Concentration, Opacity, Illiquidity, Leverage, Skill (COILS)

Tactics to Generate Alpha

Written by:

Douglas W. Evans, CFA, CIMA
Senior Managing Director,
Asset Management

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Concentration, Opacity, Illiquidity, Leverage, Skill (COILS)

Tactics to Generate Alpha

> ***al · pha** (æl'fə)*
> *noun*
>
> ***Alpha is a risk-adjusted measure of excess return on an investment. It is a common measure of evaluating an active manager's performance relative to a benchmark index or "risk-free" investment.[1]***

One of the primary objectives of active investment managers is to generate alpha. Most investors can easily gain exposure to broadly diversified stocks and bond funds that target specific investment styles or benchmark indices that follow the market. However, successfully producing alpha over long periods of time is quite difficult. It requires keen investment insight, exploration of untapped opportunities and inefficiencies, and integrating a robust risk management process that addresses concentration, illiquidity, and transparency, among other risks.

This paper addresses how inefficiencies may be exploited to help generate alpha. This viewpoint is developed from our assertion that outperformance requires strong fundamental research and insight by skilled managers, and looks at the methods by which alpha may be extracted under the umbrella topics of Concentration, Opacity (or lack of public information), Illiquidity, Leverage, and Skill (COILS).

C – Concentration

O – Opacity

I – Illiquidity

L – Leverage

S – Skill

Concentration—Raising the Stakes on Calculated Opportunities

Investors may hold concentrated positions in a couple of ways: through securities held in an individual company or as an investment strategy targeting a specific asset class, sector or industry.

Single Company Concentration

Concentration in a single company's security may result from option and restricted stock grants to senior company executives, or from a liquidity event after a privately held family business has been taken public or purchased by a public company. There are typically four reasons why investors hold onto single security concentrations. First, there may be legal restrictions around the sale. Second, a low tax basis may mean that a sale could trigger a large tax liability. Third, inertia or an emotional attachment to a business that once meant a lot to a particular family may make family members reluctant to diversify the holding. And fourth, investors may think more highly of the prospects of this particular company versus any other prospective investment.

Given the different vehicles available to help diversify concentrated positions, one of the few rational reasons why an investor should consider holding onto such a position is the belief in the future outperformance of the company. An investor who chooses to take that option must also be prepared to take on the risk associated with holding such a concentration. As executives at companies such as Enron or Worldcom can attest, concentrated positions may make you rich but won't necessarily keep you rich.

Any investor willing to take on the risk of holding a single company concentration should abide by a number of common sense rules. First, carefully and regularly monitor the performance of the company, its markets and its sector in general; in short, educate yourself on the risks of this particular company.

By all means, don't let an emotional attachment blind you from more rational considerations. Second, if you cannot afford to lose all the capital tied up in the company, consider diversifying at least a portion of your holding. Third, don't take out an unhedged loan against your concentrated position. If for some reason your bet doesn't pay off, you do not want to end up owing more on your loan than your stock is worth.

Asset Class, Sector and Industry Concentrations

Managers with unique knowledge of a particular asset class, sector, industry or geographical area may be able to increase returns through concentrated positions. With a focused number of holdings, analysts can dedicate more time to conducting in-depth research in each position and provide greater scrutiny over the merits of the investment. The depth of research facilitated by a focused approach can support a higher degree of confidence in portfolio holdings.

An investment concentrated in a narrow asset class may in fact generate alpha for an investor's portfolio. Those who concentrated their investments during the emerging technology era of the 80s and 90s can provide ample testimony to this strategy's success. However, such an investment is also likely to expose an investor to greater risk and short-term volatility than with a more diversified portfolio, as subsequent events illustrated.

Opacity—Looking through a Dark Glass

Market movements are driven by new information, and there is ample research to suggest that even the most liquid markets are not perfectly efficient at reflecting information in prices.[2] The less transparent or the more complex a market, the more likely mispricings are to exist. In general, less-transparent, less-observed and poorly-understood markets offer the greatest number of untapped opportunities to produce excess risk-adjusted returns.

Mainstream investment strategies often involve absolute or relative valuation of various market sectors or securities, a process that identifies ambiguities, complexities and inefficiencies that exist in the market. Some of these investment opportunities and structures are so complex that having an edge requires specialized knowledge and good access to information in a field where free information may be scarce. The nature of opaque investments also limits the number of investor participants, and as a result, can potentially improve the likelihood of generating alpha.

