Letter to the Editor: Coin Flipping and the Search for Alpha

May 20, 2008

The following two letters were received in response to last week's letter/article entitled Coin Flipping and the Search for Alpha:

Dear Editor,

Just a quick observation regarding Mr. Kam's mutual fund: According to the Morningstar data his article links to, his Marketocracy Master 100 fund underperformed its benchmark by 1.66% and ranked below average among its peers over the past five years. As a firm supporter of passive investment management, this comes as no surprise to me. Does Mr. Kam have an explanation for why his active manager selection process seems not to be adding alpha over the past five years? If not, here's a couple: efficient markets and expenses.

Regards,

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Dear Editor:

Ken Kam's letter to the editor opens an important and quite frankly little discussed need to differentiate money manager skill from luck. While I applaud Mr. Kam for revealing his process, it also reveals the flaws in Modern Portfolio Theory (MPT), the Capital Asset Pricing Model and alpha as indicators of skill or success. Advisors must know graduate level statistics and math in order to utilize the tools necessary to discern skill from luck.

Understanding Alpha's Shaky Foundation

When Markowitz published Portfolio Selection in the mid 1950s, he alluded to the fact that the mean-variance method (measuring volatility around the average or mean return) upon which his theory was based was not the best option. Instead Markowitz concluded that semi-variance (measuring the propensity to underperform a set objective) was a far more accurate procedure. However, unlike today, he did not have access to a 2GB DELL laptop with Excel 2007.

Such calculations were simply too time consuming to add value for the investor before the advent of the micro processor.

In order for MPT to have any validity without a solid mathematical foundation, two important assumptions are needed:

1. Investment returns are symmetrical – that is an investor should be equally rewarded against a 10% drop in the value of their investments with a 10% rise.
2. All investors have a singular goal – to beat the market (known more accurately as the Capital Asset Pricing Model).

Not only will simple math prove that a 10% loss offset with a 10% gain does not make an investor whole, research by Brian Rom at Investment Technologies almost a decade ago found nearly 60% of investments were asymmetrical with no rhyme nor reason to their returns.

The problem with assuming symmetrical returns and singular goals to beat the market have led to Alpha, Beta and other ratios equating to little more than garbage in/garbage out encouraging investors to bet the farm at the top of a market and scaring them away from equities at the bottom.

