Implied Alpha: Reflections of Portfolio Managers’ Conviction

Introduction

Many active portfolio managers profess to be stock pickers, but their portfolios may tell a different story. Some purported high-conviction portfolios are haphazardly constructed with much of the risk derived from systemic factors, not from stock selection. The crux of the issue is if managers don’t coordinate conviction with risk, they fail to make the most of stock picking. They begin as high-conviction stock pickers and end up as macro factor investors.

IN OUR VIEW, HIGH-CONVICTION EQUITY INVESTING MEANS:

- Having a high degree of stock selection risk in relation to a portfolio’s active risk.
- Establishing position sizes based on conviction in both expected return and expected risk with a view across the entire portfolio. Too many investors only look at expected return.

Only when portfolio managers accomplish both can they expect to consistently compound good returns.

READ INSIDE

- High-Conviction Investing Defined
- Unintentional Risk Exposures in Many High-Conviction Portfolios
- How Implied Alpha can Quantify Conviction, Help Emphasize Stock Selection, and Manage Systemic Risks
Emphasizing Stock Selection

There is compelling logic as to why equity investors should emphasize stock selection risk and minimize systemic influences such as interest rates, oil prices, currencies, and other factor risks including beta, size, value, momentum, and volatility. Consistently predicting the direction of these systemic factors is difficult as the variables are broad and prediction periods long. In contrast, variances associated with stock selection are narrower in nature, tend to be better defined, and consequently, subject to better estimation. While macro and micro estimates are to varying degrees linked, generally there are fewer and more accessible key assumptions required when predicting corporate cash flows and earnings than with a country's level of employment or GDP. Further, successfully predicting profitability is more closely linked to stock price performance than correctly calling a macro trend in oil prices, for example. Analyzing company-level variables spares a portfolio manager the added challenge of tying macro predictions (i.e., systemic risks) to stock performance.

Systemic factor risks are an integral part of stocks. Exxon Mobil is never free from the variances in oil prices, Chinese economic conditions, interest rates, or geopolitical tensions, for example. Smaller companies roll with their own sets of macro forces. In prioritizing stock selection, portfolio managers cannot just avoid stocks with macro or factor exposures. Instead, they must account for the macro exposures inherent in each stock and attempt to minimize their impact by balancing — or hedging — these exposures across the entirety of a portfolio.

The approach is intuitive but not always implemented. Many managers assemble stock picks into portfolios in ways that introduce unintended systemic risk exposures, counter to what makes sense and counter perhaps to what the managers intend. Consider the hypothetical, but not extraordinary, portfolio shown in Exhibit 1.

Exhibit 1 demonstrates a high-conviction, long-only global portfolio of 40 stocks where conviction is expressed in terms of absolute weights; that is, the higher the portfolio manager’s conviction, the higher the portion of the portfolio’s capital allocated to the position. What is most noteworthy about this portfolio is stock selection accounts for only 29% of total active risk. More than 70% of active risk comes from systemic risk factors (i.e., uncompensated risk) where the portfolio manager arguably has limited or no insight.

In contrast, Exhibit 2 demonstrates a portfolio that better prioritizes stock selection skill. Substantially greater than 60% of total active risk for this portfolio emanates from stock selection. Stock selection skill, not exposure to the right systemic risk factors, will likely determine the success of this equity portfolio. Top-down managers try to exploit macro views and while we may disagree in style, they are at least clear in their intentions. Bottom-up managers who do not attend to macro risks end up undermining their skills and not fulfilling their promises.

Although hypothetical, the portfolio in Exhibit 1 is indicative of high-conviction portfolios with little focus on risk discipline. Too many bottom-up, stock-picking managers simply choose to ignore systemic risks because they are incredibly difficult, if not impossible, to anticipate. Far too
often, pure stock pickers are oblivious to systemic risks in their portfolios and unknowingly allow uncompensated risks to dominate stock selection risk. The managers think they are stock purists, but in their failure to account for the influences of systemic risk factors across different stocks in their portfolios, they become macro factor investors. Such portfolio managers often exhibit wild swings in returns: top in one period, bottom in the next.

