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TRIVARIATE RESEARCH

5 REASONS ALPHA HAS BEEN CHALLENGING AND 3 WAYS TO DEAL WITH IT

8/27/2021

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SUMMARY

We have traditionally used valuation dispersion, company-specific risk, and pairwise correlation as quantitative metrics to suggest whether the environment is reasonable for alpha generation (pages 5 and 6). In summary, the environment has looked more attractive than average. With the market up nearly 20% YTD, and the hedge fund industry in the US running at 60% net long, many managers expect to be up in the mid-to-high teens when hedged and the low 20s long only YTD. Yet, few managers have been performing at that level. Hence, we analyzed the data with more granularity and found five meaningful reasons why alpha generation has been more challenging in 2021

1. **Conflicting signals at the industry level:** We analyzed pairwise correlation, company-specific risk and dispersion of price-to-forward earnings for each of the 24 industry GICS. We found that while the aggregate looks directionally above average for alpha generation, many of the industries show conflicting signals (page 7). Only five of the 24 GIC industries in the market look above average on all three metrics, meaning there are competing signals at the industry level to the overall market view. In particular, we think looking at transports here is interesting

2. **Far fewer good longs than good shorts**: This year there have been the fewest number of longs beating the market by 20% or more in 15 years. After several years of long alpha being substantially easier than short alpha, this year the percentage of shorts lagging the market by 20% or more has been far greater than the number of longs beating by 20% or more. Following the MEME short-selling difficulties at the beginning of the year, many managers gave up on their single stock short processes, right at a time where more shorts lagged than longs beat (page 8)

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SUMMARY

3. **High conviction hedge fund holdings are having a bad stretch**: After strong performance through much of 2020, the high conviction (3% or more of long AUM) long ideas of 60 hedge fund managers have lagged the market. So not only have here been fewer long ideas, but the fundamental managers high conviction names are performing in the 4th percentile over the last 6 months (page 9)
4. **Growth now more "macro" than value**: The names with the highest company-specific risk are now more likely to be value than growth, a sharp reversal from the environment in 2020. The dispersion on price-to-forward earnings of the most idiosyncratic names has also sharply corrected, now only modestly elevated and back to pre-COVID levels, presenting a relative challenge to bottom-up stock pickers (page 10). Most bottom-up stock pickers rightfully gravitate toward more idiosyncratic names, and this has not been the best area to operate in this year
5. **Factor reversals and volatility in signal efficacy:** The volatility of signal efficacy and the amount of a signal's performance explained by one short period instead of a sustained period are both at 10-year highs (page 11). This means it is very challenging to use the same approach for investing, as each period where, for example, buying cheap on price-to-cash flow works, is followed by a sharp reversal. The May to June transition was particularly challenging, with nearly all the top 20 worst performing signals in May performing in the top 20% in June (page 12)

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CONCLUSIONS

1. **The potentially optimistic message?** Historically, we saw better alpha generation in periods 6-12 months after challenging environments like this – particularly with high alpha long opportunity set - potentially a positive harbinger for alpha generation late this year and in 2022
2. **Look more at value**: The value universe is now more idiosyncratic than the growth universe, so bottom-up stock pickers who have been over indexed to growth need to push themselves to entertain value candidate ideas. This is not making a value over growth call, rather a call that alpha generation might be better in the value universe than the growth universe for the next several months
3. **Risk management**: When quantitative signals are this volatile in their efficacy, our judgment is the important for analytically rigorous risk management grows
   - Run with a more diversified than average portfolios (more names / smaller positions than normal)
   - Trade more than normal - managers whose allocators can't handle market-induced (not manager induced) volatility need to trade more often than usual
   - Employ more rigorous risk management – make sure your long / shorts are balanced on growth / value or that you are aware of your signal / factor bets to avoid "Texas Hedge" periods where a huge reversal in efficacy of signals can hurt your portfolio

