Novus Research Review

How Hedge Funds Can Grow Assets in Today’s Tough Environment
Dissecting the four main obstacles for growth.

Is Poor Performance Always Tied to Manager Ability?
Understanding how correlation and dispersion affect returns.

Kingsford Capital
A case study on a short-only manager’s ability to generate alpha.

Seven Habits of Highly Successful Portfolio Managers
How to make great investments while running a great business.
Since 2008, hedge funds have faced a difficult challenge—to prove to their investors that their support is warranted by outperforming in a consistently rising market. While some hedge funds have risen to this challenge, many have shut their doors due to performance and investor outflows. In fact, 2016 was the first year since 2008 to see net outflows from the industry. In light of these challenges, how can hedge funds gain an edge over their peers, raise capital, and outperform this year?

It won’t surprise you that there is no magic answer—and anyone who says differently is in the business of marketing fantasy. However, we set out to try to understand exactly why hedge funds struggle to capture alpha in this environment, why investors are leaving active management, and why investors are now immune to traditional hedge fund marketing. We may not have all the answers, but the insights we’ve gained from our research—collected here in this review exclusively for hedge funds—sheds some much needed light on the struggling future of the alternatives space.

Several pieces in this review focus broadly on the market environment to answer the question of why hedge funds are struggling. ‘Is Poor Performance Always Tied to Manager Ability’ and ‘Hedge Fund Liquidity: Alpha Generator or Risk Factor?’ look at factors such as correlation and dispersion, industry liquidity, and total industry AUM to better understand the difficulties hedge funds face today. The root of these articles is this: when is underperformance a consequence of the market, and not necessarily the manager’s investment acumen?

The first two pieces in this collection, which we’ve aptly titled ‘Focus on What You Can Control,’ continue this thought by dividing the challenges hedge funds face into two categories: systemic & behavioral. By focusing on the challenges that you can actually exert your influence over (fee structures, security selection, sizing, etc.), managers will be better prepared to face those they cannot (low volatility, low breadth, growth of hedge fund industry assets, etc.).

Two additional pieces, ‘How Hedge Funds Can Grow Assets in Today’s Tough Environment’ and ‘An Allocator’s View on Effective Hedge Fund Marketing’ examine investors’ changing expectations regarding marketing and pitching. It’s not enough to simply say you create unique alpha—you must show investors how you do it, and demonstrate proof. These two pieces explain how to do just that.

Before you get started on the articles in this review, a final word. I’d like to personally thank you for your continued readership of our research, and wish you the best of luck this year and all the following. If you have any questions about any of the articles here, please feel free to reach out to me or my colleague Stan Altshuller at the email addresses below.

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Growing Assets

How Hedge Funds Can Grow Assets in Today’s Tough Environment 21
By Stan Altshuller

An Allocator’s View on Effective Hedge Fund Marketing 32
By Shaunak Amin & Joe Peta
Is Poor Performance Always Tied to Manager Ability?
By Faryan Amir-Ghassemi

Market Factors

Focus On What You Can Control 7
By Stan Altshuller

Hedge Fund Liquidity: Alpha Generator or Risk Factor? 46
By Faryan Amir-Ghassemi, Colleen White & Mike Perlow

How Do Hedge Funds Become Better Forecasters? 56
By Faryan Amir-Ghassemi & Cameron Hight (Alpha Theory)

Good to Great: Private Data Proves How a Good Hedge Fund Became Great
By Joseph Peters

Kingsford Capital
By Stan Altshuller & Charlie Russo
Visualize Your Portfolio.

Learn more about the Novus Alpha Platform by contacting us at alpha@novus.com
There’s no doubt that active managers—and hedge funds in particular—are struggling to generate alpha in today’s environment. Many clients find it helpful to divide their business challenges into two categories: issues they can do something about and issues they should ignore.

In his popular book, The Seven Habits of Highly Effective People, Stephen Covey argues that the number one habit of highly productive people is to be proactive where it matters. He recommends focusing effort and energy on your circle of influence rather than your circle of concern. You have control over the former; the latter is independent of you and your actions. It’s helpful to view the challenges facing active investment managers in this light, because most of the discussion regarding their underperformance focuses on the circle of concern and not on the circle of influence.

Using this framework for our research on the growing role of hedge fund crowding, I compiled two groups of challenges confronting hedge fund managers; one group is systemic, a function of the current market environment—in Covey’s words, the circle of concern—and the other is behavioral—the circle of influence.

This piece will deal with systemic issues, and the next in this series will focus on behavioral issues.

How often do you hear managers and their investors lamenting one or more of the topics in the next page? Besides crowding, which we’ll discuss later, most reasons for underperformance will be cited as extraneous to the managers. We’ve discussed many of these market issues at length. While all valid, they don’t present a way for managers to outperform in the future, since they don’t depend on managers’ actions. You can’t change them or rely on them to change in the near future—they’re simply what they are: the circle of concern. Let’s go through them one by one.
Focus On What You Can Control

Systemic
Low volatility, low breadth
Low dispersion, high correlation
Low interest rates
Value over momentum
Large cap over small-cap
Geopolitical concerns/macro
Growth of HF industry assets

Behavioral
Fee structure
Timing the market
Drift from core competency
Security Selection
Overtrading or holding too long
Sizing
Crowding

Low Volatility, Low Breadth
Today we’re in a medium- to low-volatility environment, something that managers often point to when explaining poor performance. Certain derivatives strategies rely on high volatility, and even managers using purely equity investments can use volatility to generate returns. Furthermore, as we’ve shown in prior research, one specific source for return is directly dependent on volatility. Managers shift net exposure to capture market rallies or protect from down swings. Exposure management—specifically that of net exposure—can yield a return only when there’s some volatility to take advantage of.

There are admittedly few managers that can generate timing value consistently, but they do exist. Clearly, when there’s little volatility, the skill set will yield less incremental return by definition, no matter how skilled the manager is at timing the market.

Low Dispersion, High Correlation
While consistent market timers are few and far between, a more reliable strategy is the commonly applied “pairs trade.” With this tactic, a manager expresses views on two companies relative to each other, hoping to forgo market volatility altogether. For instance, a manager

Fig 1 shows the thirty-day volatility of daily returns for the S&P 500 Index. With a few brief exceptions, we’ve been in a low-volatility environment since 2013. In fact, out of 918 thirty-day periods, only 153 periods exhibited volatility above the historical average of 16%.

Of course, market volatility has no dependency on the specific actions of any one manager (although acting together is a different story), thus waiting for volatility to return to start making money isn’t a good strategy.

Fig 1 - 30-DAY VOLATILITY OF DAILY RETURNS FOR THE S&P 500 TR: MARCH 2004- YTD 2016
might go long Apple and short Samsung, capturing the spread between the performance of the two stocks, while shielding from industry and sector volatility that affects both securities together. If the manager’s right, this trade will yield a return based on the dispersion between the two stocks. When market dispersion is high, the potential for gain from such trades is also high. Likewise, when market dispersion is low, the potential reward is low, no matter how skilled the manager is at identifying great pair trades. The pairs trade is not the only strategy dependent on dispersion—other approaches such as going long a stock and shorting an ETF are also partially dependent on dispersion.

There are a few good ways to measure market dispersion, and we’ve studied multiple methodologies. Most of them show the same trend. In Fig 2, two types of dispersion calculations for the Russell 3000 are charted. The first is the difference between the average returns of the top and bottom halves of all stocks in the index (Over Under – Blue Line), and the other is the cross-sectional standard deviation of all stocks’ daily returns (St. Dev. – Orange Line). Both measures have similar findings.

As you can see, while we’re not at the bottom, we’re certainly below the historical average dispersion. The years between 2012–2013 were exceptionally low, but recently the metric has been on the rise—a potentially good sign for managers.

Correlations between stocks increased over the long term but do show a meaningful drop since 2011. In Fig 3, the average correlation is calculated as the mean pair-wise correlation between every constituent on a thirty-six-month lookback period. The weighted metric takes each securities market-cap into account, so AAPL correlations are weighted heavier. It’s interesting to see that the largest companies...
are currently much more correlated than the rest of the market (Blue line over Orange). An environment conducive to alpha generation has low correlations and high dispersions. But, this is something managers have no control over, and cannot bet their success on the hope that dispersion comes back.

**Low Interest Rates**

A client of ours at a large foundation recently pointed me to a great source of research and market commentary—the work of Horizon Kinetics. Here is a little excerpt of theirs on the “historically low” interest rate environment that puts things in perspective:

They have a bit of fun defining “historically” and cite a book by Sidney Homer called A History of Interest Rates spanning five thousand years. If that’s too much to take in, have a look at just the last 150.

In their search for yield, investors pushed stocks to record highs, and rates remain at record lows. Short-biased and market-neutral managers cite low, risk-free rates as they reflect the amount managers earn on short proceeds. But the flip side of that argument is that investors should, in theory, allocate more to performing hedge funds for the lack of better yielding alternatives. In any case, managers have no control over the rates and should adopt to a low-rate environment or a slow, protracted, tightening cycle.

“But what makes such observers react so in the face of “historically low interest rates”? Because what we mean is “in the recorded history of mankind.” Meaning in the last 5,000 years. Near-zero and negative long-term interest rates, which are now a near-worldwide phenomenon, have never happened before.”
Value Over Momentum and Other Factor Exposures

While many managers describe their process as value-oriented, data shows that the industry is heavily exposed to a momentum factor. Sharp reversions like the one we saw early this year will hurt managers who are unaware of their top-down risks. In this case, managers should understand their individual factor exposures even (or especially) if they follow a bottom-up portfolio construction process.

Understanding which names contribute to certain factor bets, like momentum, will help in managing the risk of sharp reversions. Managers should particularly beware meaningful factor mismatches on the long and short side of their books. Are you long momentum and short value? In this environment, you have to know.

Upon speaking with dozens of fundamental long/short managers, we realized that very few of them put much value into knowing their VaR number or looking at risk in the way their quant-trading counterparts do. To combat this, we built a risk system that simulates the thinking of a fundamentally driven hedge fund manager. You can learn more about our take on risk at Novus.com under Risk Management in the products section.

Large Cap Over Small

Even though managers have been moving up the market cap spectrum, they’re still heavily overweight small and mid, while underweight mega caps compared with the S&P 1500. Some larger managers don’t have the choice to invest in smaller cap stocks, but many smaller managers do. To succeed in this environment, it’s imperative for managers to understand their skill sets in adding alpha across market cap segments. For some, moving up the market cap spectrum is beneficial; for others, it can mean giving up their alpha.

From Fig 5, we can see that in the past, a smaller cap tilt has helped hedge funds. But since mid-2014, smaller capitalization stocks have underperformed large caps, adding to the systemic headwinds facing managers. One might argue that being overweight a certain market segment is a behavioral issue, and while this is true on an individual manager basis (especially for the smaller managers), the wider industry is very much exposed to the size factor.
Geopolitical / Macro

Oil price shocks, Brexit, European instability, uncertain interest rate policies, and China’s growth slowdown have all played a role in disquieting markets and making the investment environment challenging. But investors rarely accept these reasons as justification for underperformance. After all, these uncertainties should affect passive indices while providing the active manager opportunity to navigate the volatility and avoid loss.

Growth of the HF Industry

In the recent years we’ve seen hedge fund assets test the 3T mark, and today they’re not far off. Furthermore, there seem to be a record number of hedge fund managers raising and running assets. But growth of the industry—though highly correlated to increased crowding—is not a reason for all managers to buy the same securities. Growth is systemic and not under the manager’s control—it’s strictly driven by investor flows. Crowding, however, for individual managers, is a behavioral and not a systemic issue. Buying crowded securities is a manager’s investment choice; one they can decide not to make.

In the next piece, we’ll compare the industry’s growth with the increase in overall crowdedness. We’ll show that while growth certainly has affected crowding, much of the crowding can be explained by manager behavior.

Today managers can employ a crowding metric in their investment process. For instance, one of our clients thoroughly reviews the names in their book and exits any position with a crowdedness score of .99 or above. Don’t forget that four out of five of the most crowded stocks from last summer have crashed spectacularly. The risk is too great.

For the less extremely crowded stocks, the manager buys left tail protection. For crowded stocks being introduced to the portfolio, there must be higher conviction to weather the potential volatility—thus the target price goes up.
Conclusion

Now more than ever, managers need to communicate a clear value proposition, differentiate themselves from the rest, and deliver attractive, risk-adjusted returns to their investors. Managers need, most of all, to focus on their circle of influence and do more of what they’re truly great at while spending less energy on what’s out of their control.

Part 2

Behavioral

By Stan Altshuller

In today’s challenging environment for hedge fund managers, we’re starting to see some important indicators begin to recover. We recently discussed a few such measures; in particular we looked at systemic factors—the factors outside of a manager’s control. In this second installment, we’ll focus on how managers can take advantage of turning tides in the markets. We’ll specifically emphasize using intrinsic investment skill and other available tools. As the systemic headwinds turn to a tailwind, managers should focus on their proven investment process—the behaviors they rely on to generate alpha. The circle of control for managers is a lot larger than people realize and give credit for. Let’s dissect these tools one by one.

