Seeking Alpha α

The Active Quest for Alpha: A Loser's Game

by: Larry Swedroe

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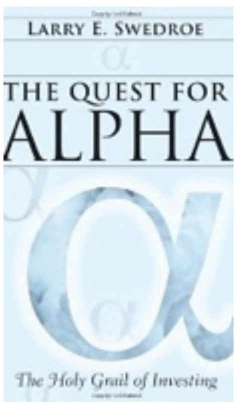

Larry Swedroe is principal and director of research for Buckingham Asset Management, LLC, a Registered Investment Advisor firm in St. Louis, Mo. He is also principal of BAM Advisor Services, LLC, a service provider to investment advisors across the country, most of whom are affiliated with CPA firms. Swedroe was among the first authors to publish a book that explained passive investing in layman's terms — *The Only Guide to a Winning Investment Strategy You'll Ever Need*. He has authored or co-authored nine more books including 2011's *The Quest for Alpha*, published by Bloomberg Press. Swedroe authors the Wise Investing blog for CBS's personal finance Web site MoneyWatch.com.

Seeking Alpha's Jonathan Liss recently caught up with Swedroe to discuss his latest book and discover why he believes the "quest for alpha" has done nothing but made Wall Street wealthier, while leading investors astray. Excerpts from their lengthy discussion follow:

Jonathan Liss (JL): Congrats on the book Larry and thanks for taking time out of your busy schedule to speak with Seeking Alpha.

I want to first say that I really enjoyed this book on a personal level. In a relatively small amount of space you lay out the case for passive over active investing in an articulate and highly accessible way. It seems to me from the many hours of financial reading I do daily on Seeking Alpha and across the web that the average investor - and that includes professionals - doesn't have any clue about the wealth of data you present favoring passive over active investing approaches, has no concept of the significant obstacles they would need to overcome to actively outperform passive strategies. How do you explain this phenomenon?

Larry Swedroe (LS): First of all, it's important to understand that the education system has entirely failed the American public and I'm assuming that's true in other countries as well. The odds are great that if you don't have an MBA, you haven't taken even a single course on capital markets, leaving you to seek your investing advice from people that have a direct conflict of interest: Wall Street and the media.

Second, people seem to have this great need for gurus who tell them that they can protect them from bad things happening even though there's no way any human being can realistically make such a guarantee. If people focussed on the sorts of things they can control: amount of risk they take, types of risks, diversifying risk away, keeping costs low and being tax efficient, they are essentially guaranteed to outperform the vast majority of investors simply because their costs are lower.

JL: In *The Quest for Alpha*, you present overwhelming evidence that the "quest for alpha" is largely a sham, a loser's game, and certainly for the average investor not a pursuit worth undertaking. Yet, most investors continue trying. I'd like to delve a bit deeper into why you think that is.

LS: I think most investors are unaware of the evidence. Additionally, there seems to be a laziness among the American public where they don't want to do the basic reasearch necessary to become good investors and learn the truth. *The Quest for Alpha* (which is only 152 pages long) is my 10th book and I finally discovered this point. Here I have taken a crack at writing a much lighter book, where instead of presenting 10 studies on a subject, I present 2 or 3 and also sprinkle in many quotes from famous investors ('guru' types), who in moments of honesty admit that passive investing trumps active investing for most individual investors. For most people, it'll take maybe 3 hours to read and maybe they'll stop watching TV for one evening. The goal is that ignorance should no longer be an excuse not to know the truth about active investing.

JL: I'm not sure how familiar you are with Seeking Alpha. I'm wondering if you think most of the analysis on sites like Seeking Alpha - long/short articles, articles predicitng the direction of markets - is inherently dangerous to investors' financial health in that it's a constant enticement to be active?

LS: If these articles on the whole were genuinely helpful, we'd see evidence via mutual funds and hedge funds that there's persistent skill in forecasting and stock picking. There basically are no experts when it comes to forecasting and this isn't specific to finance.