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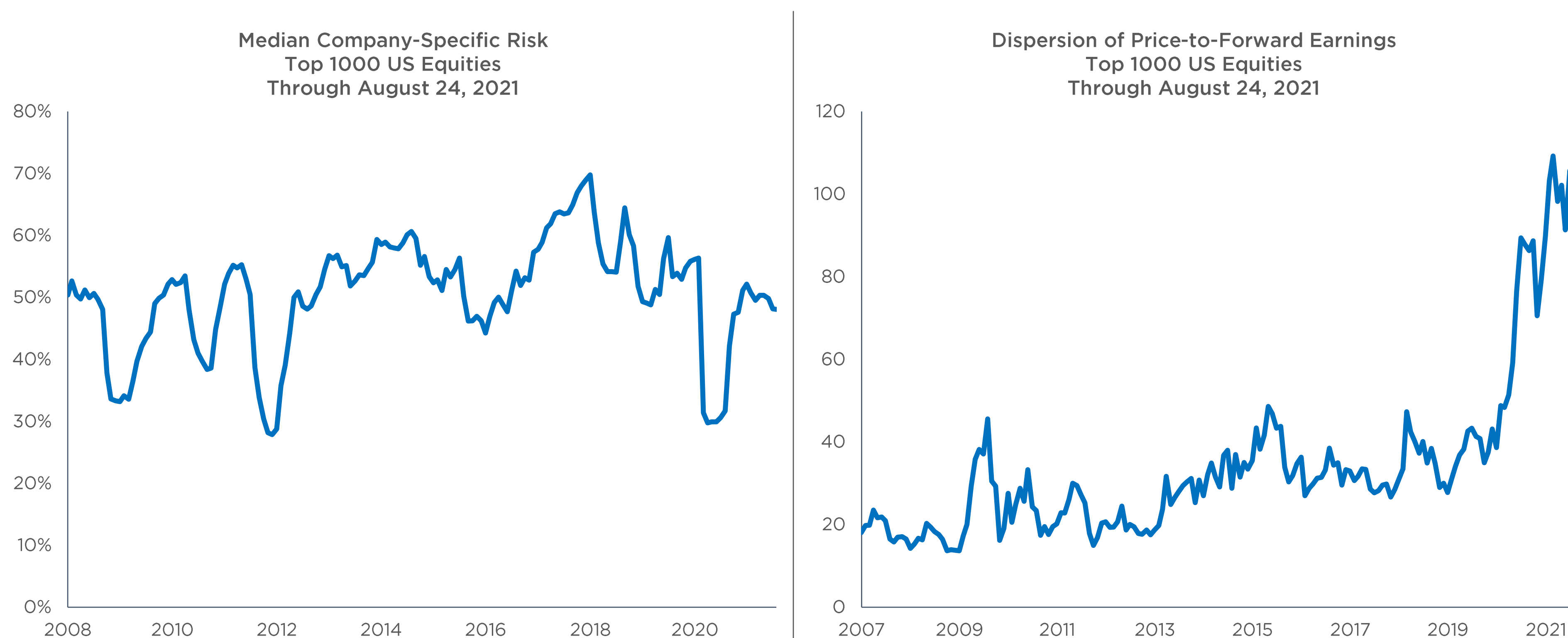
COMPANY-SPECIFIC RISK HAS PAUSED, DISPERSION REMAINS WIDE

Two of the gauges we use to comment on the market environment are company-specific risk (left) and dispersion on valuation (right). Company-specific risk rose markedly off the bottom as the crisis abated but has more recently paused for the median stock. It is currently in the 26th percentile vs. history. Dispersion on price-to-forward earnings remains quite high, signaling some overall opportunity, in the 94th percentile vs. history



Note: The median's stock return can be explained by our proprietary seven factor model – equity market beta, two size factors (mega/large vs mid and mid vs. small/micro), style (growth vs. value), substance (quality vs. junk), liquidity, and momentum. At the peak of the COVID market hysteria, nearly 70% of the average stocks' return could be explained by these macro signals. Today, it is less than 50%.