Sizing

If we challenged an excellent L/S Equity HF manager to invest in every stock in the S&P 500 in their book, this manager could still consistently outperform the index through sizing decisions. They could weight 490 stocks at 0.10% and use the remaining half of the portfolio for the ten stocks they truly believed would outperform. Their security selection (excluding sizing) would be zero (the average ROI on each stock would be equal to that of the index), but their alpha would depend predominantly on the performance of the ten stocks sized at 5.1%.

After researching over a thousand managers, we’ve seen that most do add value through sizing decisions. But some managers are better than others at this critical skill. We found that almost 60% of managers add sizing alpha—meaning they outperform equally weighted versions of themselves. And when they do, the

FIG 7 - POSITION SIZING ALPHA (ANNUAL) HFU: 2010-2015

58% of managers add alpha
2.8% avg. added per year

41% of managers lose alpha
1.6% avg. lost per year
reward is substantive. Managers with this ability added an average of 280bps per year for the period of 2010–2015, and those that didn’t add value lost—on average—160bps to an equal weight portfolio. Not a disaster, but certainly an area of improvement for many.

What can we do with this data? Put it in the context of your current portfolio. All of our hedge fund clients use Novus to analyze their portfolio by position sizing buckets; they find their sweet spot and amplify it by increasing exposure to that bucket. Alternatively, if they lose alpha to sizing decisions, they might consider equal-weighting the portfolio to temporarily stop the relative loss. More often, the manager simply identifies the bucket that consistently loses alpha and trims it. The trend this year has been to both increase exposure to top conviction trades and to trim position counts, getting rid of the smallest positions.

This concept requires a side-note. Many managers reveal that they keep their smallest positions on the books to track performance and have analysts keep them under close watch. But when we quantify the actual cost for this technicality, the managers usually change strategy.

**Novus** I notice a lot of small positions in your book.

**Manager** I keep these farm names so we can quickly grow them to core size when the time is right.

**Novus** But did you know that your farm names dragged your performance down by 20bps a month over the last five years?

**Manager** No … Now that we quantified this, I should revisit each name.

Above is a recent conversation with a manager. This regime has rewarded conviction in top ideas and punished dilution of capital efficiency. Many managers are adopting this “risk-on” action, allowing the manager to turn up the dial without increasing overall net or gross exposures.

**Timing the Market** (or Exposure Management)

Very few managers claim to consistently make money by timing their net exposures opportunistically. Data shows that, with a few exceptions, most of the thousand-plus hedge
fund portfolios we monitor do not consistently make money moving around exposures. Our advice to clients is simple: With net exposure management, your goal is to not underperform the static net exposure scenario. In other words, don’t lose money trying to time the market.

To measure this concept, we tracked a version of a portfolio using the total period’s average net exposure for each month, instead of the actual exposures. The delta between the two lines is the value added (or lost) through moving exposures. In Fig 9, a manager gave up 31.3 percentage points because of these changes. Yet we can see that the losses haven’t been consistent—in fact, there was positive value-add for a period of time.

This is typical. The problem arises when a manager makes money through exposure changes and then believes this is a persistent skill of theirs. Most of the time the pendulum ultimately swings back and detracts more alpha than it provided in the first place, as we can see in the above example.

Style Drift
What happens when a manager skilled at stockpicking in the small cap arena is forced out of their area of expertise by asset growth? There are many types of style drift, but moving up the market cap spectrum is the most ubiquitous with equities.

On the next page are two charts for a real manager’s 13F data since 1999. (We’re withholding their name to protect the innocent.)

Here we compare the manager’s assets (left) to the weighted-average market capitalization (right) of their holdings. Clearly, as the manager grew assets, they shifted up the market cap spectrum, winding up in mega cap space from their mid-large beginnings.

But in this case, the shift isn’t necessarily detrimental to returns. Most of the alpha was generated in the large and mega caps, consistent from early days to more recently.

Managers undergoing even a fraction of such growth must measure their efficacy by market cap buckets to understand their inherent sweet spot. If they find that alpha is exclusive to smaller market caps, they can pull some other levers and avoid the shift up the spectrum. Namely, they can increase position count or allow their liquidity to decline, while hopefully communicating their data-driven decision to investors.
Security Selection

What if you find out you’ve never generated alpha (ever) in the healthcare sector? What if, in fact, your stock picking is detracting 10bps of total P&L each month? Let’s say you still believe healthcare is generally a good place to be, and you want that exposure. It’s much cheaper to buy a sector ETF and avoid the alpha drain while you figure out a longer-term solution.

Even though buying cheap exposure (such as ETFs) saves research dollars, trading costs, and negative alpha in an area of little skill, many managers shy away from it. There’s an expectation that hedge fund managers must make stock picks in every sector. But just like the position-sizing concept, this doesn’t hold up against the losses they absorb due to this decision. Once it’s clear how much it’s costing you, you’ll likely move to plug the leak quickly with a cheap ETF or index future.

The flip side of this is also true. When making conviction bets, be sure they’re in your area of maximum alpha generation. Per the below example, consumer discretionary, IT, and materials have been steady and reliable sources of alpha throughout the years. Taking conviction bets in these three sectors increases the odds of success, strictly based on the data. Conversely, conviction bets in areas of poor security selection are a bad idea.

Additionally, as we’ll see next, conviction bets on the short side can be tricky.

Overtrading

Trading is a reliable skill set with many managers we work with. But that’s largely true for the long side of the book. Shorting is a different story, mainly because when a short position moves against you, your exposure to that position grows, requiring you to start trading to risk-mitigate.

We measure the value add for trading on both long and short sides of the book, and the short side often looks like the above.

In Fig 12 we compare actual short returns to a monthly no-turnover short portfolio. The short book clearly cost them in absolute terms, but the manager lost an additional 906bps to short side trading (seen as the difference between the blue and orange lines).

Some of this loss may be unavoidable, but managers should be mindful. This means taking less conviction bets on the short side, providing the flexibility to tolerate greater upswings in the shorted stock without being rushed to cover.

Hedge Fund Crowding and Liquidity

Holding investments in the most concentrated securities doesn’t seem to have a good risk/reward payoff and has truly hurt recent hedge
FIG 12 - NOVUS FRAMEWORK (LONG)

Alpha by sector since inception

FIG 13 - MONTHLY TRADING ACUMEN

Alpha by sector for the past 5 years
fund performance. To illustrate this, we’ve constructed our Concentration Index from the twenty stocks that have the highest percentage of outstanding shares owned by hedge funds. (Now available on the platform to Novus clients.) These stocks began a dizzying descent in 2013 and have demonstrated significant rolling underperformance to the S&P 500 as of June of this year. The most illiquid stocks follow a similar trend.

When we look at the entire market by concentration and liquidity buckets, an interesting trait is revealed. The performance sweet spot tends toward the middle rather than the left and right extremes of the spectrum.

Intuitively, this makes sense. As managers identify an alpha opportunity, they invest in it heavily. As awareness grows, managers “crowd in,” and the price soars. Eventually the price reaches a ceiling, and managers then rush out simultaneously. It’s critical to know exactly when that ceiling has been reached, and it seems that hitting 50% or more shares outstanding indicates you’re close to a ceiling.

Over the last six years, managers haven’t been rewarded for investing in names with extremely heavy underlying hedge fund owner-
ship and in fact have been punished for crowding into them late.

Though industry growth is systemic, crowding is a behavioral factor—completely dependent on active investment decisions. Today it’s fairly simple to calculate the crowdedness of every security you’re invested in or plan on adding to the portfolio. Novus does this systematically for clients, but even non-clients can approximate crowding and avoid these securities once they cross a critical threshold.

Fee Structure

Hedge Fund fees have been garnering a lot of investor (and media) attention and come under serious pressure. The focus has been on management fees, which represent the part of the fee structure independent from manager returns. Managers are completely in control of the fees they charge and often make concessions in exchange for larger checks or liquidity considerations. Even some of the largest managers facing performance pressures are voluntarily lowering fees for all their investors.

Data from a recent Prequin poll exposes that while managers are indeed responding to investor concerns by lowering fees, they still have a long way to go in satisfying most investors.

Many of our clients believe that high management fees are mainly a problem for larger managers. Smaller managers are already incentivized to perform (to raise assets), while larger managers are only incentivized to maintain the income from their management fee. My colleague, Faryan, unpacked this misalignment of interests in a blog post last winter.

Conclusion

While it’s tempting for managers to explain underperformance with external factors, it’s more productive to focus on what they can immediately control. In many cases, data and self-analysis is the key to capitalizing on your own intrinsic sources of alpha. As the markets turn more favorable to active managers, who will be most likely to succeed? Having worked with hundreds of managers, we at Novus feel that those who are retrospective and careful in scrutinizing their own investment patterns are much more likely to outperform.
EASILY REPORT TO YOUR INVESTORS...

...WITH NOVUS

Seamless data collection & portfolio aggregation.
How Hedge Funds Can Grow Assets in Today’s Tough Environment

By Stan Altshuller

According to feedback from our readers, today’s greatest challenge facing hedge funds is growth, and for some managers it’s even more fundamental: simply staying in business. For multiple reasons, most hedge fund managers find the current environment extremely difficult for raising capital. From conversations with clients on both sides of the equation (asset owners and managers), we’ve found four main obstacles to growing assets. Let’s dissect each one and explore ways to overcome these hurdles.
**Overcome Performance Headwinds**

First, the elephant in the room: Hedge funds haven’t kept up with the broad markets and have lower alpha and higher beta today than twenty years ago. The last eight years were especially challenging, even on a risk-adjusted basis. Below, two charts show the alpha and correlation of the HFRI Equity Hedge Index to the S&P 500 on a five-year rolling basis.

Even if you’ve performed well in the past, there’s no doubt the industry’s backdrop looms over your prospects. When large allocators divest from hedge funds, this is usually why. Unfortunately, by divesting from the entire segment, allocators lose good managers along with the mediocre. However, not everyone is divesting, despite what headlines would have you believe. Dispersion of returns between best- and worst-performing hedge funds is still very wide. Some of our allocator clients are in fact increasing their investment to hedged strategies, judging the bull cycle long in the tooth.

We humbly propose that to win business today, you must listen to your prospects and learn why they hired hedge funds in the first place. Tune into their needs in that first meeting in order to learn about them and get a second meeting.

Zero in on allocators whose goals line up nicely with your strategy, and don’t spend much time with the others. For instance, if the prospect’s goal is to diversify their predominantly equity holdings, and you’re an equity manager, their business isn’t worth your while.

If, on the other hand, you’re a relative-value credit manager with low correlation to the prospect’s book, you can bypass the return side of the conversation and focus on reducing risk for the client.

Understanding the investor is key, and they’ll appreciate your time spent considering their needs. You’ll become a partner in finding a good solution, versus someone simply selling a product. This changes the tone of the meeting and differentiates you from those who pitch regardless of fit.
Differentiate Yourself Among Record Number of Hedge Funds

Large allocators are inundated with managers pitching their funds through email, phone calls, and events. The total number of hedge funds in operation has tripled in twenty years, and there are a record number of managers to keep track of and many more opening shop at a rapid pace. How do you differentiate your offering from the thousands of others competing for the same investment dollars? Our hedge fund clients who’ve achieved this goal usually follow the below steps in presenting their firm to prospects.

• Build a compelling narrative—simplify your message, and clearly communicate why your business exists. You’re telling a story, not listing off facts from a bio.
• Show, don’t tell—add color to your narrative with one or two illustrations that reinforce your main point.
• Don’t try to do too much—assume the prospects will only remember one thing from your presentation. What do you want it to be?
• Focus on repeatable skill—investors want you to perform on their dollar. Show them how you’ll do that in one clear slide.
• Demonstrate that you invest in your process and improve over time—investors are more sophisticated and in tune with the changing economic landscape than ever. More effective presentations make it clear that the manager has built an adaptive machine vs. a static investment process at the mercy of shifting winds.

Beat the Size Bias

Most new capital is allocated to the biggest managers. Investors, especially larger ones, want institutional processes in place, and many managers simply won’t get there. If you’re a smaller manager, weed out the prospects where this is a nonstarter, and focus your efforts on those that can be swayed. Then, examine the reasons investors wind up going to the brand names.

In reality, most allocators are conflicted regarding asset size. They understand the benefits of investing in smaller managers—namely, they have higher performance (on average), their incentives are more aligned, and they more often offer favorable terms like liquidity, transparency, and fees. But from what we’ve seen, these benefits don’t help the smaller manager raise capital because of the higher risk associated with smaller managers.

FIG 2 - NUMBER OF GLOBAL HEDGE FUNDS

Source: HFR
Investors are drawn to larger managers mostly to avoid this risk. Will your business operations be able to handle growth? What about your investment process? Will it survive a change in market regime? Do you have a plan to adopt if you raised capital? How “institutionalized” is your business from the investment process to operations and providers? The best you can do is make the investors comfortable on these fronts and move on.