I'll give you an example from my own experience. I worked at Citicorp where we had some of the top economists in the country. And I ran trading rooms. When I was right, I of course took credit for my 'brilliant' analysis. And when I was wrong, it was always because of some unexpected event that no one could have predicted. What I learned ultimately is that there is no way to consistently be a successful forecaster. I was either lucky or unlucky.

People say, "Well what about Warren Buffett?' Buffett rarely trades. He's extremely passive in his approach. He doesn't believe in forecasting market direction and he regularly says so.

One last story about why you should ignore all forecasts. A year ago the chief economist at Goldman Sachs said the single biggest risk to the economy was deflation. At the same time the chief economist at Morgan Stanley had the exact opposite prediction, believing significant inflationary risk was imminent. Now I think you and I can agree that both of these guys are really smart. You don't get to be the chief economist at Goldman or Morgan otherwise. So how are you supposed to decide between them?

One more story. In July 2009, the WSJ polled 50 top economists in their annual interest rate contest. Guess how many correctly guessed the direction of the 10-Year Treasury? Seven. Guess how many got the big number right, the number before the decimal point? Two.

So to get back to your initial question, and I apologize in advance for saying this, but I think the sort of analysis that is predictive in nature is fairly dangerous, because it gets people to act when inaction is far more likely to be the right strategy. I read recently someone had an article titled, "When Things Return to Normal." Right now is normal. No one can predict an earthquake or tsunami or political unrest suddenly sweeping an entire region of the world. Negative shocks to financial markets are normal so you better pick an investment strategy without taking more risk than you have the ability, willingness or need to take.

JL: And then rebalancing at set intervals regardless of what's taking place in markets?

LS: If there's any reversion to the mean, you're gonna end up buying low and selling high. The only thing I would disagree with is I don't think rebalancing at set intervals makes any sense though it's a simple tool that can be useful. The logical way to do it is, in the absense of transaction costs, to rebalance daily. Why let the market determine your asset allocations? However since that's usually not cost-effective, I tell people to rebalance with set bands. I like to use the '5/25' rule: 5% in absolute terms or 25% of whatever your target was - whichever gets exceeded first. Of course, you should always avoid paying short-term gains unless they're minimal.

JL: In terms of indexing, do you believe in straight market cap indexing, or do you use some of the alternative indexing strategies that have gained popularity in recent years such as Rob Arnott's RAFI indexes, or equal weight indexes offered by companies like Rydex?

LS: We like DFA's funds because they take the benefits of indexing and enhance them. Benefits like low turnover, tax efficiency, exclusion of groups of companies with certain negative characteristics.

In terms of Arnott, I've looked at the research and I'm convinced there's nothing there. All it is is a size and value tilt. And because he reconstitutes annually, he's losing exposure to the risk factors over the year. He's getting less value over the year. In contrast, DFA reconstitutes their indexes daily. We use the TM Bridgeway Small-Cap Value Fund (BOSVX) which is similar to the RAFI funds but it's reconstituted monthly.

JL: So you think you're getting alpha over a standard cap-weighted small-cap fund with BOSVX?

LS: I think we're getting more exposure to the value risk effects. It's not alpha per se. When you go deeper into value and deeper into small caps, you get higher expected returns (but more risk), but the higher expected returns you pick up allow you to lower your exposure to beta (stocks) at the same time, thus keeping the portfolio's expected return the same. However, that combination reduces the portfolio's potential dispersion of returns, cutting the risk of the fat tails (it cuts both good and the bad fat tails). Since almost all investors would prefer the potential dispersion of returns to have more of the weight of the returns to be close to the middle, and less risk of the tails showing up, this becomes a more attractive way to build portfolios.

JL: Here's a theoretical question - what would happen if everyone became indexers?

LS: First of all, I think we can agree that will never happen, though we are moving towards that model as a higher percent of individuals move to passive investing.

