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Conviction – Blessing or Curse

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The power of conviction is nuanced...

Conviction may be essential  Or an unstable source of risk
Conviction – what is it?

**conviction**

kənˈvɪkʃ(ə)n/

1. The state or appearance of being convinced.
2. A fixed or firmly held belief, opinion, etc.
3. The act of convincing.

**Synonyms**
assurance, assuredness, certainty, certitude, cocksureness, confidence, doubtlessness, face, positiveness, satisfaction, sureness, surety

**Related words**
Authoritarianism, dogmatism, decisiveness, determination, firmness, purposefulness, resoluteness, resolve
A mixed virtue?

But compared to what?

Antonyms
doubt, incertitude, nonconfidence, uncertainty

Near Antonyms
Hesitancy, hesitation, indecisiveness, irresolution; disbelief, incredulity, unbelief; anxiety, concern, misgiving; distrust, mistrust, suspicion

How do you expect me to believe in you?
Maybe it’s about being human...

- People tend to place value on conviction
- A lack of conviction feels wishy-washy
- We abhor fence-sitters and vacillators
- Preferring those with the strength to back their views
- “Belief” is such a part of culture everywhere
- “You HAVE to believe in something – right?”
Why should we care?

Confidence implies realistically trusting one’s knowledge and ability.

Overconfidence suggests an unreasonable assessment of one’s control over a situation.
Confidence/success relationship is not highly correlated

According to a study...

• Over-confidence is greatest when accuracy is near chance levels
• Over-confidence diminishes as accuracy increases from 50% to 80%
• Once accuracy exceeds 80%, people often become underconfident
• Discrepancies between accuracy and confidence are NOT related to a decision-maker’s intelligence

The Psychology of Judgment and Decision Making
Scott Plous, 1993
Let’s take a driving test...
Does this apply to investment managers?

In a 2006 study entitled *Behaving Badly*, researcher James Montier surveyed 300 professional money managers and asked them to (confidentially) rate their job performance as:

- ABOVE AVERAGE
- AVERAGE
- BELOW AVERAGE
And the actual results!

Strong evidence of an irrational level of overconfidence.
Active Management - How to beat the index

Need to get them all right to be successful...
Active Management – Conviction is the Amplifier

POSITIVE SKILL
LOW CONVICTION

NEGATIVE SKILL
HIGH CONVICTION

SKILL & CONVICTION ARE REQUIRED
In practice it isn’t so easy to get right

Only 15% Beat Their Benchmark
Active % of funds (as of 3 Dec 2014)

The Failure of Active Management
Active Funds that Failed to Outperform Benchmark

*Mutual fund performance is net of fees
Source: Goldman Sachs

S&P Score Card Mid-Year 2011
Our industry is made of interesting personalities!
• Diversification is for wimps and the feeble unskilled
• Theory schmeary, evidence schmevidence
• Risk is just bad research
• Markets are driven by sentiment
• Ideal lab rat for behaviouralists!
• Active management – the preserve of naïve egoists...
• ...or those with goldfish-like traits
• “The evidence is unequivocal!”
• “I have studied behavioural finance”
• “The future is clear to those who open their eyes...
• ...and have the second sight!”
• Macro themes drive performance
• Probably got some big call right in the past
• He has a newsletter and disciples
• Lack of self-confidence is not an issue (which comes from legions of disciples)
• Randomness is his inconvenient nemesis
• “As it happens, we called it completely right.. but no-one could have predicted..”
• I’m an Active Manager, really I am
• I have a CFA and MBA
• And manage $600bn in assets
• We have 120 analysts in 20 countries
• OK, confession time: my name is Paula and I am a Closet Indexer...
• ...but I am a great marketer
• Show me the evidence
• What do we know to be true?
• This world ain’t linear, so what are my options?
• What do I do when I find mispricing (and where am I most likely to find it?)
• How should I respond when faced with pure randomness?
• Theory is just a framework for thinking
Measuring conviction quantitatively

**Tracking Error** is a measure of how closely a portfolio follows the index to which it is benchmarked.
Measuring conviction quantitatively
Measuring conviction quantitatively
Measuring conviction quantitatively
Measuring conviction quantitatively

**Active Share** is a measure of the percentage of *stock* holdings in a manager's portfolio that differ from the benchmark index.
Measuring conviction quantitatively

**PURE INDEXING**

- Active Component: 20%
- Benchmark Component: 80%
Measuring conviction quantitatively

CLOSET INDEXING

Active Component: 40%

Benchmark Component: 60%
Measuring conviction quantitatively

TRULY ACTIVE

Active Component: 80%

Benchmark Component: 20%
Measuring conviction quantitatively

**TRACKING ERROR**

*Tracking Error* is a measure of how closely a portfolio follows the index to which it is benchmarked.

Good proxy for: SYSTEMATIC FACTOR RISK

**ACTIVE SHARE**

*Active Share* is a measure of the percentage of *stock* holdings in a manager's portfolio that differ from the benchmark index.