However, there’s another, more difficult reason investors go with larger managers. There’s safety in numbers, and large managers guarantee many peers by the investor’s side. Although investors rarely state that outright, we believe it accounts for some of the discrepancy between interest and actual investor cash flow.

**Turn Negative Perception on its Head**

There’s a sense among the broad investment community that hedge fund managers operate under an air of mystery and don’t justify their fees. You can see it in the media, the commentary sections of news stories, and even coming from some hedge fund managers themselves.

To combat this perception, treat your investors like partners. Show them flexibility on fees in exchange for a longer lock-up or some other trade-off that’s less important to them. Investors want to feel that the manager is working with them to come to a common solution. Display your aligned interests by investing a significant portion of your own capital into the fund. This is a big one with many investors, and a show-stopper for some.

Another important attribute is transparency. Investing is an act of trust, and trust works both ways. If you don’t trust an investor to properly handle the details to your portfolio, why should they trust you with their capital? Our allocator clients want to feel like their managers are truly their partners. This can be a great source of differentiation, since four out of five managers don’t provide position-level transparency to their investors.

As partners, investors want to know that you have their best interests in mind. This means giving them a call when things don’t go as planned, not only to inform them of good news. When an analyst leaves, or when there is a bout of unexpected volatility in a fund, reaching out first goes a long way. Especially in this tough environment.
Risk Reports.
Like You’ve Never Seen Before.

Learn more about the Novus Alpha Platform by contacting us at alpha@novus.com
Seven Habits of Highly Successful Portfolio Managers

By Faryan Amir-Ghassemi

In today’s hyper-competitive business world, there’s a never-ending deluge of self-help lists, management consultants, and executive mentorship training. You can read Medium or HBR, you can watch TED talks, and you can attend a Coursera webinar. While most management observers point to improved baselines across corporations, the zeitgeist of media attention gravitated toward the Silicon Valley startup space and their novel adaptations toward scaling. Meanwhile, asset management has seemingly lagged behind the cutting edge, as today’s young talent opts for Mountain View instead of Wall Street. Whether or not you
see this as a secular change or simply a cyclical trend, little has been written about asset management needing to evolve in the face of a drastically different regulatory and competitive landscape.

In the active management space, specifically, the image of hedge funds run by eccentric geniuses barking out buy orders like soothsayers is a dying trope. In today’s world, top management techniques will be a requisite for fund managers to survive the washout of organizations hit by redemptions, closures, and fee compression. The later point, in particular, has forced noticeable belt-tightening amidst a historically profligate niche industry. The silver lining here is that tightening can be healthy if it leads to more prudent evaluation of expenditures and emphasis on cultivating human capital.

In this piece, I’ll use personal experience interacting with dozens of hedge fund PMs—from small 50mm startups to multi-billion-dollar world-beaters—to explore successful techniques in running great businesses instead of simply making great investments. Borrowing a theme from our friends over at Sentieo, these techniques will be framed around (you guessed it) Stephen Covey’s Seven Habits of Highly Successful People.

1. Be Proactive

No one knows where the market will be in three, six, or twelve months. Ask anyone who’s burned premium on downside protection for the last seven years. The current abnormal macroeconomic conditions make this type of prognostication near impossible beyond assigning probabilities to outcomes. Thus it’s difficult for portfolio managers to focus on long-term investment perspective or adapt to violent sub-trends that ripple underneath the calm veneer of the market’s upward drift. A thought-provoking chart by Goldman Sachs Investment Research (Fig 1) displays the recent dislocation between market volatility and that of “fundamental factors”:

Beyond doom and gloom, this “new normal” makes the proactive positioning of one’s portfolio more important than ever. Under-
standing how the portfolio, sleeves, or individual securities will behave under exogenous circumstances is crucial to maintain balance during turbulence. Take, for example, High Yield’s return trip in the last twelve months, or that of media companies in the first quarter. Biotech may be another example, as are the currently en vogue “low-volatility” ETFs. In the last year, many funds scrambled to identify how these sub-trends blindsided their portfolios. A proactive orientation about investigating beyond the fundamentals allows for better decision making when volatility picks up.

2. Begin with the End in Mind

One of the best adages I’ve heard from portfolio management is from a former hedge fund PM talking about his objective for each year. It wasn’t tied to a specific performance metric (e.g., 20% annualized), which is almost impossible to project if you have market sensitivity (he ran l/s equity). Instead, he aims to produce the following:

Fund’s Expected Gross Return = .4 \cdot \beta + .1 \cdot \alpha

He started by focusing on capturing 40% of the market’s beta (which can be controlled by adjusting net and monitoring the beta of longs, shorts, sectors, geographies, and cross-asset class correlations). He then focused his primary research effort on generating 10 percentage points of alpha. Obviously this is easier said than done! But starting with that end in mind, the investor has a framework for evaluating the inclusion criteria for every security prior to entry into the portfolio: How does this name affect our beta? What’s the upside/downside potential? How much incremental risk am I assuming to achieve a portion of our annual alpha objective? How attractive is the merger/arb opportunity given our risk/reward parameters? Can I leverage Bayesian frameworks for making opportunity cost assessments? Can I track my efficacy in achieving the end goal? Beginning with the end helps clarify thinking in the now.

3. Put First Things First

In Seven Habits, Covey speaks of an instrumental prioritization grid. It looks something like this:

<table>
<thead>
<tr>
<th>IMPORTANT</th>
<th>URGENT</th>
<th>Not Urgent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Urgent and important</td>
<td></td>
<td>Important but not urgent</td>
</tr>
<tr>
<td>Urgent but not important</td>
<td></td>
<td>Not urgent and not important</td>
</tr>
</tbody>
</table>

As seemingly basic/obvious as this is, it’s a superb mental model for long-term prioritization that combats our tendency to focus on urgent tasks. Most highly functional thinkers (whether HF PMs, med school students, or summa cum laude law graduates) start their career path by successfully executing urgent tasks (deliver a project, cram for a final, memorize a brief). In the investment management industry, career progression often starts with quick turnarounds surrounding timely events. As you transition to leader and business owner, these highly honed skills—while important—need to be complimented, and often fully replaced, by less urgent but perhaps more important tasks such as running a business, portfolio construction, cultivating and mentoring talent, and providing leadership to drive alignment/common purpose. Portfolio Managers need to live in the important/not urgent box, while figuring out the organizational structure to satisfy the rest. Crossing that Rubicon is crucial for successful PMs and for organizations that want to scale from performative to institutional businesses.
4. Think Win-Win

This isn’t an immutable law, but a common trait across the institutional asset managers we interact with isn’t necessarily the genius of the PM in feeling the market or understanding trends in sectors or interest rates; it has been the focus of the principal to cultivate talent in their organization. They understand the multiplier effect of passionate employees. There is a Silicon Valley saying about employee effort:

\[ 1.025 > .9810 \]

This simple equation basically says that if your base ingredient (human capital) delivers above and beyond (102% output) with only five of those ingredients (employees), it will outperform twice the investment (ten employees) operating only 2% below peak. While the math here is drastic, it’s rooted in the reality that scaling organizations leads to exponential increase in complexity. What worked with one PM and two analysts at $250mm of capital doesn’t scale linearly when capital is tripled. You can’t simply add bodies and expect the same cohesiveness, focus, and quality. PMs may have to wear several hats to ensure that their startup’s lights are on and their bills are paid, but they need to make effective transitions to building institutional businesses rather than struggling to maintain status quo. The easy answer is always to hire more bodies, but that approach can be dilutive if quality and alignment are compromised. This is an extremely challenging balancing act that we’ll address more thoroughly in point 6.

5. Seek first to Understand then to be Understood

Novus offers high-touch consulting services to investment managers who want our proprietary expertise to review their portfolios.
Having performed many of these reviews, I’ve been kicked out of a corner office or two for presenting unflattering analyses to PMs. I now empathize with outsiders/consultants offering advice (for a fee) about someone’s business. One of the most pointed criticisms about consultants is that they rarely understand the intricacies, nuance, and difficulties of their practice, choosing one-size-fits-all aphorisms and Band-Aid solutions. This can especially be the case when taking a generalized approach (in a field such as data analysis).

Some of the most effective PMs I have encountered, however, are those willing to hear an outsider perspective—even against immutable truths they know—and then debate why they disagree with the conclusion. This readiness to converse permeates analyst meetings where ideas are discussed as well as interactions with portfolio management companies. It demonstrates patience, a willingness to step away from confirmation biases, and the process orientation to synthesize information through open-minded rigor. Those that seek to understand first are often those that develop the most impressive businesses by being open and vulnerable to self-improvement.

6. Synergize

Creating cohesive workflows is crucial for successful PMs. As we discussed earlier, PMs must graduate from primary research/vision to executive skills like optimizing staff strengths and workflow. Balancing getting 102% from one’s analysts (Point 4) against overstretching/burning them out is a critical challenge.

Understanding that Jane is excellent at EMEA, while Jacob has a bias toward Industrials cycles isn’t only imperative in positioning their output and portfolio impact (remember 102% vs. 98%); it’s essential in fostering motivation and development that help analysts grow to become accretive contributors to the fund’s success. Having the risk team spend less time on model implementation and more time on analysis and actionable insight is another relevant analog.

Providing operational leverage to one’s human capital is critical to winning the balancing act that pits self-driven alignment against constant task mastering. At a recent panel discussion on private equity, Michael Milken outlined his personal framework for engendering this prosperity:

\[ P = \sum Ft \ast (\sum HC + \sum SC + \sum RA) \]

- \( P \) = Prosperity
- \( Ft \) = Financial Technology
- \( HC \) = Human Capital
- \( SC \) = Social Capital
- \( RA \) = Real Assets

The prescription is quite clear: To drive prosperity (in the form of organizational excellence and ultimate shareholder or partnership returns), investment firms must achieve operational leverage through financial technology to get the most out of human capital, social capital, and their real assets. PMs need to carefully consider which tools allow these forms of capital to be leveraged to their fullest extent.

Over the last ten years, we’ve seen a change in how office work is done at asset management firms. Some firms remain deeply rooted in Excel for their DCF models, their data gathering/analysis, and their risk/attribution modeling. Others have moved to database infrastructures with querying languages like SQL that allow them to store, access, and manipulate data at a greater scale. Cutting edge organizations are using vendor software services for repetitive tasks, allowing human capital to focus on synthesizing information into actionable insight.

The build vs. buy vs. body approach must be done judiciously: Know when an employee should wear two hats versus outsourcing a function; understand when to graduate that function to unlock the employee’s extra core-competency contribution while reducing low
ROI time-allocation. Providing employees adequate training in new technology is also crucial to ensuring growth. The end result isn’t just increased productivity—it means attracting and retaining talent not only with compensation (which breeds mercantilism) but also through meaningful work and personal growth. This is how to engender Matthews Effects in highly competitive markets.

7. Sharpen the Saw

Brian Chesky may have understood this best: when a business leader is entirely consumed by her passion, she may lose perspective of how the functional reality around her has evolved. Physical renewal is definitely one aspect of it (healthy mind and body), as is mental balance (as Ray Dalio has espoused through his championing of meditation).

Focusing on renewal will not only sharpen your execution but will also ensure that your perspective doesn’t fall out of balance. Evaluating companies as anonymous widgets on a 10-Q may divorce one from the intangible realities of the business and its end-consumers. While that might seem like a stylistic choice (e.g., the investor who prefers meeting with management versus those who separate from potential bias), it’s really about retaining the ability to make quality judgments over time. Ultimately, the ability to really understand the business requires a centered, healthy lifestyle—as opposed to living in Excel and Bloomberg for eighty hours a week.

These prescriptives won’t work for every organization and should be tailored to the idiosyncrasies of each situation. Nonetheless, the rapidly shifting environment necessitates a positive evolution in asset management business practices, and I’m willing to wager that highly effective organizations that understand how to leverage their resources while navigating the difficulty of scaling will win out in the long run.
An Allocator's View on Effective Hedge Fund Marketing

By Shaunak Amin & Joe Peta
Despite the hilariously outdated technology props and some extinct jargon, Oliver Stone’s Wall Street is still revered by financial industry insiders. Even today, more than 25 years after its release, Wall Street is regarded as a realistic depiction of the industry largely because the film nails the dynamics of some important relationships in the business.

Take the above quote, for example. Fund managers are perpetually being pitched. Sell-side analysts fill portfolio manager’s voice mails and inboxes with research ideas. Bankers want to bring their traveling roadshow to the buy-side office to pitch the latest company issuing paper. Today’s fund managers, just as Gordon Gekko implied, know how irritating it can be to face a bombardment of pitches that all look alike.

And yet, based on our discussions with allocators (endowment, pension, fund of funds or the like), when the tables are turned – when the hunted becomes the hunter – and managers need to do their own fund raising, many of them forget that very lesson.