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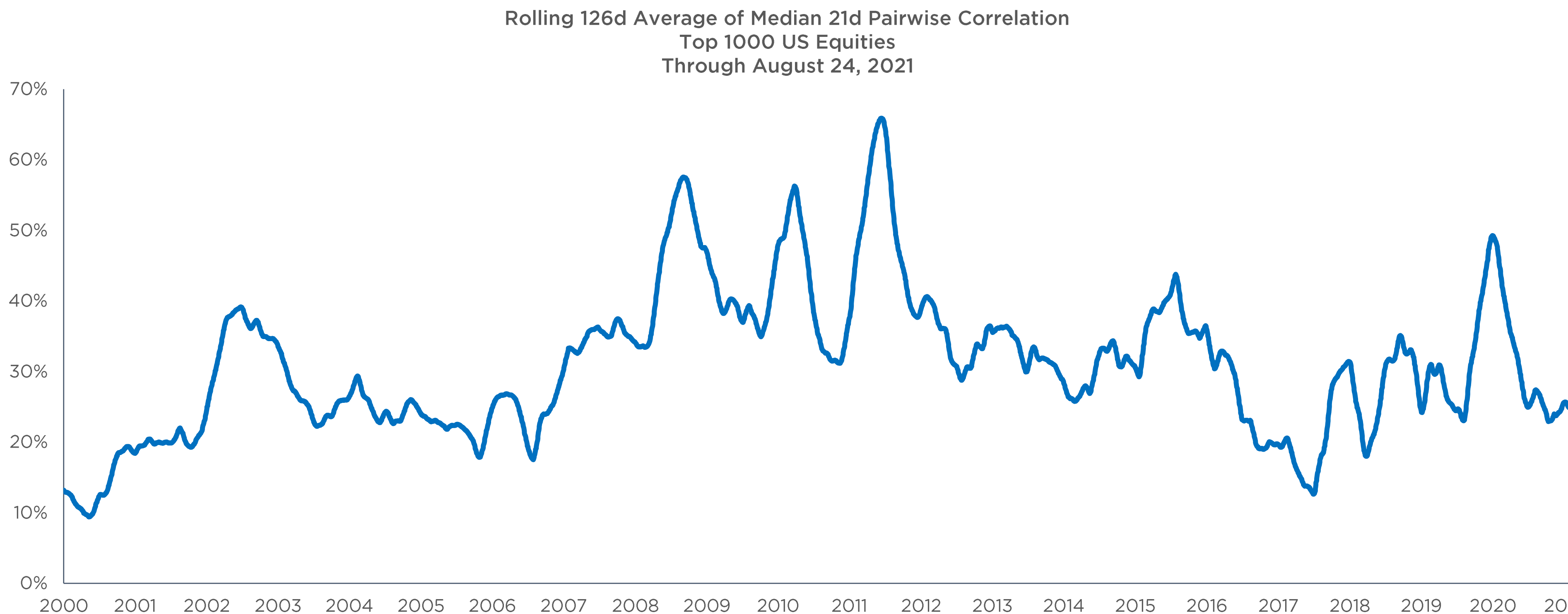
PAIRWISE CORRELATION IS BELOW AVERAGE

Another potential tailwind for stock selection is that the average pairwise correlation of stocks is below average. Building a risk-adjusted and alpha-generative portfolio is typically easier when correlations are low, and today the average is in the 32nd percentile vs. history



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POINT 1: CONFLICTING SIGNALS AT THE INDUSTRY LEVEL

Only 5 of the 24 industries are above average on each of the three signals, pairwise correlation (low is good), company-specific risk (high is good) and price-to-forward earnings dispersion (high is good)

Percentile Rank vs. History of the Industry Group (US Top 1000)
Through August 24, 2021

Industry Group	Median Pairwise Correlation	Company Specific Risk	Price-to-Forward Earnings Dispersion
Automobiles & Components	50.2%	37.1%	89.3%
Banks	95.7%	6.0%	61.5%
Capital Goods	62.6%	31.7%	89.3%
Commercial & Professional Services	42.3%	27.5%	81.8%
Consumer Durables & Apparel	74.0%	25.1%	67.4%
Consumer Services	80.1%	16.8%	96.8%
Diversified Financials	33.5%	39.5%	94.1%
Energy	88.0%	18.0%	19.8%
Food & Staples Retailing	57.8%	65.3%	70.1%
Food, Beverage & Tobacco	55.3%	29.9%	97.9%
Health Care Equipment & Services	25.5%	35.9%	92.5%
Household & Personal Products	8.0%	49.1%	95.7%
Insurance	76.5%	24.6%	62.6%
Materials	67.0%	39.5%	39.6%
Media	24.4%	30.5%	83.4%
Pharmaceuticals, Biotechnology & Life Sciences	20.4%	54.5%	89.3%
Real Estate	30.1%	65.3%	79.1%
Retailing	20.2%	25.7%	97.3%
Semiconductors & Semiconductor Equipment	92.6%	15.0%	74.3%
Software & Services	34.9%	31.1%	95.7%
Technology Hardware & Equipment	79.3%	31.7%	41.7%
Telecommunication Services	39.2%	24.0%	97.3%
Transportation	23.9%	59.9%	99.5%
Utilities	56.4%	77.2%	79.7%

