein, Skating Where the Puck Was: The Correlation Game in a Flat World. 2012.

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Annualized Returns 2010-2019

Benchmark Index	Return (%)
HFRX Global Hedge Fund Index	1.1
Domestic Indexes	
S&P 500	13.6
MSCI US Small Cap 1750	12.4
MSCI US Prime Market Value	11.9
MSCI US Small Cap Value	11.2
Dow Jones US Select REIT	11.6
International Indexes	
MSCI EAFE (net dividends)	5.5
MSCI EAFE Small Cap (net dividends)	8.7
MSCI EAFE Small Value (net dividends)	8.0
MSCI EAFE Value (net dividends)	4.0
MSCI Emerging Markets (net dividends)	3.7
Fixed Income	
BofA Merrill Lynch One-Year Treasury Note	0.8
Five-Year Treasury Notes	3.2
20-Year Treasury Bonds	7.6

Source: Dimensional Fund Advisors and Hedge Fund Research.
Information from sources deemed reliable, but its accuracy cannot be guaranteed. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio nor do indices represent results of actual trading. Performance is historical and does not guarantee future results.

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Active Managers Provide Societal Benefits

Source: Jonathan B. Berk and Jules H. van Binsbergen, Measuring Skill in the Mutual Fund Industry,. Working paper, November 2013.

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Increasing Hurdles for Alpha Seekers

- Pool of available alpha has been shrinking
- Pool of victims is shrinking.
- Competition is getting tougher.
- Amounts of assets competing is growing.

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So What's the Good News?

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