Active management is a loser's game, not because markets are efficient or because active managers are dumb, but simply because of the 'Costs Matter Hypothesis'. William Sharpe made this argument in a very succinct, yet elegant paper he wrote entitled 'The Arithmetic of Active Management.' We know that in aggregate, active managers must lose after costs. So all you have to do to beat the majority of investors is remain passive, rebalance, stay tax efficient.

We already have a ranking system for the most part of more and less efficient markets. U.S. large caps are the most informationally efficient, small caps less so and emerging markets the least so. There's no indication active managers outperform in even the most inefficient of these areas and there's no way they can. If a market returns 10%, that means that both active and passive investors on aggregate receive 10%. So since active management is more costly, by definition active investors take home less than passive investors.

But even if markets become informationally inefficient, it won't matter because Sharpe's principle still holds true. And anyway the more inefficient a market is, the more there are trading impact costs, higher research costs. It becomes harder to profit off that inefficiency, even if you can successfully locate it.

The great thing about Efficient Market Hypothesis is that even when an inefficiency is discovered, how many investors can exploit it? Maybe a few. Then everyone piles into the trade and suddenly the inefficiency has been ironed out. I called it the Adaptive Market Hypothesis. Jonathan Berk goes into this in much more depth in his seminal paper 'The 5 Myths of Active Management' (pdf).

JL: Another point from the book that I think nicely supports this argument is that most mutual funds with good long-term returns usually achieve those returns when they're smaller. The larger they get, the harder it is for them to exploit market inefficiencies they discover.

LS: It really is very difficult to have persistence in outperformance. Bill Miller is a great example of this. For 15 years he beat the market with a smaller amount of money. But the average investor in his fund has actually underperformed the market, because Miller had by far his most under management - around $22 billion - when he lost 40%. David Baker is another great example. His fund was the top returning fund in the 1970s, up 400%. But in the 1980s, he was literally the worst, losing 72% during an extended bull market. And therein lies the problem. By the time you have enough data to say someone's outperformance is based on skill, not luck, it's too late. Even Buffett says there's no way he can continue to offer the kind of returns he delivered in the past, because Berkshire (BRK.A) is simply too big now.

JL: In terms of individual investors and ETFs, their benefits over mutual funds are fairly numerous. But people like John Bogle have nonetheless come out against their use by the typical retail investor since they're so easy and so cheap to trade and so the temptation to be active is simply too great. Do you agree with Bogle that most investors should stick to index mutual funds, even if they're less tax efficient, because the ability to trade on a whim is greatly reduced?

LS: Let me first say that I'm not against ETFs in the way John Bogle is. They may not be great for the small investor trying to dollar-cost average into a fund although with the introduction of commission-free trading at Schwab and Ameritrade, etc., that is much less of an issue. The tax efficiency argument certainly goes away when you're talking about IRA-type accounts though it is valid for taxable accounts. However, what's missing in that discussion is a well-managed tax managed fund like those of DFA can be even more tax efficient than ETFs in terms of treatment of dividends.

Let's agree though that ETFs are certainly cheaper, especially with no-commission trading. The supposed "advantage" of being able to trade them intraday - I'd actually call it a disadvantage, because they're likely to tempt you to act when inaction is almost always certainly the better move. People trading intraday are generally trading with their stomachs, reacting to short-term events, acting out of a sense of panic. The only time you should be trading is when there's a change in your risk tolerance or need, or if you need to rebalance.

Funds are often created to encourage people to chase the current hot sector. That's why there were so many tech funds in 1999. All of these sector funds, double leveraged and inverse funds, they're all terrible products. They're meant to be sold, not bought. No one should own them. They lead to taking uncompensated, idiosyncratic risk and there's no reason to think anyone can identify which sector will outperform the market long-term. They don't offer any additional exposure to risk factors that add to your level of diversification. And there's no reason to think any sector-specific information you have is value relevant. If you know it, so does Goldman and Morgan Stanley and it's likely already baked into the price.

JL: What about building a portfolio using mainly index funds but mixing in individual stocks as well? I've seen Monte Carlo screens that have claimed to mix individual stocks with index funds to actually increase expected returns without increasing risk - what are your thoughts on this?