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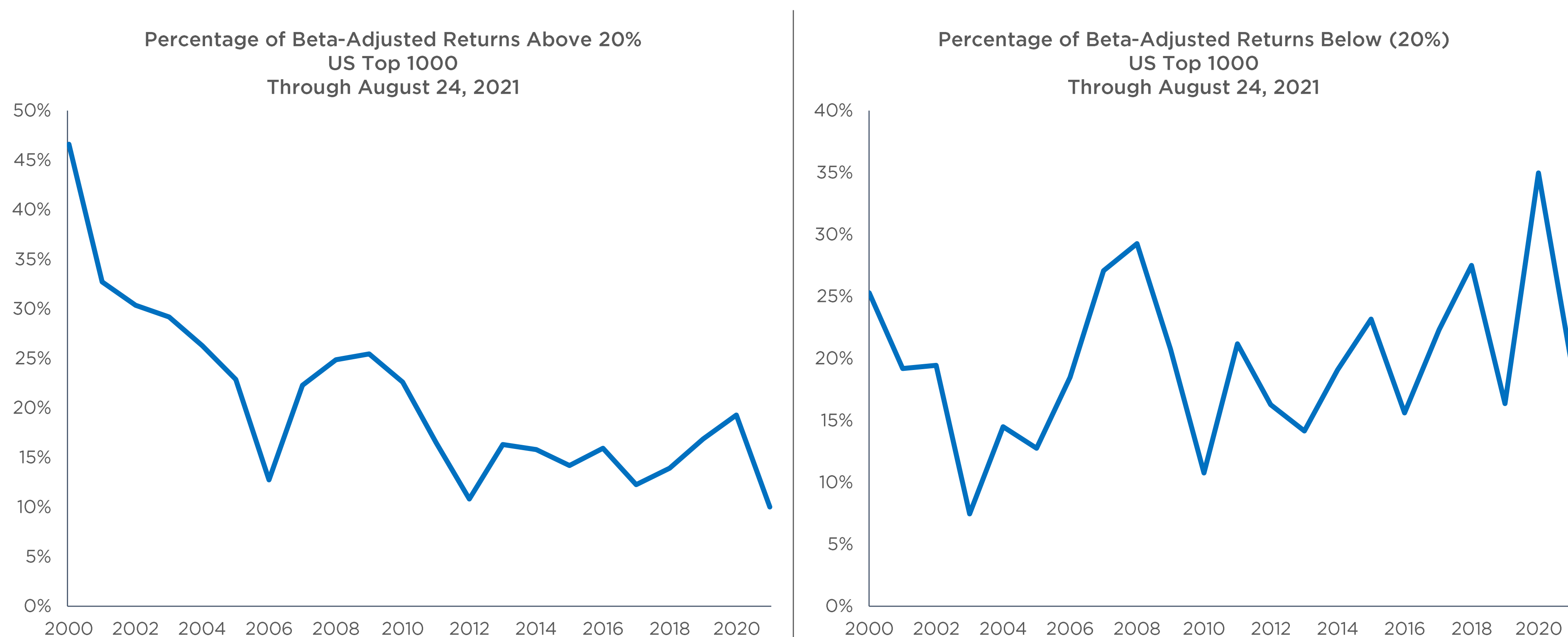
POINT 2: THERE ARE FEW GOOD LONG IDEAS