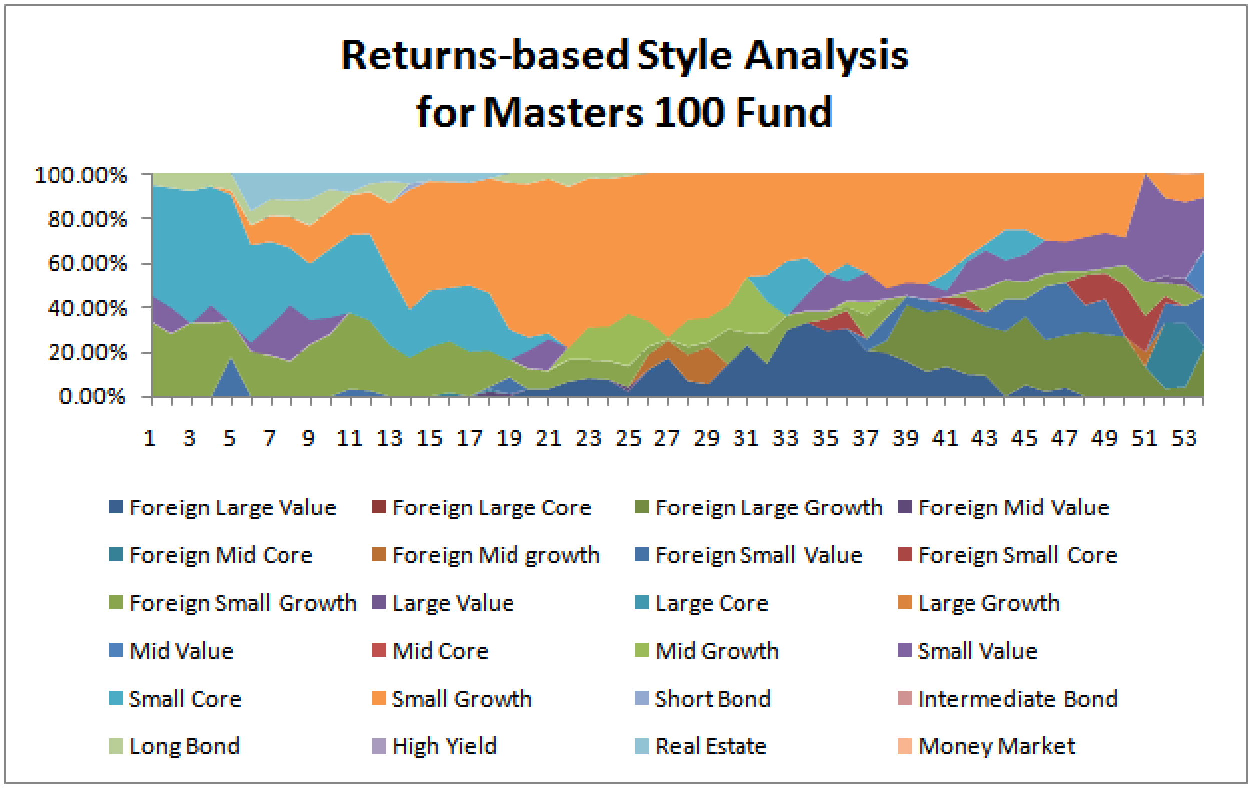
No Clear Insight

Currently AdvisorCFA is ranked at the top of Mr. Kam's website. The manner in which Mr. Kam is measuring 'skill' could leave one to conclude that AdvisorCFA has skill. However, the data is not conclusive because of the short time period and incorrect benchmarking.

In order to prove skill, we would need to compare AdvisorCFA's results over longer time periods and against a true benchmark, like a global energy index. Compared to the Surz Global Energy Index over the same time period, AdvisorCFA lags the index on an annualized basis (36.51% vs 39.3%). Although the sum of the averages appears quite impressive (438.76% vs 189.00%) the index outperforms AdvisorCFA by nearly 300 basis points over the term. Averages prove nothing.

Such problems with short periods and singular comparisons were addressed in 1992 when William Sharpe developed a procedure for identifying a manager's style in terms of a set of passive indexes, which we refer to as the manager's 'style benchmark.' If a manager's style can be identified in terms of a style benchmark of passive investments, one can use twenty or more years of data instead of being limited to the data of the manager.

Using this procedure, it can be easily ascertained how Mr. Kam's own mutual fund (MOFQX) is performing since its inception.



Note: In the chart above, the horizontal axis represents monthly time periods.

This insight allows us to not only avoid pigeonholing Mr. Kam into a single style (and possibly penalizing him for raising cash in a falling market or staying in a underperforming asset class) but can more accurately determine whether the manager has skill in both the allocation to an asset class as well as picking the best equities within the class. As seen in the chart above, comparing Mr. Kam's portfolio to the S&P 500 would not allow us to determine skill because his best fit benchmark over the period would be the Surz Small Growth Index. (Morningstar, using holdings-based returns analysis, proved similar results).

While Mr. Kam has done an excellent job outperforming the S&P and Surz Small Growth Index, one cannot accurately claim he is skillful in his allocation of capital, since Small Growth was not a great performing asset class over the period. He had much better options, so greater due diligence would be required to understand if his focus is on small cap or if the fund is unconstrained by such objectives. With an expense ratio of 195 basis points, I would hire Mr. Kam as a small growth manager, but avoid him for an iShare (index fund/ETF) if his goal was as stated "*A fund that constantly strives to be in the right sectors and stocks at the right time, so you don't have to constantly change funds.*"

A Better Mousetrap - OMEGA

I agree with Mr. Kam that skill cannot be easily identified. In order to best meet advisors' goals and discern whether a manager is skillful in meeting those goals, we offer a tool known as OMEGA and the OMEGA Excess Return which overcomes the mathematical shortcomings with MPT. Omega and our process for finding skill will hopefully be highlighted in a coming issue of this publication.

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