LS: We've run those models and you have to be increasing risk since by picking individual names, because you're taking on idiosyncratic risk. Think about Enron, Bear Stearns. You're better off owning the entire sector rather than taking on single name risk. You're not compensated for the idiosyncratic risk of an individual company. Therefore, it's not a risk worth taking, especially when you can eliminate most of that risk by owning a wide range of stocks in an asset class.

The difference between investing and speculation can be summed up very simply. Investing is taking a compensated risk where you have a higher expected return based on the underlying risk. Speculation is when you have no real reason to believe you're being properly compensated for the risk you're taking. The market will not compensate you with extra returns for any risk that's diversifiable.

JL: Turning to commodities, and especially in non tax-sheltered accounts, do you feel owning commodity producer equities is sufficient for diversification purposes, or do investors need to hold physical or futures-based commodities despite their less beneficial tax treatment?

LS: The problem with commodity producers is that their correlation to the market at large is around 0.6%. It gives you some diversification but it's very limited. Commodity futures on the other hand have a correlation of almost zero with the market so they're a much better diversifier of equity risk. A great example: oil prices could go up a lot and

Shell could go bankrupt at the same time. Or a gold producer located in South Africa has the government seize its assets. It doesn't matter how high gold is, you lost 100% on that equity investment.

In terms of commodities generally, there are some that argue you don't really need them to create a well-balanced portfolio. Personally, I think they're good to have. But contango is a serious issue on the futures-based products. Commodities that are easily storable like gold don't have that issue. But oil does. So there's a definite advantage to using some of these managed products that get around some of the contango issues if you want exposure to oil. PIMCO's managed commodities fund (PCRCX) is a good example of that sort of product. There are problems with indexes and a good manager can design a product that gets around these problems. Another fund that does a nice job managing contango is an ETF, USCI (United States Commodity Index ETF), which uses a SummerHaven index.

If you are going to hold commodities, you should consider lengthening the nominal length of the bonds in your portfolios, because there's never been a prolonged period when bonds, stocks and commodities have all gone down together. Commodities go down about a third of the time stocks go down. But when that happens, it's because there is deflationary risk showing up like in 1981 when Volcker tightened, or after 9/11 or in 2008. And that's when bonds do best. So if you're going to add a small allocation to commodities - between 5% and 10% at the most - then lengthen your bonds, pick up the term premium, because it's basically a free lunch.

JL: How about REITs - I notice you left those out of the section of your book with model asset allocations?

LS: REITs should only be owned in an IRA-type account because they're so tax inefficient. You could own REITS in taxable accounts if in the lowest tax brackets. Anyway, you can create a very well diversified portfolio without REITs so there's no reason to have them in place of a more tax-efficient holding. TIPS, for example, is a much better diversifier.

JL: Any last remarks about the book or investing in general?

LS: People that say 'you can't beat the market', that's clearly not true. But what we do know from all the research and data, which I've assembled in the book, is that it's very difficult to beat the market. Very few people manage to do so consistently. So if you want to try, do so in an entertainment account. Don't try it with a large percent of your retirement savings. You don't bring your retirement account to Vegas or the track. So don't take it to Merrill Lynch either. The strategy most likely to get you to your retirement goals is a passive investing strategy. That's the prudent strategy.

The sad thing is many of the people taking these unnecessary risks with hedge funds and the like are high net worth individuals. They've already won the game. They don't need to try and generate alpha. They have enough to live off of comfortably without taking risks. If they blow up and go from rich to poor, it'll be unbearable, whereas if they double their money, it'll probably make little difference to them. All they'll get is bragging rights. And no one ever had "I achieved alpha" inscribed on their tombstone.

I think that's the most important message in the book. If you're a passive investor, you don't have to spend your time listening to Cramer or reading Money magazine. You get to spend your time on the things that really matter in life: spending time with your family, doing community service, in short, winning at the game of life.