The number of stocks generating 20%+ alpha on the long side is at a multi-decade low (left exhibit). Less than 100 of the top 1000 US equities by market cap. have beta-adjusted returns above 20% YTD, a 21-year low (if it holds until the end of the year). Only 7 of the 24 industry groups have average beta adjusted returns that are positive (Diversified Financials, Food & Staples Retailing, Real Estate, Energy, Banks, Consumer Durables & Apparel, Retailing). On the other hand, the number of names lagging by 20% or more YTD is above average (right exhibit)



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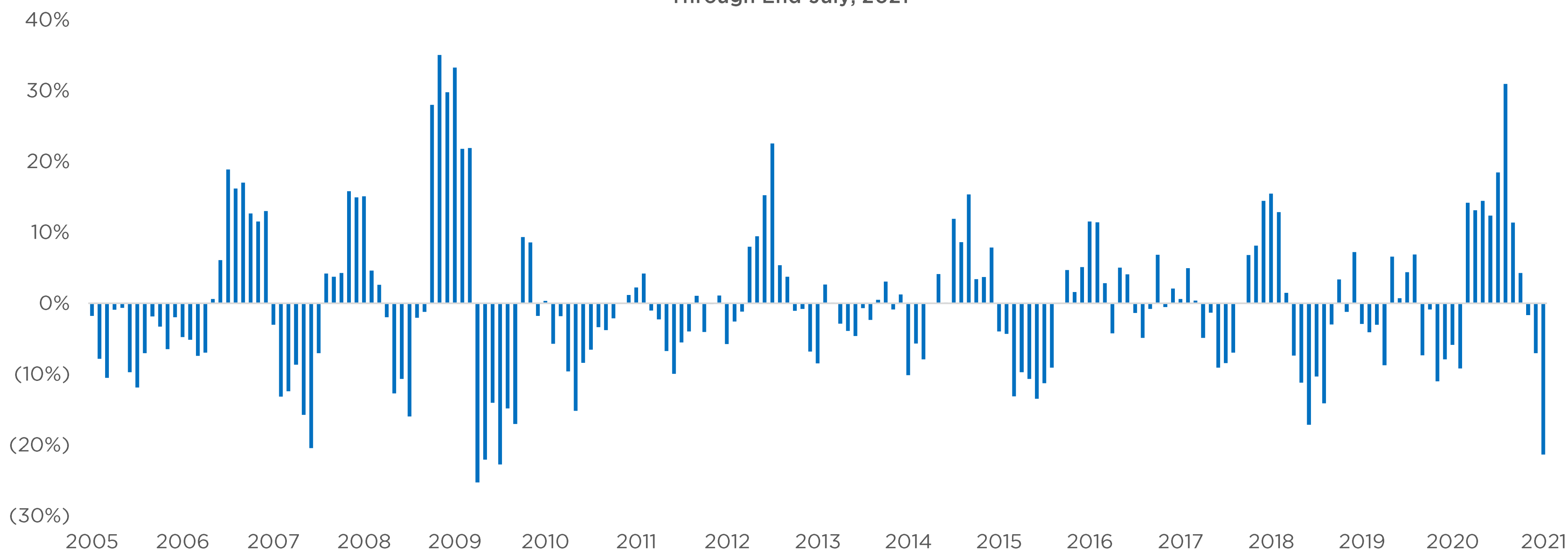
POINT 3: THE BIG POSITIONS HAVE NOT WORKED

We analyze the high conviction (3% or more of their long AUM) holdings of 60 fundamental hedge fund managers who run between $1 and $15b that are not disproportionately owned by the rest of the asset managers. Since the fall of 2020, these hedge fund manager's high-conviction, non-consensus long ideas began degrading and have lagged the market since December. The difference between the most recent six-month beta-adjusted return – based on January 2021's ideas – and that of the return six months before that – based on July 2021's ideas – are in the bottom 1.5% of all six-month differences