Allocators who interview hundreds of managers each year tell us that it’s paramount for managers to distinguish themselves. One sure way not to do that is for managers to tell potential investors that they “have an edge” without accompanying evidence.

From the perspective of a hedge fund looking to raise capital, it can be perplexing to think about how allocators are making decisions about investing capital. One wonders if there is a clear path to moving things forward, and could one have improved the chances of getting a follow-up meeting? Let’s find out by getting into the minds of allocators.

**Silly But True**

- Allocators will prioritize a fund that is “soft-closing” vs. a fund that is perpetually open. It helps to have phases when you exclusively meet with allocators and other phases when you are focused on investing. It builds up demand. Deadlines help.
- Playing hard-to-get works.
- The biggest influence on investors’ opinions of a hedge fund is the opinion of other investors. There are very few who simply decide for themselves. When an allocator hears about your hedge fund from a peer at another firm, you’ve already done the heavy lifting. To this point, it can help to have a mind map of who knows who. Similarly, the same effect can cause one allocator to redeem when someone else is redeeming.
- The story is what people remember.
- Like it or not, your fund is “bucketed” in a particular strategy/style in the allocators’ book. Knowing your “bucket” helps anticipate questions.

**How Can A Hedge Fund Have An Effective First Meeting That Results In A Follow Up?**

In a typical year, an allocator meets with hundreds of hedge funds. Most first meetings tend to be centered around topics like pedigree, research process and edge, ideas and theses on those ideas. After an allocator has 20 of these meetings, the story starts to sound the same. This routine does not give an allocator a true sense of what makes a manager unique. An open-ended meeting is often ineffective and results in no clear next step.

**A better way to differentiate your value proposition**

One of the most common questions an allocator is trying to answer is “What’s the edge?” While the question itself oversimplifies investing and carries some implicit assumptions, a simplistic, unsupported answer like “Our edge is security selection/research” by itself does not hold much weight. Talking about one or two high-conviction names does not really answer the question either.

For the first meeting to be effective, a hedge
A fund manager must clearly articulate the value proposition to prospective allocators. Numbers and actual unadulterated statistics are more impactful than esoteric conversations around processes. For example, if research and security selection are indeed core drivers of returns, a more thoughtful answer would involve statistics that prove a manager is actually a good stock picker. One approach to highlight persistent security-selection skills would be to lay out batting average and win/loss ratios by sector/market cap/position size/liquidity or any other category that is most relevant. The table on the previous page lists a variety of skill-sets and how to present evidence of their existence.

Consider that for the first meeting to be effective, it is important to share with allocators:
- The true value proposition, supported by skill-set-centric results.
- The elements that differentiate your fund from other hedge funds.

**What not to focus on in the first meeting?**

The risk in covering too much in the first meeting/call is that allocators spend 90% of the time on a topic that makes up less than 10% of the book and is not core to the overall strategy. These topics could be P&L derived from IPO’s or a few private positions that make up a tiny portion of the book. This is often unintended and it should be avoided.

The goal of the first meeting is to take baby steps to get to the second meeting; spending too much time on a small portion of your book can derail the conversation.

“For the first meeting to be effective, a hedge fund must articulate its value proposition to prospective allocators. Numbers and actual unadulterated statistics are more impactful than esoteric conversations around processes”
What is effective hedge fund marketing?

The world of marketing has changed, and it’s critical for managers to rethink how they communicate with investors by taking a moment to see things from the investor’s point of view.

Investors today have access to more information than they can effectively consume. They are being bombarded by emails, marketing brochures, pitch books, and bold claims from managers competing for their capital. Increasingly, this sort of “push marketing” is having less impact on investors who have heard it all before. To be competitive in today’s environment managers need to differentiate themselves by clearly demonstrating their value to the investor through data-supported narrative.

An increasing number of innovative managers have evolved their marketing efforts by tapping technology and data analytics to help them quantify the value they deliver. Through the use of portfolio intelligence tools, they have gained an edge in raising and retaining capital. Demonstrating their skill and highlighting the drivers behind their investment process, these managers can substantiate their claims and win the trust of investors along with their capital. In the meantime, managers who continue to rely on subjective claims alone will be at a significant disadvantage, even if they are as skilled as they claim.

Here are four specific steps to take your marketing to the next level:

1. **Focus on what makes you unique**
   Investors are looking for unique opportunities—not another “fundamental 1/s” fund. Focus on your key differentiators and connect them to your background and expertise.

2. **Align your message with the objectives of your investors**
   Investors from pensions to funds of funds are faced with criticism of putting up with sub-par returns, paying high fees and not fully grasping the complexities and risks of hedge funds. Whether they are looking for uncorrelated sources of returns, absolute returns, or alpha, it is your job to understand investor needs and challenges.

3. **Talk about your “fund” as a business**
   Besides running a portfolio, you are running a business, and investors are keen to understand the strengths and challenges of your organization. Organizational structure is often highlighted in marketing documents but few talk about organizational ‘health’. What is the reason the fund was launched? What are your beliefs and guiding principles? If you are clear on those and you dedicate time to them in your messaging, you are more likely to attract strong, long-term partners who share your values.

   The rest of the article will focus on our final point – and one we feel is most critical in separating effective marketing from mediocre. It is the ability to show value rather than just tell folks about it.

4. **Show, don’t tell**
   A picture is worth a thousand words. In our day and age, it’s worth a lot more since no one has the time to read a thousand words but they are happy to quickly glance at a chart and discover the insight for themselves. Of course, it’s critical which data you choose to visualize.
**Impala Asset Management**

Impala Asset Management is a multi-billion dollar long-short hedge fund founded in 2004 by Robert Bishop, (Formerly the CIO of Soros Fund Management and a PM at Maverick & Kingdon). Impala now employs dozens of analysts and invests globally, primarily in companies within cyclical sectors including consumer cycicals, industrials and materials. Impala is known for its deep fundamental analysis and strong understanding of the businesses they invest in.

That is the story they want to tell. When communicating with investors, they build a unique narrative by showing, explaining and demonstrating rather than hoping the audience will take them at their word. To do this, Impala has leveraged Novus to organize and dissect their trading data. The endeavor has paid off – the data strongly supports their story and the result is a powerful, memorable and objective message.

Throughout its 10-year history, Impala has invested over 93% of its gross exposure in the sectors it knows best, Industrials, Materials, and Consumer Discretionary. Moreover, since 2004 Impala has generated 93 percentage

| Security Selection Alpha by Sector (April 2004 - December 2014) |
|------------------|------------------|
| Industrials | 93.61% |
| Materials | 163% |
| Mining | 0% |
| Utilities | 0% |
| Energy | 0% |
| Financials | 0% |
| Health Care | 0% |
| Index | 0% |
| Information Technology | 0% |
| Consumer Discretionary | 0% |
| Consumer Staples | 0% |
| FX & Rates | 0% |

**93%**

of risk based exposure is attributable to the Top 3 Sectors. [2009-2014]

**163%**

of Security Selection Alpha in Top 2 Sectors. [2004-2014]
points in Materials and 70 percentage points in Industrials just based on security selection. That is 163 percentage points of security selection alpha in just those two sectors.

Focusing on security selection within each sector, this chart paints a compelling picture of long-term alpha generation through picking stocks within Materials and Industrials.

Many firms say they know what they are good at and stick to it; Impala has more than ten years’ worth of data to show investors that’s so.

Buckingham Capital Management

Whether knowing your companies, or some variation of “kicking tires” or “deep diving”, nearly every single manager uses fundamental security selection as a selling point. However, any investor will tell you, this is not a differentiating point because everyone tells them that.

The value that a hedge fund offers to investors managing an endowment-style portfolio lies in its ability to provide superior risk-adjusted returns. Those are most commonly achieved, when deploying less net exposure to the market, through the shorting of stock. A manager with 80% long exposure and 30% short exposure is only 50% net long. But if the longs outperform the shorts (either by advancing more in up markets, or declining less in down markets) the investor will capture more of a market’s advance than its exposure would yield alone. A manager’s ability to identify the relative value of securities and his ability to capitalize on it demonstrates security selection skill.

Buckingham Capital Management, a rarity in the world of hedge funds in that its founder has been investing since before the 1987 crash, has compiled an enviable record of security selection; not only on an outright basis, but on a relative basis as well.

61% of securities generated alpha on the long side. [2009-2014]

56% of securities generated alpha on the short side. [2009-2014]
In every year but one from 2009 through 2014, Buckingham returned to its investors a larger share of the market’s gains than their net-exposure to the market during that year. What’s remarkable about the alpha they’ve generated is that it has come from superior relative-value stock selection across every sector they’ve invested in. Take a look at this chart which shows Buckingham’s return on capital, long and short, across every sector they’ve invested in since 2009:

It reflects a large positive spread in every sector, except energy which currently represents less than 1% of the book. In the eight sectors where both longs and shorts have been entered into over the last six years, Buckingham can show investors that they have captured positive relative value and generated alpha through security selection.

Clearly, it takes effort to do this sort of analysis, while simply ‘telling’ investors what you’re good at takes a lot less. But the efforts pay off. Like in our prior example, this manager has made a business decision to invest in analyzing their own trading data through Novus, and has used the resulting insights to craft a strong, differentiating message.

**Conclusion**

In speaking with our investor clients – some of the world’s largest endowments, pension plans, family offices etc. – we’ve learned that a differentiated marketing pitch is crucial for managers raising assets. But if you’re a manager, you can’t ‘show’ investors what you’re core skills are, or how you’re unique without the proper tools to measure and display them. This also involves the managing of data to support such analysis.

That’s why we founded Novus – to enable investors to consistently maximize their performance potential through the discovery of true investment acumen, proprietary industry insights and expertise and effortless data management and enlightenment.

**BCM manages assets in two investment strategies: a long/short multi-sector strategy (“The Diversified Strategy”), and a long/short consumer-focused strategy. The portfolio included in this case study is BCM’s Diversified Strategy, which is co-managed by David Keidan and Brian Clifford.**
How illiquid are your investments?

Analyze your liquidity and so much more.

NOVUS
The recent under-performance of hedged equity strategies has received a lot of attention, especially among investors, who are beginning to doubt the effectiveness of hedge funds and fund of funds. Critics point to persistently high fees coupled with declining alpha. But what are the underlying reasons for this under-performance? Since managers have been able to deliver alpha in the past, could the recent poor results be a function of the market, and not one of declining manager skill? In other words, what role does the prevalent market environment play in managers’ ability to generate alpha?

To explore these questions, we worked with one of our larger equity fund of fund clients to construct this paper. The work analyzes correlation and dispersion regimes in the markets and measures their impact on long/short equity managers. Our work highlights the importance of these factors in the ability of hedge funds to generate alpha in differing market regimes, and finds that, in the end, managers should be using these metrics to show investors that their money is not misplaced.

**Correlation vs. Dispersion**

A large portion of active alpha depends on stock picking, or managers’ ability to buy stocks that outperform and sell short the stocks that underperform their benchmarks. Intuitively, this ability will be affected by how individual stocks move with respect to one another. If all securities move in perfect unison, there is no room to capture security selection alpha.

Correlation and dispersion can be used to track the broader movement of stocks within an index. Correlation measures the extent to which stocks move in unison, while dispersion is a measure of magnitude differential between the highest and lowest performing stocks.

When markets exhibit high correlation, it is often driven by macro-economic factors rather than stock-specific fundamentals. Most recently, we saw this type of environment during the risk-on/risk-off regime of 2010-2012. This translates to a difficult environment for picking winners and losers, especially for a fundamentally focused stock-picker.
Dispersion is usually driven by company or sector focused trends. An example would be the out-performance of tech/growth stocks versus value in 99-01, or the recent out-performance of healthcare and technology sectors. In a low dispersion environment, the spread of performance between winners and losers is marginal, making it less profitable to capture relative value through strategies such as long/short.

When looking at these two factors, there are naturally four possible combinations that we should consider. Our fund of fund client was particularly interested in understanding which of the four presents the best opportunity for hedge fund alpha.

To analyze these four quadrants, we need to test against hedge fund return streams. We use three distinct return series each with their own benefits and drawbacks.

1. Public Ownership Data
The first is our Novus Hedge Fund Universe (“HFU”), which we’ve written extensively about both in prior research as well as our blog. The HFU is a proprietary list of over 1000 hedge funds’ public regulatory filings, capturing over $2 trillion of long assets through our Public Ownership product. This index measures the performance of long securities from largely fundamental-focused hedge funds before management or incentive fees. We have compiled this data set back to April 1999.

2. Hedge Fund Index
The second return stream is the HFRI Equity Hedge Index (“HFRI”), an industry standard for long/short equity performance. This index is net of both incentive and management fees.

3. Equity Fund-of-Fund
The third return stream is the performance of one Novus client, a diversified long/short equity fund of fund (Client fund of fund, or “FOF”). FOF is comprised of some of the most successful equity long/short managers in the world and consistently weaves in many of the
Is Poor Performance Always Tied to Manager Ability?

rising stars of the industry. The returns are net of incentive/management fees from the underlying managers. However, the data set has a few less years less history than the HFU and HFRI.