Translating Conviction into Position Weights

A disciplined portfolio construction process requires translating investment insights into individual position weights. A naive, high-conviction approach may rank stocks by their expected returns, as seen in Exhibit 3. In this hypothetical 40-stock portfolio, Cigna Corp represents the highest conviction name with a 3.9% dollar weight and Volkswagen the lowest conviction name with only 1.9% weight. Even though Volkswagen represents the lowest conviction name, it contributes more to this portfolio’s active risk than Cigna (7.7% vs. 6.1%). It is counterproductive to overall return when the lowest conviction stock from this manager’s view actually possesses the most active risk. A better way to construct a portfolio blends expected upside, conviction levels, and the interaction of stock prices among all stocks in a portfolio.

Implied Alpha

Unlike many quantitative investors, fundamental investors infrequently use implied alpha measurements. They should. Implied alpha helps quantify the embedded conviction in the anticipated risk-return profile of each holding across an entire portfolio. It takes into account not only the underlying risk of a stock but the impact that stock has on the aggregate volatility of the overall portfolio. It allows a manager to think among several dimensions around one stock: expected return, risk of the holding, confidence in expected return, exposure to a range of systemic risks, and correlation of these risks to other holdings in the portfolio. No portfolio manager – or human being really – could possibly come close to intuiting these important and complex relationships in a portfolio.

Implied alpha is an unbiased and independent check on conviction levels. It incorporates historical volatility relationships among stocks in a portfolio into the portfolio construction process. Exhibit 4 demonstrates how one may derive implied alphas through a reverse portfolio optimization process. In a traditional portfolio optimization process, a portfolio manager inputs his or her expected return and risk forecast into an optimizer and obtains position weights for the optimal portfolio. Implied alpha is, in essence, an output of a reverse optimization process where position weights serve as inputs into the process.
Referring back to Exhibit 3, the implied alpha for Volkswagen – the lowest conviction name – is 1.1%, nearly three times greater than that of Cigna – the highest conviction name. Based on implied alpha, Gazprom should be the highest conviction holding, but it ranks only 32nd in conviction. Implied alphas of the stocks in this portfolio reflect no discernible order in relation to conviction.

Determining stock level position sizes based on implied alphas requires determining the appropriate active risk a portfolio manager is willing to take, which is a vastly different mindset from the typical intuition-based approach. A dollar invested in Cigna is quite different from a dollar invested in Volkswagen. Volatile stocks that are highly correlated with the rest of the portfolio require small active weights to demonstrate conviction; conversely, less volatile stocks with little correlation to the rest of the portfolio may require large active weights to move the risk needle for the aggregate portfolio. A stock that adds to an already overweight sector would require comfort with a higher implied alpha than a stock that lowers the risk of the portfolio. If a portfolio is overexposed to high oil prices and underexposed to technology, then adding an additional energy holding requires a higher expected return hurdle than a diversifying technology stock given the initial portfolio positioning. In the same portfolio, if the manager buys Microsoft to lower the underweight to the technology sector and sells a highly volatile small oil company, this will most likely increase the conviction level of the portfolio and stress stock selection even more. This occurs because the magnitude of the portfolio’s systemic overexposure to oil prices is reduced even though the active share of the portfolio may actually fall. For this reason, even the ubiquitous active share is not a complete measure of stock-picking conviction.

Critically, it is important to note a stock’s implied alpha does not forecast expected return. The expected return forecast derives from the portfolio manager’s company-level fundamental and valuation analysis. The value of implied alphas rests in the portfolio manager’s ability to compare fundamental analysis-based risk and return forecasts with implied alpha measurements across an entire portfolio. The stock with the highest implied alpha should be the stock with the highest expected dollar return adjusted for risk. High-conviction portfolios missing this key insight will display characteristics of the hypothetical portfolio in Exhibit 3, where implied alphas are patently inconsistent with the portfolio manager’s conviction levels.

To be sure, many portfolio managers consider the risks of individual stocks and attempt to size positions appropriately. A small-cap name with an uncertain business model could have a high expected return but receive a small weight in a portfolio due to inherent business uncertainty. Such a consideration is helpful but assesses only the risk to the expected return of that particular stock and not the contribution of that stock to the aggregate risk of the overall portfolio. To that end, implied alpha is a far more robust tool to construct a portfolio as it helps prioritize stock selection risk and minimize systemic risks by accounting for risk/return inter-relationships across a portfolio.