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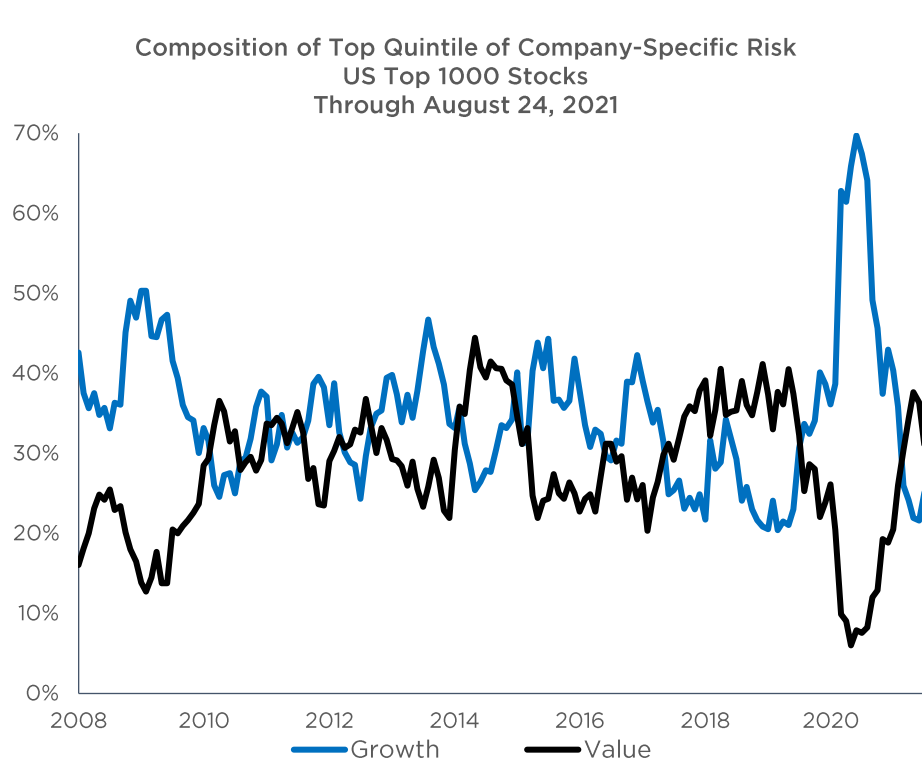
POINT 4: GROWTH IS TRENDING MORE "MACRO" THAN VALUE

The most idiosyncratic names are now more value than growth, a sharp reversal from the peak levels we saw for growth last year (left chart). Many bottom-up stock pickers have gravitated toward growth given its strong outperformance over the last decade, but this has become a more macro group than value this year. The most idiosyncratic names have seen a sharp reversal in the dispersion on price-to-forward earnings, back down to pre-COVID levels and only modestly elevated today, suggesting there is less potential dislocation in the most idiosyncratic names (right chart)