Calculating Alpha

These three return streams each provide a different lens for defining alpha. We used the Russell 3000 as a benchmark for the study. Our dispersion and correlation factors are also calculated on the Russell 3000 for consistency. HFU alpha is a simple calculation: the excess return over the benchmark. For the HFRI, the returns presented also comprise short performance. To calculate alpha, we used a 12-month rolling CAPM calculation against the benchmark. The FOF data is similar to the HFRI data, but is enriched with the net exposure each month. This net exposure allows us to adjust the benchmark returns to compare excess net-exposure adjusted returns as alpha.

This chart shows the underlying data we used for regression on our three return streams. In looking at the historical patterns of equity market correlation and dispersion, it’s interesting to note the interaction of the two factors over different market regimes. For example, the period from 1999 through 2001 shows a very low correlation and high dispersion environment, likely as the tech sector within the Russell 3000 was behaving inversely to the broader market. This is a very ripe environment for alpha generation.

The following 6 years (2001-2007) show a declining dispersion environment with waves of correlation regimes, followed by a spike in both correlation and dispersion during the financial crisis. The years that followed (2009-2013) show spikes of market correlation with low dispersion. Correlations spiked in the third quarter of 2011 (“US debt ceiling debacle”) as well as in the second half of 2012 (Draghi’s memorable “We’ll do whatever it takes” speech), only to nosedive into the beginning of 2013. During 2013 and 2014, dispersion remained low while correlation steadily increased, although it did not reach the extreme levels seen from 2008-2012. In the very tail end of 2014, we
saw an uptick in dispersion, likely as market dislocations in tech, healthcare, and most notably energy afforded a wider spread of return outcomes within the market.

Findings
In order to analyze the impact of these factors on our return streams, we ran regressions of alpha against the factors to test for significance. To smooth some of the variance/noise of the monthly alpha values, we regressed against trailing twelve-month alphas. When we regress our three index return streams against these factors – both as single factor tests and multi-factor tests – the results are very interesting for investment managers. The fundamental takeaways are:

- Periods of low correlation with high dispersion are best for alpha. For CF and HFU return streams, the most consistent periods of alpha generation are low correlation / high dispersion followed by low correlation / low dispersion. The worst periods for alpha were high correlation regimes.
- Higher correlation predicts lower alpha. The long/short return streams proved a statistically significant relative alpha and correlation.
- High dispersion regimes are good for alpha through stock-picking. The long-only HFU return stream did not prove significant with correlation; but it did with dispersion. Dispersion has a positive effect on stock picking alpha on Correlation negatively impacts long/short strategies more than long-only.
- Recent market environment has not been conducive to alpha generation. Since 2009, the markets have experienced correlation and low dispersion – the worst environment for hedge fund alpha generation.
- While the results are in line with our expectations in light of historical hedge fund performance, we were neve by the quality of the results.

Evidence
Testing each return stream, we calculate the significance of dispersion and correlation. Beginning with the HFRI, the periods of high alpha coincide with low correlation. The negative alpha periods move almost in tandem in direction and amplitude with the high correlation regimes. A possible explanation for that is high correlation regimes presented a challenging environment for generating alpha through shorts.

A very similar pattern is observed with the returns of the FOF. Again, a low correlation environment was conducive to high alpha, and high correlation periods coincide with negative alpha.

**FIG 3 HFRI - DISPERSION, CORRELATION AND ALPHA**
With our public data set, the HFU data shows how stock-picking alpha can be amplified by dispersion environments. The period of highest alpha generation is clearly the early regime of declining correlation and increased dispersion during the tech bubble. 

During high dispersion periods, hedge funds have a clear tailwind to apply security selection to outperform the market.

**Quadrant Analysis**

Going back to our original framework of correlation/dispersion quadrants, if we treat individual months as independent units and bucket them into our four quadrants, we can specifically identify if one of those four regimes is more conducive to generating alpha.

For example, the HFU chart below shows the highest alpha months come in high dispersion, low correlation months. Almost no positive stock-picking alpha was generated within the HFU during high correlation and low dispersion months.

Comparing our HFU to the FOF, we can again see that low correlation is imperative for hedge funds to generate alpha. The FOF returns, which include short exposure, are clearly more sensitive to correlation than the long-only HFU:

**Conclusion**

Market environment is absolutely an important factor in equity long/short alpha. By analyzing the impact of market correlation and dispersion, you can see that the last market regime has been a poor environment for hedge funds to produce alpha. Hedge fund investors can likely empathize with the outcome.

The question will be how allocators and funds alike are evaluating results in the face of this structural headwind, and how they choose to react from an allocation perspective. Will the low dispersion environment persist and correlations continue to rise? If so, then hedge funds will likely continue to disappoint. But if the environment changes to resemble
the late 90s, active management will be the place to be.

Explaining recent hedge fund performance though this lens should quell any fear your allocators may have as to your individual performance and stock-picking abilities. As we have seen in the past, the market is continuously fluctuating, and while the previous few quarters have not created an ideal environment for hedge fund performance, this could change, and fast.

**FIG 5 POSITIVE ALPHA ONLY: HFU**

**FIG 6 ALPHA BY REGIME**
Hedge Fund Liquidity: Alpha Generator or Risk Factor?

Faryan Amir-Ghassemi, Colleen White, & Mike Perlow

Liquidity has been an ongoing concern for market participants since the financial crisis. This concern is partly due to structural changes like the disintermediation of banks as market makers, as well as the rise in High Frequency Trading. It is also due in part to the lessons investors learned about the dangers of investment illiquidity during market stress. Those with legacy side pockets from 2008 alternative investments know this all too well; some are still in the process of liquidating even today.
But illiquidity can be a tool in the belt of the active manager; a degree of freedom they can leverage to generate superior returns. This is best exemplified by institutional investors, who have gravitated en-mass towards illiquid investments over vanilla marketable securities. The practice, pioneered by David Swensen and Yale University’s Endowment, aims to capture an illiquidity premium to generate superior returns over a longer time horizon. With that potential for upside can come serious risks, and this series of papers aims to unpack various trends in liquidity, particularly as it pertains to the Hedge Fund industry.

Novus has focused on illiquidity as a risk parameter since its founding. We made a name for ourselves by warning clients of the liquidity profile of several high profile fund blowups in the lead up to the financial crisis. We spend a lot of time broadly thinking about hedge fund liquidity, and in this paper, we provide an introductory analysis of the relationship between fund liquidity profile and performance during periods of market stress. The question we are essentially trying to answer in this introductory piece is how funds with impaired liquidity profiles fare in periods of market stress.

We do so by leveraging our Hedge Fund Universe (HFU), an index of over 1100 hedge funds’ public regulatory filings, representing approximately $2.2trn of reported assets and over 15,000 equity securities. With that data indexed and categorized, we create composite portfolios of each fund. After adding simulated Profit/Loss by assuming buy and trade occurrences on quarterly cycles (primarily from SEC 13-F filings), we can do some in-depth holdings-based attribution and risk analysis on this universe of hedge funds.

**Liquidity Comparisons**

In order to compare fund liquidity, we have historically used static measures such as the % of a fund’s reported assets that can be liquidated in 30 days (assuming 20% of average daily volume constitutes a liquidity day). Having analyzed funds extensively for years, we have found that a good introductory measure for fund liquidity, but not necessarily a true descriptor of its liquidity profile. The liquidity curve of an investment vehicle behaves much the same as a yield curve:

The key difference between a yield curve and a liquidity curve is that the liquidity curve is additive, whereas a yield curve can invert or kink further down the time-horizon.

The importance in analyzing the full liquidity curve versus an arbitrary point is how indicative the arbitrary point may or may not be to the overall distribution or shape of the curve. Case in point, we superimpose a second portfolio’s liquidity curve which has the same 30 day liquidity metric:

Clearly portfolio B has an inferior liquidity profile, as a greater percentage of the portfolio is illiquid, irrespective of the comparable 30-day liquidity metric.
In order to normalize each of the 1000+ funds’ liquidity curves, we approached this indexing issue in two ways: using an integral function and performing a principal component analysis.

The integral function simply looks at the weighted total area under the curve at each time step, providing an aggregate numeric which describes the total liquidity curve. Integral functions only work with additive distributions. The principal component analysis is the methodology most risk providers use to create factor inputs, and it is what we use internally to condense yield curve sensitivities into singular values (i.e., DV01). Principal components are necessary for non-additive distributions, as twist is a characteristic of a curve that an integral cannot capture. Having tested both methodologies on the liquidity profiles of all of our portfolios in the HFU, we found both tools provide nearly identical index results:

With this data now indexed across all of our hedge funds at every time step, we have the necessary inputs required to regress each funds’ liquidity profile against their simulated returns in periods of market stress.
**Stress Analysis**

In order to test the impact of inferior illiquidity, we decided to isolate stress periods in capital markets over the last 10 years. We approached this in two ways: The first was picking thematic examples such as Lehman, the US Debt Downgrade of 2011, Grexit 1.0 (May 2010), and the market turmoil of October 2014. These acted as tangible episodes of market stress. We then systematically scanned for periods where the CBOE VIX moved relatively more than 3x, with a nominal threshold to remove minor fluctuations. Both approaches yielded similar sample periods.

We collected 6 relevant market environments since 2007 to run the regressions. While we could have extended the test period back to the late 90s in order to include stress periods such as LTCM, the internet bubble and September 11th, we found the sample set of managers in our HFU did not provide a statistically significant sample set. We ran regressions on fund liquidity leading into stress events, and their 2 month performance immediately preceding, with the hope of finding a statistically significant relationship between a fund’s liquidity profile and its simulated returns. All of our results are provided in the appendix of this paper.

The top-level takeaways are as follows:

- 4 of 6 events yielded statistically significant coefficients on the liquidity term.
- Model fits were sometimes poor, as there was a wide dispersion of funds with uncorrelated returns.
- Certain regressions showed contradictory results to what our internal private-data analysis proved, exemplifying the limits of public-data simulation in capturing stress related risk.
- The most recent market cycle has repeatedly rallied after stress events, which makes the sample period challenging to test true tail-risk.
- Let’s dissect the periods of importance starting with the Quant meltdown of 2007:

**Key takeaways**

Public regulatory data likely is not the best model fit for definitive results, as trading is a huge psychological component that weighs on how a manager handles such periods of market stress. The US Debt downgrading and October 2014 perhaps best exemplify this, as many of our private hedge fund clients use our proprietary skill-set simulations on their daily position-level data to understand how impactful these buy/sell decisions had been during stress events.

As mentioned before, the post-Lehman market rally has provided little comfort for correctionists (or bears), as every stress event has simply provided an opportunity to “buy the dip.” Lehman was probably the best testing ground for the perils of illiquidity, and it coincidentally occurred on a period where 13-F analysis provides a reasonable sense of manager trading patterns during stress. Lehman showed that impaired liquidity is a factor that can put a portfolio at risk during a severe market stress.

We conclude that illiquidity has been a powerful alpha-generator for strategies such as activism in this market cycle. However, as one of our clients has put it, liquidity is one of three "bullet to the head" risks, which cannot be accurately teased out in a rising tide market. Being cognizant of liquidity constraints should we transition to a new market regime, or undergo a severe correction is undoubtedly a critical risk parameter to monitor.

*Case Studies on Following Pages*
Quant Meltdown – August 2007

This is a prime example of a strong correlation between impaired liquidity and negative performance. On the chart below, the X axis represents standard deviations in the distribution of our liquidity scores. Think of 0 as the average, with 1 as a more liquid fund and -2 (or -3) as severely illiquid funds. The Y axis shows the monthly performance in August 2007. The upward slope of our fitted line shows how funds with impaired liquidity fared poorly during this month of market stress, as several quantitative funds blew up in the precursor to the financial crisis. In particular, we expect a fund with a plus one standard deviation liquidity profile to have a return half a percent higher than a fund with an average liquidity profile.

<table>
<thead>
<tr>
<th>Liquidity Coef</th>
<th>P Value</th>
<th>Intercept</th>
<th>P Value</th>
<th>R2</th>
<th>n</th>
<th>Liquidity Date</th>
<th>Performance Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.0119436</td>
<td>&lt; 2e-16</td>
<td>-0.0051014</td>
<td>1.88E-07</td>
<td>0.153</td>
<td>712</td>
<td>7/31/2007</td>
<td>8/31/2007</td>
</tr>
</tbody>
</table>

**QUANT MELTDOWN**
Lehman – September 2008

Lehman is another strong fit. Here, the Y-axis represents cumulative performance for September and October of 2008. While there is a wider dispersion of results, the regression shows a clear positive slope. Lehman is an interesting example, as the two month performance period we test occurs between two SEC 13-F filings (the 2Q filings represented in the September month performance and the 3Q filings represented in the October month performance). As such, we’re able to capture the managers’ portfolio changes during the heart of the crisis, rather than other examples (i.e., inter-quarter months) where we are forced to assume the positions were held static. This provides a far more compelling lens into the true psyche of the active manager under duress, than a buy-hold simulation of lagged securities. We can better measure what active changes the manager made at the epicenter of a crisis.