Good proxy for: STOCK SELECTION
Probably the most influential paper of the lot...

Different types of active management

- Diversified Stock Picks
- Concentrated Stock Picks
- Closet Indexing
- Factor Bets

Pure Index (Passive)

Active share and Mutual Fund Performance – Petajisto and Cremer 2013
Probably the most influential paper of the lot...

Different types of active management

- **Diversified Stock Picks**
  - Gross Alpha: 2.61%
  - Net Alpha: 1.26%

- **Concentrated Stock Picks**
  - Gross Alpha: 1.64%
  - Net Alpha: -0.25%

- **Closet Indexing**
  - Gross Alpha: 0.44%
  - Net Alpha: -0.91%

- **Factor Bets**
  - Gross Alpha: 0.06%
  - Net Alpha: -1.28%

Benchmark adjusted. Fund performance, Jan 90 – Dec 09

Active share and Mutual Fund Performance – Petajisto and Cremer 2013
Probably the most influential paper of the lot...

Different types of active management

Diversified Stock Picks

Concentrated Stock Picks

Closet Indexing

Factor Bets

Active Share

Tracking Error

THE AGHASTIC
“I’m the Boy Marketers Love to Hate”

THE IMPOSTER
“I’m an Active Manager, Really I Am.”

THE ALPHA WORSHIPER
“I’ve Read Warren Buffet”

THE ALPHA DENIALIST
“Efficient Market Hypothesis Is my Religion.”

THE WIZARD
“I am the Possessor of Pervading Insight”

Pure Index (Passive)
Not everyone agrees...

VANGUARD PAPER

• Found little PREDICTIVE power using active share and subsequent returns
• High active share portfolios associated with higher costs
• High active share was typically accompanied by high dispersion of excess returns

AQR PAPER

• Little economic intuition justifies why it should “work”
• Strong correlation between active share and type of benchmark
• When controlling for benchmarks, no evidence of predictive power
However...

**VANGUARD PAPER**

However, used short data periods over an unrepresentative period

- Evaluation period: Jan 2001 to Dec 2005
- Performance period: Dec 2005 to Dec 2011 (including atypical dislocations)

“The portfolio manager’s bets must also be accompanied by manager skill, and the overweights must be in the outperforming stocks.

Thus, active share by itself does not indicate whether a fund will outperform an unmanaged benchmark.”

**AQR PAPER**

Study does not really address the nuances around factor risks and holding periods
Active Management – How to beat the index

- DIRECTION
- SIZE
- HOLDING PERIOD
- SKILL
- CONVICTION
Combining active share with holding periods

Previous studies have not confirmed a strong link between Holding Period and Performance.

A new study shows evidence is stronger when applied to: Longer Holding Period combined with High Active Share (>2% per annum).
Combining active share with holding periods

Long High Active Share, Short Low Active Share Mutual Fund Portfolios (Net of fees)

![Graph showing performance of long/short portfolios over time.]

- **Top Fund Duration** quintile only
- **All Funds** Bottom Fund Duration quintile only

*Image*
Combining active share with holding periods

Long High Active Share, Short Low Active Share Institutional Holding Portfolios (Gross of fees)
Combining active share with holding periods

- Closet trackers with long holding periods still underperform
- High active share portfolios with high turnover also underperform
- Frequently traded mutual funds systematically underperformed their benchmarks

Intuitively:
- If markets are efficient, then information quickly traded into the price
- But, certain mispricing may take a while to be identified
- Performance may suffer in the interim
- Investors and employers need to be patient (yeah, right!)
Is there actually a winning strategy after all?
Is there actually a winning strategy after all?

- Active Share
- Tracking Error
- Diversified Stock Picks
- Holding Period

Graph showing the relationship between Active Share, Tracking Error, and Holding Period.
Is there actually a winning strategy after all?
Good managers are getting harder to find...

Evolution of Active Share, 1980-2009

Average Holding Periods of a Stock on the NYSE

Source: SG Global Strategy Research. © 2011 RS Investments
Conviction - In conclusion

Conviction must be proportional skill

Too much conviction leads to high concentrations and less diversification.

Too little conviction in implementing good views adds little value.
What we need to look for in a manager...

- Active positions to be as independent as possible
- “Bets” and risk need to be deliberate, not inadvertent
- Bet size needs to be scaled
- We need evidence of patience in holding periods
- We want to control for factors that reasonably can’t be predicted
Key takeaways

Don’t throw the baby out with the bath water – Alpha exists but is hard to find!

Small advantages in performance make a big difference over time – it’s worth looking for them.

There is unlikely ever to be one silver bullet method of identifying ex ante performers.

Diversification is described as the only free lunch in finance, but don’t walk past the buffet unless you know what’s on the a la carte menu!

If you don’t have the resource to dedicate to finding Alpha, it is probably best to settle for passive.