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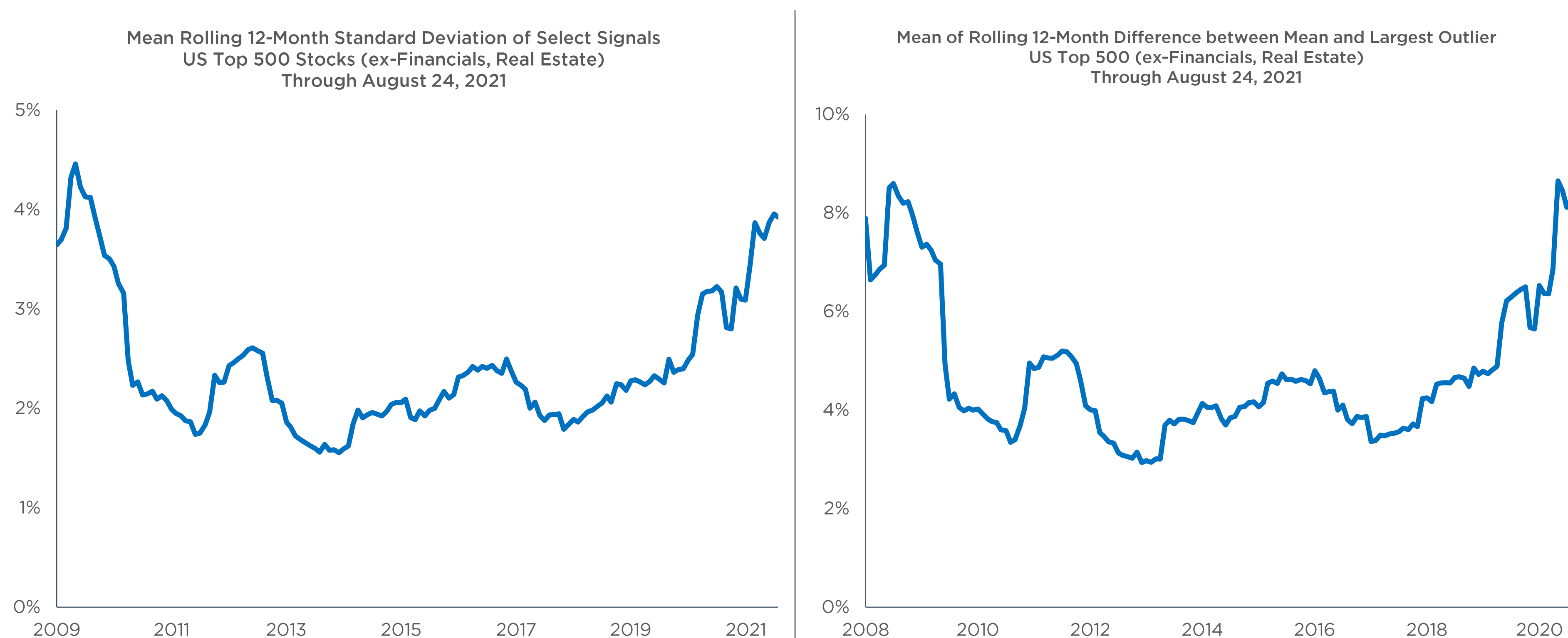
POINT 5: EXTREMELY HIGH VOLATILITY IN SIGNAL PERFORMANCE

We took a group of over 200 signals (e.g., forecast price to earnings, six-month momentum, forecast net margin expansion etc.) and analyzed the volatility of their efficacy since the financial crisis (left chart). The average standard deviation of signal spreads is in the top 5% of all months and the highest it has been in ten years. Return-spreads are driven by one great month instead of steady positive performance (right chart) as evidenced by the cross-sectional mean (across all signals) of the absolute difference between the mean and the largest outlier in any given 12-month rolling window. It is hard to have a sustained framework this year