<table>
<thead>
<tr>
<th>Liquidity Coef</th>
<th>P Value</th>
<th>Intercept</th>
<th>P Value2</th>
<th>R²</th>
<th>n</th>
<th>Liquidity Date</th>
<th>Performance Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.010542</td>
<td>0.000549</td>
<td>0.301709</td>
<td>&lt;2e-16</td>
<td>0.01534</td>
<td>775</td>
<td>8/31/2009</td>
<td>9/30/2009-10/31/2009</td>
</tr>
</tbody>
</table>
Grexit 1.0 – May 2010

Here we have a case where our regression provides contradictory results. Perhaps it is due to the event being a global (European) stress, versus a US based event. Our HFU was comprised of 82% US securities as of the time of this event. Nonetheless, the slope of the regression was clearly influenced by certain outliers which may have been less impactful had we ran a robust regression.

<table>
<thead>
<tr>
<th>Liquidity Coef</th>
<th>P Value</th>
<th>Intercept</th>
<th>P Value2</th>
<th>R2</th>
<th>n</th>
<th>Liquidity Date</th>
<th>Performance Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>-0.010048</td>
<td>4.13E-08</td>
<td>-0.120815</td>
<td>-2e-16</td>
<td>0.0384</td>
<td>771</td>
<td>4/30/2010</td>
<td>5/31/2010-6/30/2010</td>
</tr>
</tbody>
</table>
US Debt Downgrade – September 2011

This was a period where many funds were caught flat-footed, and underperformed the market heavily. However, the regression above proves inconclusive, compared to Lehman. There is actually a slightly negative slope to the regression which belies conventional wisdom. We believe the anomalous results are due to an inability to capture the trading component that occurred during this period of market stress. Managers that held steady during this V-Shaped market swing generally did fine, but many cut risk near the bottom when market fear hit an apex. Unfortunately, our simulation assumes a buy-hold from 06/30/2011 – 09/30/2011 and so the negative trading component cannot be captured from public regulatory filings without stretching assumptions. This data set in particular provides a worthwhile opportunity to compare realized returns with the simulated buy-hold to better understand the negative impact that trading under duress can have.

<table>
<thead>
<tr>
<th>Liquidity Coef</th>
<th>P Value</th>
<th>Intercept</th>
<th>P Value2</th>
<th>R2</th>
<th>n</th>
<th>Liquidity Date</th>
<th>Performance Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>-0.001425</td>
<td>0.644</td>
<td>-0.164434</td>
<td>&lt;2e-16</td>
<td>0.0002776</td>
<td>771</td>
<td>7/31/2011</td>
<td>8/31/2011-9/30/2011</td>
</tr>
</tbody>
</table>

DEBT DOWNGRADE (CUMULATIVE PER)
Momentum Reversal – January 2014

January 2014 acted as a reset for many popular hedge fund names after a torrential 2013 saw momentum stocks vastly outperform value. This was a period of market undercurrent, as many hedge fund specific names heavily underperformed the broader market. Hedge fund centric names such as Best Buy, JC Penney, YPF, Nationstar Mortgage, Sprint, Ocwen Financial, CVR Energy, Baidu, General Motors and Apple were particularly hurt this month. Given that we see little correlation between illiquidity and underperformance, this period appears more symptomatic of crowding as a precipitator for underperformance than fund illiquidity. Perhaps this is why we see a wider dispersion of results than other regressions, and this will be a period of focus on our crowding follow-up.

<table>
<thead>
<tr>
<th>Liquidity Coef</th>
<th>P Value</th>
<th>Intercept</th>
<th>P Value2</th>
<th>R2</th>
<th>n</th>
<th>Liquidity Date</th>
<th>Performance Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>-0.004698</td>
<td>0.00516</td>
<td>-0.019168</td>
<td>&lt; 2e-16</td>
<td>0.0116</td>
<td>673</td>
<td>12/31/2013</td>
<td>1/31/2014</td>
</tr>
</tbody>
</table>

JANUARY 2014
Oil Dive – October 2014

Finally, the Oil Dive of 2014 was in many ways a miniature version of the US Debt Ceiling crisis of 2011. While there was significant market stress by the middle of October 2014, we saw a V-shaped recovery for the broader market (outside of Energy) to close out the month. As a result, trading is likely the key factor that we could not capture, which would likely have amplified our results.

<table>
<thead>
<tr>
<th>Liquidity Coef</th>
<th>P Value</th>
<th>Intercept</th>
<th>P Value</th>
<th>Rs</th>
<th>n</th>
<th>Liquidity Date</th>
<th>Performance Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.002273</td>
<td>0.131</td>
<td>0.01534</td>
<td>&lt;2e-16</td>
<td>0.003154</td>
<td>724</td>
<td>9/30/2014</td>
<td>10/31/2014</td>
</tr>
</tbody>
</table>

OCTOBER 2014
Securities investing is a challenging game to master. Part financial modeling, part domain expertise, part vision; we are constantly reminded – and humbled – by how demanding this vocation can be. What makes investing so hard is the seeming omniscience of your foe – the market – a living and breathing reflection of all financial speculators. Its long term track record and increasingly cheap availability is the hurdle for success. The most storied investors of all-time, from Warren Buffett to Joel Greenblatt, and from Julian Robertson to David Einhorn have been carefully studied in hopes of emulating their brilliant track record.

Because information about managers and their skills is opaque at best compared to say studying film on professional athletes, it is hard to gauge what common factors, if any, drive success. Fundamentally, we grapple with whether successful investors rely on intuition or process. The mystery around intuition in finance has spawned a deep field of study, known as behavioral finance. Its champion is Daniel Kahneman, Nobel Laureate and Eugene Higgins Professor of Psychology Emeritus at Princeton University. Kahneman’s work stresses that intuition “works less often than we think.” With regard to investing, Kahneman furthers this by saying that expertise “develop[s] from big data”, and “the immediacy of feedback.”

On the other hand, a purely logic-driven decision process is counterintuitive to any fervent follower of Paul Tudor Jones. Investors like Jones seem to have a preternatural feel of the markets, and have uncanny track records off the back of feel. Kahneman explains this phenomenon with the example a husband’s ability to instantly sense his spouse’s discomfort from a mere glance or touch. To further the analogy to finance, hedge fund manager Steve Cohen purportedly feels markets moving and puts on futures trades with wondrous mastery, and George Soros uncannily knows when to pounce on volatile global event trades.

This instinct-based decision process is championed by academics Gary Klein and Gerg Gigerenzer and was made popular by Malcolm Gladwell in Blink. The debate falls into a gray area when empirical studies have shown that both methods can be effective depending on the situation. Their argument is solidified by studies where repeatable positive decisions are made while the decision makers are unable to describe how they made their decision (i.e., athletes, air raid listen-
ers, firemen, etc.). In fact, Kahneman and Klein collaborated to write “Conditions for Intuitive Expertise” where they describe “a failure to disagree” because intuition and logic both deserve a seat at the decision-making table.

Given the constant debate between intuition and process, Philip Tetlock, the Annenberg University Professor at the University of Pennsylvania, has written a seminal book (Superforecasting: The Art and Science of Prediction) about forecasting skill and the common attributes across “superforecasters”. The findings tend to support a general logic-driven framework (Kahneman) underlying the forecasting process, but there are also instinctual elements to many of the inputs that go into the logical framework.

“More often forecasts are made and then...nothing. Accuracy is seldom determined after the fact and is almost never done with sufficient regularity and rigor that conclusions can be drawn. The reason? Mostly it’s a demand–side problem: The consumers of forecasting – governments, business, and the public don’t demand evidence of accuracy. So there is no measurement. Which means no revision. And without revision, there can be no improvement.” – Philip Tetlock, Superforecasting: The Art and Science of Prediction

Understanding what it takes to be a great forecaster is critical to investors because forecasting, in many ways, is the foundation of any fundamental investment process. Tetlock, through his work on The Good Judgment Project sought to define what makes someone able to project events better than the consensus.

He did this through a massive study of hundreds of event forecasters, pitting them against prediction markets, and even the CIA’s intelligence apparatus. The results were shocking, as these seemingly average civilians, armed with little more than access to public information through the internet showed persistent and statistically significant outperformance in forecasting future events. If you haven’t had a chance to read the book, we both highly recommend it as a foundation for examining the traits behind outperformance in prediction. How did they do this? Tetlock outlines ten traits in his book “Superforecasters” that he found in common amongst those uncommonly successful. Traits we’ve highlighted suggest a logical orientation (see also that none are explicitly instinct-based):

1. Intelligent – above average but genius isn’t required
2. Numerate – not only understands math but applies it to everyday life
3. Speaks in terms of possibilities, not absolutes
4. Humble – understands the limits of their knowledge
5. System 2 Driven – uses logic instead of instinct
6. Does not believe in Fatalism – life is not preordained
7. Makes frequent small updates to their forecast based on new information
8. Believes that history is one of many possible paths that could have occurred
9. Incorporates the Inside and Outside view (a term coined by Kahneman)
10. Constantly searches for ways to improve their forecasting process

Point #10 (continuous development) encapsulates a lot of what can help develop a superforecaster. A feedback loop to measure forecast accuracy was central to process improvement. Irrespective of vocation, we believe both are key determinants of success in any complex endeavor. It is in many ways the topic of this
Objectivity is gained by making assumptions explicit so that they may be examined and challenged” Richards Heuer, CIA Analytical Methods Expert

Price Targets and Historical Analysis - An Objective Framework

Price targets are central to most great fundamental investment processes. The reason is simple: fundamental investors buy a security because they believe that its intrinsic value is greater than where it is currently trading. How much more is a critical question to answer. So is answering how much could be lost. Many investors chafe at price targets because they smack of “false precision.” Those investors are missing the point because the key to price targets is not their absolute validity but their explicit nature which allows for objective conversation about the assumptions that went into them. Said another way, the process of calculating a price target and the questions that they foster are central to any good process.

In fact, Alpha Theory performed two analyses to measure the impact of price targets on performance. First, we measured performance differentials amongst high engagement scores (scores were determined by how many of their investments had price targets, how recently they were updated, and how often they looked at them) versus low engagement scores (sample size was 48 funds). The results suggest a material connection between performance (Return on Invested Capital) and price targets (Engagement Score). The table on the next page (Fig 1) shows that each quartile outperformed all lower quartiles. The second analysis was simply measuring the actual performance of assets with price targets versus those without targets. The results suggest a 3x improvement in the return of investments with price targets versus those without.

The natural extension of price target forecasts is applying probabilities to calculate risk-adjusted returns, and then leveraging them to manage the portfolio. Alpha Theory gives clients a rules engine on which they can build their own “Optimal Position Size” formula. The formula maximizes exposure to high expected risk-adjusted returns within a set of constraints for liquidity, max drawdown, sector exposure, crowdedness, conviction level, work stage, etc. that are defined by the fund. The Optimal Position Sizes are then compared to actual position sizes to highlight the largest discrepancies. Analysis of historical optimal position sizing and price target forecasts are delivered to clients to help pinpoint areas for improvement. The example in Fig 2 shows an Alpha Theory Analyst Scorecard that highlights areas for improvement.

Working with Alpha Theory, the Novus Alpha Platform ingests our fund clients full position-
level holdings on a daily basis. We enrich this dataset by gleaning attributes from the holdings across our security master. This can include categorizations like liquidity, geography, sector, and asset class. Novus can also ingest custom attributes for our clients such as Alpha Theory’s optimal position sizes and price targets. This allows our clients to analyze their fastidious position tagging in a time series of exposure, attribution, and risk to ultimately decompose true drivers of alpha generation. This allows portfolio managers to understand if their process has actually been value accretive or if they have not been sizing their positions appropriately. The charts on the next page unpack exposure, return, and excess return.

The ability to drill into those drivers of risk and return at the atomic level can help portfolio managers understand the trends in their portfolio that have worked (and how to amplify these) versus pockets that have not (and how to avoid allocating capital to those). This ultimately provides the accurate historical report card that can be accessed at one’s fingertips, rather than relying on erratic memory or an ad hoc approach to self-reflection.

### FIG 1

<table>
<thead>
<tr>
<th>Engagement Ranking</th>
<th>ROIC</th>
</tr>
</thead>
<tbody>
<tr>
<td>75% - 100%</td>
<td>10.7%</td>
</tr>
<tr>
<td>50% - 75%</td>
<td>9.6%</td>
</tr>
<tr>
<td>25% - 50%</td>
<td>4.9%</td>
</tr>
<tr>
<td>0% - 25%</td>
<td>0.1%</td>
</tr>
<tr>
<td>50% - 100%</td>
<td>10.1%</td>
</tr>
<tr>
<td>0% - 50%</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>No Price Targets</th>
<th>Price Targets</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROIC</td>
<td>2.6%</td>
</tr>
<tr>
<td>Price Targets</td>
<td>9.2%</td>
</tr>
</tbody>
</table>

Source: Alpha Theory™
How Do Hedge Funds Become Better Forecasters?