Accordingly, portfolio managers who state they are stock pickers may be distorting their portfolios and undermining their professed talents if they neglect implied alpha measurements.
Key takeaways of implied alpha are:

• The largest position or even the largest active position may not be the one where managers are reflecting the highest conviction.

• Active share is helpful, but of limited use, if the active weight introduces macro factor risks in a portfolio.

**Conclusion**

Top-down managers try to exploit macro views and while we may disagree in style, they are at least clear in their intentions and consistent in their portfolio risk exposures. But, high-conviction equity managers who do not attend to macro risks and whose active risk is dominated by systemic risks undermine their stock selection skills. As illustrated earlier, a concentrated, high tracking error portfolio may not represent a high-conviction, stock-picking portfolio. Investors are compensated for bearing non-diversifiable risks, which we believe in equity portfolios are the risks of stock selection and not of macro factors. Active share is a common and helpful tool to assess stock picking, but we suggest implied alpha is a sharper tool to construct a high-conviction portfolio. Letting stock picking drive results is easier said than done. We advise investors to look closely at how high-conviction equity portfolios are constructed to discern what high-conviction investing truly entails. An effective high-conviction portfolio measures, rather than ignores, macro risks. It is a portfolio where a manager’s skill can be consistently demonstrated over time. This success results from consistently emphasizing stock selection and matching fundamental conviction levels to the risk contribution of individual stocks across an entire portfolio using quantitative tools such as implied alpha.
About the Author

George P. Maris, CFA | Portfolio Manager

George Maris is Portfolio Manager of the Janus Global Alpha Equity strategy, the Janus Global Select Fund and all related portfolios, a position he has held since August 2012. In addition, Mr. Maris is a member of the Janus Operating Committee and the Janus Proxy Committee. Mr. Maris joined Janus in March 2011 from Northern Trust where he managed U.S. large cap core equity, international large cap core and global equity strategies. Prior to joining Northern Trust in 2008, Mr. Maris spent four years as a portfolio manager at Columbia Management Group where he co-managed the firm's U.S. large and mid-cap core portfolios. From 1999 to 2004 he was a member of the investment team at Putnam Investments, serving as an equity analyst, derivatives strategist and portfolio manager in Putnam's Value Group, working on domestic, international and global equity strategies. He was a guest lecturer on the topic of Security Analysis at MIT's Sloan School of Management from 2003 to 2005. Mr. Maris received his bachelor of arts degree in economics from Swarthmore College. He also earned an MBA from the University of Chicago and a Juris Doctorate from the University of Illinois. Mr. Maris holds the Chartered Financial Analyst designation and has 17 years of investment experience.

This publication is for investors and investment consultants interested in the institutional products and services available through Janus Capital Management LLC and its affiliates. Various account minimums or other eligibility qualifications apply depending on the investment strategy or vehicle.

Past performance is no guarantee of future results. Investing involves risk, including the possible loss of principal and fluctuation of value. This paper is for information purposes only and should not be used or construed as an offer to sell, a solicitation of an offer to buy, or a recommendation for any security. There is no guarantee that the information supplied is accurate, complete, or timely, nor does it make any warranties with regards to the results obtained from its use. It is not intended to indicate or imply in any manner that current or past results are indicative of future profitability or expectations. As with all investments, there are inherent risks that individuals would need to address.

The views expressed are those of the author as of August 2015. They do not necessarily reflect the views of other Janus portfolio managers or other persons in Janus’ organization. These views are subject to change at any time based on market and other conditions, and Janus disclaims any responsibility to update such views. No forecasts can be guaranteed. These views may not be relied upon as investment advice or as an indication of trading intent on behalf of any Janus fund. In preparing this document, Janus has relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources.

In preparing this document, Janus has relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources.

Janus Capital Management LLC serves as investment adviser.

FOR MORE INFORMATION CONTACT JANUS CAPITAL INSTITUTIONAL
151 Detroit Street, Denver, CO 80206 | www.janusinstitutional.com