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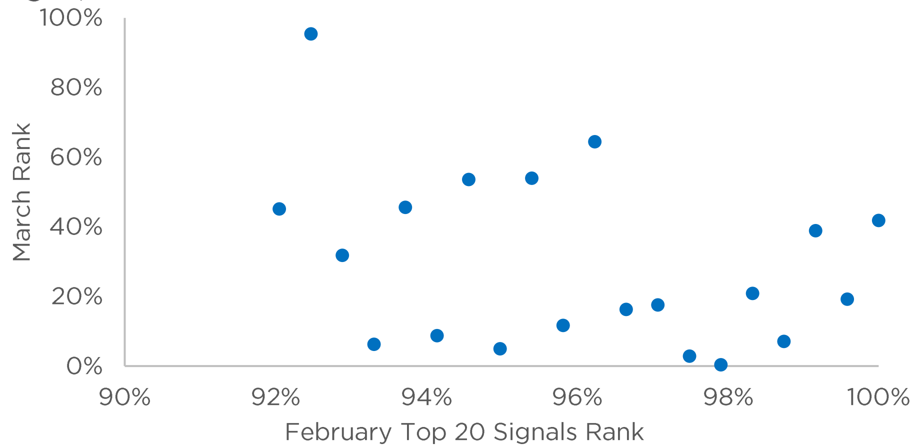
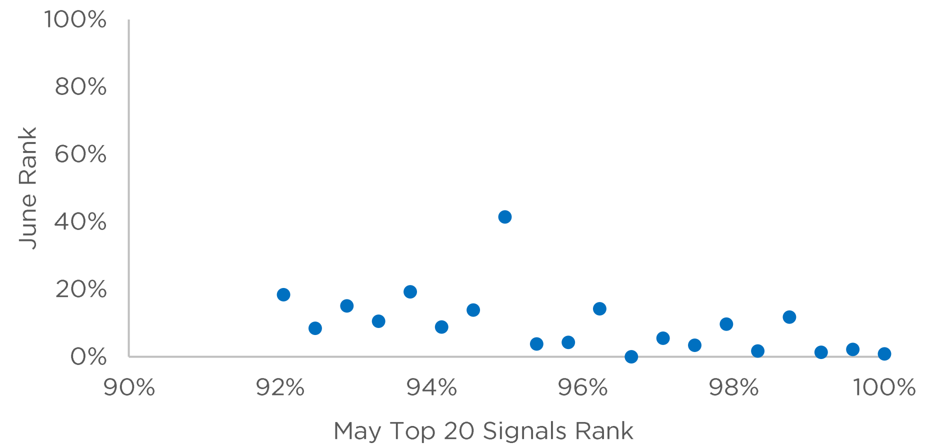
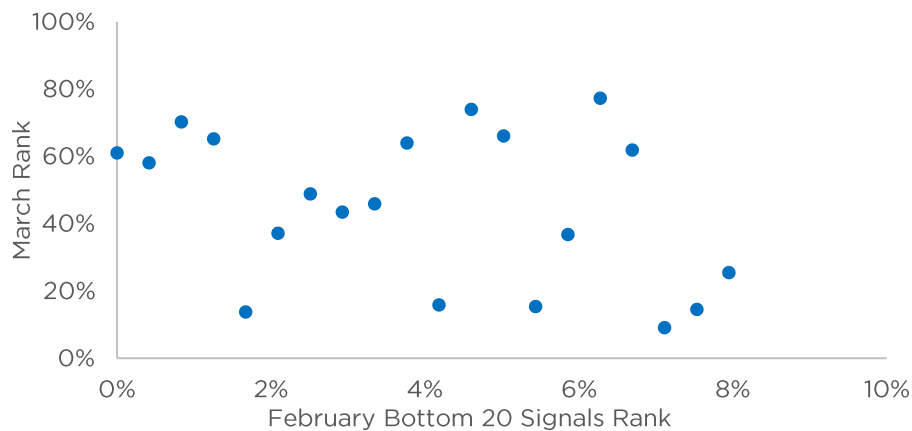
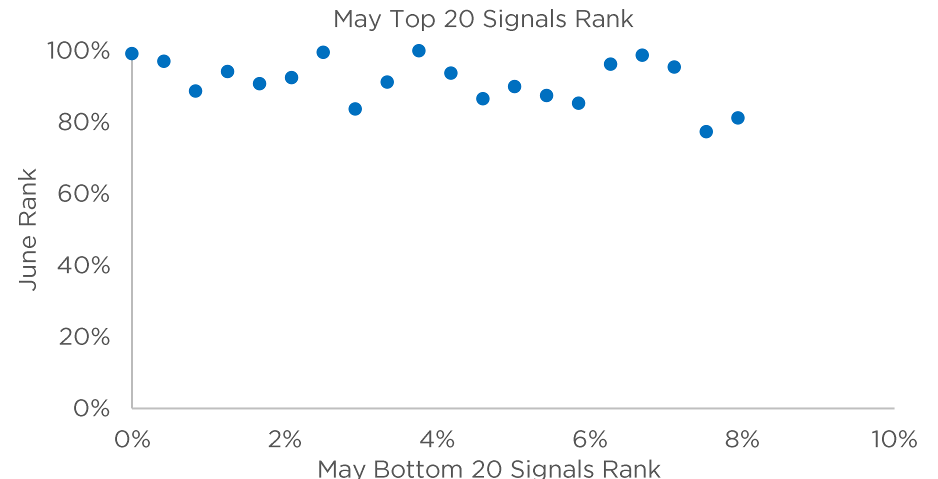
POINT 5: THE BEST SIGNALS ONE MONTH ARE THE WORST THE NEXT

To further demonstrate the volatility in efficacy we show the percentile rank of the top 20 most effective signals in February and their percentile rank in March (upper left). On the upper right, you can see the top 20 signals in May were consistently among the worst signals in June. The bottom 20 signals in February were mixed in March (bottom left). The worst performing signals in May (bottom right) were all incredibly efficacious in June and vice-versa (top right)









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