**FIG 3** HISTORICAL OPTIMAL POSITION SIZE EXPOSURE DISPLAYED OVER 10 YEARS (SAMPLE PORTFOLIO)

**FIG 4** DECOMPOSITION OF REALIZED RETURN BY OPTIMAL POSITION SIZE

**FIG 5** OPTIMAL POSITION SIZING COMPARED AGAINST EQUAL WEIGHTING
Self-reflection is key to becoming better. Looking at prior decisions through the lens of skill-sets rather than returns is crucial to avoid decision making based upon non-predictive data points. Non-predictive datasets conflate unrealized risk or market regime with demonstrable and persistent skill. For example, looking at the universe of managers in our Hedge Fund Universe (HFU), a collection of 1200+ fundamentally focused hedge funds’ public regulatory assets, representing nearly $2.0trn of reported market value, provides a great example of the importance of analyzing skill rather than return.

When we decompose this set of managers over a decade-long time series, the top performing quartile of funds compared to the bottom performing quartile changes consistently year-over-year, which indicates some aggregate degree of mean reversion. However, the sample of top performers year-over-year have persistently demonstrated excess return generated from position-sizing. We measure this by comparing the monthly excess return of their actual portfolio to an equal-weighted simulation of the same names in the portfolio. This time-series demonstrates the persistence of this phenomenon across thousands of managers and tens of thousands of positions, by vintage.

The key takeaway is that persistence is not demonstrated by excess return; it is unearthed through the skill that are the drivers of this return. Those that can articulate and unpack this skill have a chance of adapting to an ever-changing market environment.

**Skill Set Trend Analysis**

Avoiding the vagaries of memory is crucial in developing a process of self-reflection and improvement. It’s not just those interested in investments who study the fallibility of memory. Psychologists and Legal Scholars grapple with this phenomena when gauging the value of eyewitness testimony. Unlike real life, investors can track every investment choice they have ever made. Being able to analyze statistically significant trends on a complex and numerate datasets is a huge advantage and is a crucial tool in avoiding the confirmation biases that anecdotal thinkers lean on when rationalizing decisions.

Take a hypothetical equity generalist who dabbles in energy, a very subject-matter specific

If there are regularities, did the individual have an opportunity to learn those regularities, and that primarily has to do with the quality of the feedback – Daniel Kahneman
sector. She may have an inclination that her track record in energy is strong based on the recollection of one or two great investments ("we made a lot of money in ETE!"), but memory is quite fallible. Being able to access your track record in the sector helps empirically unpack value creation or destruction which can be fed back into an iterative loop of self-improvement. Objectively measuring performance in light of all past data will highlight areas of weakness that allows for frequent improvement. Pinpointing areas where mental biases are largely affecting the decision making process will allow one to avoid the same pitfalls in the future.

For example, the fund above has demonstrated a persistent but small sleeve of capital to energy, but benchmarking all of their active investments in Energy against energy-specific benchmarks clearly demonstrates value destruction. The ability to articulate this reality (over many years) is far more useful in adjusting the portfolio management process than mere anecdote.

**Key Takeaways**

Developing a process orientation isn’t about stifling fluidity or gut feel. It is about recognizing that intuition is actually an informal process. By being able to document and empirically study past behaviors, all investors can understand flaws in their internal process. With that, we leave you with a few ways any investor can get on the right track to becoming a superforecaster:

1. Get serious about your data collection and management
   This can take the form of working with data providers (custodians, prime brokers, OMS’, administrators) or taking a systematic

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Fuzzy thinking can never be proven wrong. And only when we are proven wrong so clearly that we can no longer deny it to ourselves will we adjust our mental models of the world—producing a clearer picture of reality. Forecast, measure, revise: it is the surest path to seeing better. – Philip Tetlock
approach to storing it internally. While Excel is the #1 crutch for all things data in finance, this type of data often stretches the limits of Excel’s scalability. We recommend looking at the very least at relational databases. If this all sounds like a day in hell for you, working with service providers who take data seriously is the logical next step.

2. Acquire analytical tooling that allows you to draw insight from data
This may be in the form of Excel VBA code, a team of quants playing in Python/MATLAB, or a professional service provider. While tackling the data challenge is paramount, spending too much time in the abyss of massaging and modeling data can defeat the purpose. The ability to move quickly in a flexible and intuitive user interface unlocks the power of the data you spent so much energy maintaining.

3. Take a logical and empirical approach to analyzing the data
A great data scientist once told me that there are rarely “silver bullets” in data science. Over the years I’ve come to agree with him. Even if you have an adaptive and insightful analytical framework that tells you your materials analyst overtrades, take the time to thoughtfully understand the biases behind extrapolating sample sets as truths. Simply adopting this mindset is crucial to extracting optimal value and improving one’s process.

4. Think in probabilities!
There are rarely 100% certainties so make probabilistic thinking part of the ethos of your firm. Whether that is trusting your Alpha Theory decision tree, or your Novus historical 10 year skill-set analysis, understanding the scope of potential outcomes will lead to better conversations, better decisions, and better long term outcomes.
Typically, much of our analysis is based on public data as few managers are willing to share their private data in a research study. But once in a while a manager comes along that is open and transparent about their investment process and does not mind sharing the inner workings of the engine beneath their hood. This work is based on the private position data of one such manager. They (and their investors) have benefited greatly from retrospective analysis of their investment process and are now ready to share their findings with the investment world.

Run by Richard Merage, MIG Capital is a long/short equity fund that looks to utilize their long-term investment horizon to capitalize on their transformative operational insights and short- to medium-term mispricing opportunities. Having worked for eight years in marketing, strategy, sales and operations at the Merage family business (Chef America), Richard provides a differentiated due diligence process, approaching investment opportunities from a business operator’s perspective. While classified as a generalist, much of the portfolio focuses on “consumer-facing” stocks in the Consumer Discretionary, Staples, Information Technology and Financial sectors with market caps above $250mm. In practice, the manager is not simply reading through financial statements and running DCF models. He has actual experience in the field that provides an edge in specific stock analysis.
In this case study we are going to analyze MIG’s returns and scrutinize different aspects of their investment process, looking for skill and areas of opportunity to generate even more alpha. Such analysis can only be done with the full position-level transparency that the manager has granted us.

**Long Performance and Uniqueness**

MIG has a long track record of adding value on the long side of the book. Over the 8.5 year track record, long returns have far outpaced both the S&P 500 and the NASDAQ, even while managing their long book with an average exposure of about 90%.

Looking at returns is one way of analyzing outperformance, but a more telling method is to measure MIG’s security selection and trading alpha (the portion of P&L generated by picking and trading stocks that outperform their sector benchmarks). On the next page we can see that 51 percentage points (of the total 175 percentage points) came from security selection, or 6 percentage points per year. This was evenly dispersed across investments in the Consumer Discretionary, Information Technology, Financials, and Consumer Staples sectors (MIG’s 4 core sectors). Chart 1 below displays the value add created by picking the right stocks in each respective sector, while Chart 2 depicts their historical sector exposures over time.

Per MIG’s marketing materials, the team “generates ideas by utilizing opportunistic, thematic and systematic approaches to source differentiated investments”. From an investor’s viewpoint, the only thing more appetizing than Alpha is “Differentiated” or “Unique” Alpha, as crowding tends to hurt performance when all managers flock to the gates at the same time. We wrote in the past about unique managers with high performance (sourced exclusively from public data).

MIG’s combination of performance and uniqueness landed them just outside the Top 15 list of most unique funds, as they have an overlap of only 8% to the broad Novus Hedge Fund Universe. Further data supports their statement when looking at MIG’s Long book overlap in comparison to many of their peers in the hedge fund space (again, sourced solely from public data). As of 6/30/2015, they had a 4% minimum overlap to the Novus Top 50.

Taking a closer look at the drivers of the performance of the Long book, MIG is 3 for 3 in the skill sets you would like to see (stock picking, capital allocation and portfolio management). Looking at Chart 3 below, their 8.5 year track record of generating a 65% batting average, a 73% capital deployment ratio and a 2x Win/Loss ratio tell a great story.

**Short Performance and Portfolio Management Adjustments**

Analyzing MIG’s short book is where it really starts to get interesting. From inception in 2007 through 2013, MIG invested between 20% to 50% of their short book in broad market or sector hedges, with the remaining exposure in single name equities and options.

Per MIG’s marketing materials, one of the goals of their strategy is to “minimize the risk of permanent capital loss”, and they’ve done just that by limiting drawdowns throughout the life of the fund, particularly in 2008 (down 4%) and 2011 (up 3%). This drawdown analysis is depicted below in Chart 4.

MIG was successful not only at minimizing drawdowns, but also generating security selection alpha. Over this time period, the short book generated close to 9 percentage points of security selection (roughly 130 bps per year). If we remove the market hedges and focus on the individual shorts this figure increases to over 12 percentage points (175 bps per year). It’s clear that many of the pieces were in place, but MIG needed a few finishing touches to unleash the full potential of their short book!

Throughout 2013, MIG initiated three activities based on their thesis that these market hedges were significantly limiting the potential for additional alpha in the short portfolio.
Namely:
1. A retrospective attribution analysis that was reinforced by Novus analysis
2. Changes/additions made to the investment team
3. Internal investments to develop their own data analytics and web scraping tools. This enabled them to enhance their traditional investigatory research approach with real-time observations of business fundamentals. As a result, they were able to gain much higher conviction in their shorts when they saw congruity between the two approaches.

As a result, at the end of 2013 they made an active decision to start eliminating the hedges and focus solely on single name equities and options on the short side. The hedges completely exited the portfolio by July 2014 (Fig 5 below).

Simultaneously the Top 10 short equity position concentration increased from an average of 35% to the 50% to 70% range.
These decisions have proven to be quite lucrative, as the short book generated gross attribution of 23% from Jan 2014 to August 2015 (during a time when the S&P 1500 rose 10% and the NASDAQ rose 17%). Digging deeper, we can see that MIG generated 27 percentage points of pure, security selection alpha during this 20 month period! Chart 6 below displays MIG’s security selection broken out by sector. As to be expected during a rising market, the Relative component (the portion of return attributed to being invested in a particular sector) for each sector is negative. The Selection component; however, is positive for each of
their four core sectors (particularly in Consumer Discretionary and Information Technology).

Think about that, had MIG come in each day and invested their entire short book in the S&P 1500 over this period they would have been down 1%. Based on their stock picking decisions; however, they were actually up over 23%.

Taking a closer look at the drivers of the performance of the short book over this 20 month period, MIG’s results are impressive. Looking at Fig 7 below, they have generated a 69% batting average, a 71% capital deployment ratio and a 2.5x Win/Loss ratio.

Conclusion

This analysis of MIG gives us a perfect example of a manager who used historical data to help optimize the management of their portfolio, and in turn went from producing good results to great results. MIG has always been stellar on the Long side, but recent measures taken to improve their process on shorts are paying huge dividends now. Most importantly, the manager’s effort to further improve and their retroactive analysis of their own investment process led to their identification of potential for higher alpha. After taking measures suggested by the insights gleaned from data, the alpha did in fact improve. Managers who consistently strive to be better investors are best positioned for continued success versus managers who become complacent and comfortable with their process. This is why Novus clients use our Alpha platform every day to push the limits of their performance potential and constantly improve.
Key Portfolio Stats On The Fly.

Learn more about the Novus Alpha Platform by contacting us at alpha@novus.com
Is alpha on the short side a myth? This is a timely question considering how this market cycle’s bull run is growing long in the tooth. Investors increasingly inquire about shorting, while their managers often lament the challenge of making money on individual short positions. Taking high conviction short bets is too risky, and they frequently opt for index hedges instead. On the other hand, one of the main criticisms investors voice is the lack of shorting for alpha generation purposes. From reviewing hundreds of portfolios, we can attest that few managers consistently generate alpha on the short side. As with everything, however, there are exceptions. This case study unpacks the investment process of Kingsford.

One way of generating alpha on the short side is through the research and identification of mispricing in underfollowed securities. Kingsford aims to uncover fraud or other malfeasance conducted by or for the benefit of company management. While Kingsford may also short companies with broken business models or single-product companies where investor perception of growth far exceeds reality, all of its shorts generally have the strong scent of promotion. Mike Wilkins and Todd Ammons, who, combined, have more than 30 years’ experience shorting stocks, co-founded the fund in 2001, and together manage $240M in assets as of 3/1/16. After reading their deck, we were eager to crunch the numbers and test the effectiveness of their unique and innovative process.

Their main goals include: (1) outperforming the inverse return of the Russell 2000, since Kingsford mainly focuses on smaller capitalization names (alpha); (2) capturing the downside movement of the broader market (down capture); and (3) providing a general market hedge to their investors (hedge).

This case study uses daily positions data from 1/1/08 through 4/30/16 to test Kingsford’s ability to achieve these three goals. We’ll also test one “bonus” concept—the managers’ ability to identify truly doomed companies or frauds that hit zero or decline more than 80% (zeros).
The Basics: Concentration

Managers with any experience in shorting understand that the associated risk/reward tradeoff is very different from longs. When going long a security, your downside is limited (worst case: you lose your investment), and your potential upside has no ceiling. Just the inverse is true of short selling. More importantly, when a long position moves against you, your exposure to that position shrinks (unless you actively add to it). If you’re short and the price runs up on you, your position size increases and you might be highly motivated to cover—even if only partially—to keep your position sizing stable. Hedge fund managers don’t like to be “highly motivated” sellers or buyers, therefore many managers avoid taking outsized risks on the short side.

In this Kingsford is no exception. They’re highly diversified (in terms of position count), holding an average of 246 issuers\(^1\). Though

\(^1\) Issuers: The number of issuers can be thought of as number of positions. Novus has multiple aggregation methodologies. In issuer mode, all investment instruments issued by the same corporation count as one investment. For example, issuer mode will roll up all options, war-
position count has come down to 116, their top five largest short positions have been in a band between 3.5–5.5% of equity since 2008, with a few brief exceptions\(^2\). Their largest short position has historically hovered around 1%, never reaching 2% of equity. This high diversification—presumably employed to lower the risks discussed here—implies that they rely on consistency rather than home runs for long-term outperformance. This concept is explored below in the “Skills Employed” section.

**Skills Employed**

We often talk about batting averages and win/loss ratios as key metrics to monitor. A batting average is the number of winning positions divided by number of total positions for a given period. The win/loss ratio is the average contribution from a winning position over the average detraction from a losing position. The win/loss is driven by timing and sizing decisions, both of which are considered significant active management skills. Managers generally have poor batting averages and good win/loss ratios when compared to passive benchmarks.

With Kingsford’s low concentration, the win/loss is expected to be constrained, and they must rely on frequently being right (batting average) more than making a lot when they are right (win/loss). Even in a home run, Kingsford can hope to make roughly 100 basis points on a single core short—this happens when a 1% position goes to zero.

Let’s look at some supporting data: Kingsford’s top contributor (over the whole period of 1/1/08–4/30/16) added 92bps, and the average winner adds only 8bps (low by hedge fund standards). Their batting average, however, has been 60% over that timeframe\(^3\) (high relative to other diversified funds). During the same period, only 48% of the Russell 2000 stocks would’ve been winners if you were short the benchmark. Thus, Kingsford creates value over a passive short investment by shorting stocks that decline 27% more often than in a passive benchmark short. Let’s see if this nontraditional method of return generation translates into alpha.

“Over longer periods, Kingsford has continuously provided strongly negative down capture relative to the Russell 2000.”

**Testing for Alpha: Do They Generate Value Over a Passive Short?**

To answer this loaded question, we first have to define alpha—as it might mean different things to different investors. We’ll look at two different varieties and start slow. In the simplest sense, we can say that alpha is the excess return over a benchmark. In a VAMI comparison, Kingsford’s monthly returns outperform both active (HFRI Short Biased) and passive (ProShares Short Russell 2000) benchmarks\(^4\).

Looking closer at the ProShares Short Russell 2000 ETF, Kingsford has beat the benchmark every year.

Investors may argue that this measure of alpha is too simplistic, and they’d be right. However, calculating alpha as the intercept of the regression line would yield similar results. To understand a manager’s skill, it’s necessary to dig into the true drivers of returns. We know, for instance, that the manager didn’t carry 100% short exposure the whole time. How much of the contribution was due to their skill at shorting individual securities versus trading or shifting exposures?

In tackling this more complex question, we propose a new take on alpha. Our clients think of alpha as the portion of return not explained by market factors and passive exposures; and the tool they use is Novus Framework. Novus Framework decomposes return streams into four distinct sources of contribution: market, allocation, security selection, and trading.
This framework is calculated for every single position and then rolled up into an aggregate portfolio metric. Thus analyzed, the fund has created positive active management value (alpha) in all but two years: 2009 and 2013.

Active management is a robust positive contributor in 2008, 2011, 2012, 2014, and again in 2015. Selection drives persistent positive contribution, while trading is a persistent, albeit small, detractor. It’s worth mentioning that the trading component shown here includes short borrow costs, and so is expected to be a drag over time. The two years that stand out are 2009 and 2013. We know the manager outperformed the benchmark in these years, despite a small negative contribution from their normal alpha source. The explanation is simple: Both years were robust bull markets for small caps, and the manager benefited from being less than 100% short in both years. In 2008, they took short exposure down meaningfully to ~20% and were not fully exposed until the second half of 2009. In 2013, the average exposure was ramped back up to 67% short, in line with historical average.

This evidence suggests that the manager does generate alpha, and most of the alpha comes from active management—our test for alpha has returned positive. Let’s move on to the second test, determining the manager’s ability to capture broad down swings.

“True to their word, nearly one in ten securities they pick is (or is practically) a zero.”

Testing for Down Capture: Do They Capture Downside Vol of the Market?

Down capture is often used as a metric to understand a portfolio’s performance in relation to a given benchmark in periods of market turmoil. In most instances, investors target a down capture figure below 100%, indicating that the portfolio doesn’t decline as much as the benchmark in periods of drawdown. Nevertheless, the short-biased fund is a unique beast. Investors actually want their short-biased vehicles moving in the opposite direction of a conventional long benchmark—or, in other words, to exhibit a negative down capture in order to yield a positive return in periods of broad market drawdowns. This often comes at a price, though, that being a negative up capture as well—meaning the portfolio will move downward in periods of broad market appreciation. As you’ll see, Kingsford’s case proves that you shouldn’t analyze a fund’s movement on up/down capture alone.

5 See Appendix, Exhibit 3
In 2013, how did Kingsford exhibit a negative up capture to the popular inverse Russell 2000 ETF RWM (-22.87%) yet outperform RWM (-26.49% vs. -30.58%)?6

2013 was a banner year for the Russell 2000, with the index returning 38.82%. While we can anticipate a near inverse return for RWM (due to the behavior of geared vehicles), Kingsford was able to continue its trend of lower volatility than both RWM and the Russell 2000 by providing insulation as the Russell 2000 soared, offsetting its drawdown in August where RWM was highly positive.

Over longer periods, Kingsford has continuously provided strongly negative down capture relative to the Russell 2000 (indicating significant positive performance in periods where the Russell 2000 declines) and minimal negative up capture (signifying muted declines in periods where the Russell 2000 is rising). This dynamic reveals how skill in active security selection can greatly reduce volatility in unfavorable market environments, yet still allow for outperformance when tailwinds are present.

**Hedge Test: Do They Provide an Effective Hedge?**

Outside of tactical, highly concentrated portfolios, short-biased managers are rarely utilized as a majority holding; rather they’re employed to complement a macro theme or as a hedge to the broader portfolio of managers or traditional asset classes.

To determine Kingsford’s efficacy as a small cap hedge, we constructed hypothetical two-position portfolios carrying various blends of Kingsford7 alongside the Russell 2000. Beginning with 100% Kingsford (the southernmost orange plot), we then moved to 90% Kingsford/10% Russell 2000, and continued onward in 10% increments until we reached 100% Russell 2000. Returns are simulated from 1/1/08–4/30/16.

This analysis shows multiple instances where an allocation to Kingsford has notably decreased volatility to the point of adding incremental Sharpe. The portfolio that yielded the highest Sharpe was 40% Kingsford/60% Russell 2000, yielding a Sharpe of 0.3983 versus 0.2955 of the Russell 2000 in isolation. Even a 50/50 portfolio provided a Sharpe of 0.3933.

We’ve illustrated this by plotting the capital market line from the risk-free rate to the 100% Russell 2000 portfolio, revealing additive Sharpe for each portfolio plotted above the line.

We conducted a similar analysis replacing Kingsford with RWM in order to identify whether a passive vehicle could provide the same or better hedging utility. We didn’t find a single instance in which an RWM/Russell 2000 blend provided a higher Sharpe than the Kingsford/Russell 2000 combination—further exemplifying the value added through Kingsford’s active management (skill). Effective hedge? Check.

**Testing for Zeros: Do They Identify & Short Worthless Companies?**

Capped profitability is inherent to shorting securities, unless you short more as the price falls. But what bliss must a short seller experience when the security they pegged as a short is recognized as a fraud and written down to nothing! These companies are known among short sellers as “zeros,” and are viewed as the Holy Grail. A security can’t decline below a price of $0.00, so the maximum potential gain when placing a short position is known and finite. This fact allows us to analyze a short-biased fund with precision—especially Kingsford who promotes their ability to pick companies with issues so deep that their equity will decline to or near $0.00, irrespective of market regime.

Crunching the numbers leads to an eye-opening finding. Since the start of 2008, we tracked the price movements of 1,395 securi-
ties over their holding period within Kingsford’s portfolio, and found that a staggering 9.25% of these securities declined over 80%. True to their word, nearly one in ten securities they pick is (or is practically) a zero. This is all the more impressive recollecting the Russell 2000’s near-vertical performance over the past seven years. Skill test three returns positive as well.

**Things to Consider: Scalability, Head Winds**

The most obvious consideration for a manager trafficking in smaller cap stocks is the stocks’ ability to scale with growth. This is doubly true for a short-only manager who must contend with finding enough borrow in sometimes thinly traded securities. Kingsford mitigates this concern by maintaining extremely small position sizes and a small asset base. It’s unlikely that scale will be an issue before hitting 1–2 billion in AUM, at which point liquidity, security count, and scalability should be closely monitored.

Another concern is that the current low-interest-rate environment provides no room for interest on short proceeds as it did prior to 2008. This may yet change as the Fed continues its tightening cycle. More importantly, the manager’s consistent batting average should offset the lack of interest as an alpha component.

Finally, a prolonged market rally is an obvious headwind to total returns of a short-only manager; but, as all boats rise with the tide, so do those with holes in their bows. Thus more opportunities arise for the manager to short companies destined to fail when the tide recedes again. It’s also a compelling reason for the manager to explore an alpha carve-out that isn’t dependent on market directionality.

**New Opportunities**

Having analyzed hundreds of managers, we believe that, all else equal, the managers who use data to improve their investment process will, over time, outperform those who do not. After scrutinizing Kingsford’s portfolio through the myriad lenses available on the Novus platform, it became clear that we found something truly eye-opening. The firm, of course, had negative beta to the general markets, but what came as a
surprise to the managers was how consistently their sector allocations acted as additional drag on performance—about 170 bps per year.

To quote Joe Peta, Director of Marketing and Trading: “It didn’t seem possible. After all, sectors sum up to market return, so how was it that we were consistently short sectors that outperformed the market? The answer is that our investment process leads us to short highly promoted stocks. And promoters, of course, promote stocks in hot sectors.”

Armed with this finding, Kingsford constructed and recently launched a new beta-neutral product, the Kingsford Alpha Capture Fund, to compliment its traditional short-only fund. The Alpha Capture Fund is designed to isolate Kingsford’s ability to deliver alpha, leaving out all the market and sector influences. Call it a “smart alpha” fund—based on data and tailored to isolate persistent manager skill in short-stock-picking rather than a “flavor of the month” strategy based on gut feel or investor sentiment. The fund’s driving force is the manager’s ability to perform rigorous self-analysis and, most importantly, to apply the insights the data revealed.

**Conclusion**

Returns-based analysis has traditionally been the predominant toolkit for corroborating claims made within a fund’s marketing materials or by its portfolio managers. This case study of Kingsford exemplifies how skillset analysis is necessary to fully decompose a fund’s investment process and identify not only if alpha truly exists but also if it persists in all weather conditions. This is particularly important when analyzing a specialist manager such as Kingsford, where market or sector exposure is often misclassified as alpha.

Fortunately for Kingsford, skill is vividly present and the data tells their story. They’ve generated alpha in a variety of market regimes and substantiated their bold claim of picking zeros. Also evident is their value within a
FIG 7 EXHIBIT 3: BATTING AVERAGE FOR KINGSFORD INTERNATIONAL VS. RUSSELL 2000 (1/1/08 - 4/30/16)

FIG 8 HYPOTHETICAL HEDGED PORTFOLIOS (1/1/08 - 4/30/16)
broader portfolio, beyond simple protection. In this period where dispersion is contracting, and pessimist headlines cast a shadow on alternative assets, perhaps it is time to give the pessimist manager a good hard look.

Appendix & Data Considerations

Daily data with P&L has been permissioned by the manager for this case study. We use historical positions since 1/1/08–4/30/16 for the Kingsford International Fund. All positions are used in the analysis, including non-equity instruments long and short. All analysis refers to this period, unless otherwise stated. Issuer aggregation is used throughout the analysis, unless otherwise stated. Derivative calculations on positional data performed on the Novus Alpha Platform. Third party market and pricing data was used to determine liquidity and other portfolio attributes.
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