However, lack of transparency introduces uncertainty about the future behavior of an asset or product. Transparency risk could be construed as a multiplier of all the other risk factors because it has the potential to limit an investor's ability to assess and anticipate risk in the portfolio due to concentration, leverage or any other factors.

Illiquidity—Unlocking Value over Time

Liquidity is the ability to convert an asset to cash quickly without significant sacrifice of value. It provides investors with flexibility which in turn can lower the risk profile associated with the asset. However, such flexibility is often provided at a price, an expense which in turn can lower the return prospects of the investment. For some investors with a long time horizon who have liquidity in excess of their short-term needs, there are advantages to allocating a portion of their portfolios to illiquid assets. The liquidity trade-off is the potential for higher returns over the long term. For example, an investor may choose to invest in real estate by either directly acquiring physical property (an illiquid approach) or they may access the asset class via real estate investment trusts (REITs) and benefit from daily liquidity. The cost for such liquidity and flexibility can be somewhat reflected in the premiums paid for REIT share prices versus their underlying net asset values (NAVs). REITs have demonstrated a 12–22 percent average premium over their underlying property values for sustained periods of time.[3] Such premiums can erode long-term return potentials; whereas, private real estate markets may provide a different pricing dynamic affording the illiquid investor more expected return. Illiquid investments, and the associated principles, include not just private real estate but also private equity, commodities, hedge funds and structured products.

Although several of the large U.S. endowments recently struggled with illiquidity, the 2008–2009 financial crisis demonstrated that liquidity for all asset types can vary; even money market fund operations proved difficult during that period. Those who were able to provide liquidity to desperate sellers were handsomely rewarded during the recovery in late 2009. Professor John Cochrane of the University of

> ***American investors, particularly those with long time horizons, pay far too much for liquidity.[4]***
>
> *David Swensen,*
> *Chief Investment Officer, Yale Endowment*

Chicago asserts that stock and bond returns have a substantially predictable component at long time horizons.[5] Similarly, illiquid assets such as real estate and private equity have been shown to offer the advantages of long-term return enhancement, diversification and inflation protection across many investment cycles, albeit at greater risk.

Investors must have a sufficiently high tolerance for risk in order to accept the periodically elevated levels of volatility, such as the one observed during the 2008–2009 credit crisis. In evaluating illiquid investments, an investor should be aware that the ability to rebalance a portfolio or reallocate toward new investment opportunities is severely limited due to the commonly long lock-up terms of these investments. In short, investors must have sufficient liquid holdings as well as a long time horizon to help ensure that they are able to benefit from the expected higher returns of illiquid investments.

Leverage—Intensifying the Magnitude of Returns

> *Give me a lever long enough and a fulcrum on which to place it and I shall move the world.*[6]
>
> *Archimedes*

The concept of leverage often refers to a situation where an investor borrows funds to finance assets that are higher yielding than the cost of capital in order to magnify returns. During periods of low interest rates, the use of financial leverage can be applied to spread a limited amount of funds across a greater number of investments and increase the total return of a portfolio. As such, financial leverage represents a powerful tool in supporting the potential ability to generate excess returns.

There is no magic number for the right amount of leverage for an investor. The key to successfully employing debt for investment purposes is to actively employ the funds. Capital should be deployed and then retired as the opportunity comes to fruition. Perhaps the least useful form of debt is for consumption purposes— specifically borrowing against your investment portfolio to purchase goods and services. More useful is investment debt when there is an opportunity to gain a higher return than you are paying in interest and costs associated with such an investment. Given how depressed asset prices are in the current market and how low interest rates have become, now may be a good time to consider taking on leverage.

On a cautionary note, as with other sources of alpha there are significant risks related to excessive leverage. Such risks are heightened during periods of market distress and can result in a significant loss of capital, particularly when the securities used as collateral for a loan are unhedged. In the case of leveraged financial instruments such as options, a margin call could be triggered if the value of the investment declines sharply below option value. If an investor does not have sufficient liquidity to meet the margin maintenance requirements, the paper loss can quickly become a real loss.

One of the most significant historical examples of potential risks related to excessive leverage is the Long-Term Capital Management (LTCM) crisis in 1998. Collateral calls triggered by losses exposed that the hedge fund's balance sheet was leveraged in excess of 25-to-1.[7] The size of exposure and pervasive counterparty risk had the potential to create a severe crisis in the financial markets, and prompted an intervention by the Federal Reserve of New York.[8] It should be noted that the opaqueness of LTCM's risk profile also contributed to the magnitude of risk in this situation. This example provides a cautionary tale of the degree of acceptable risk when using leverage. As with other alpha tactics, leverage should not be deployed unless an investor can afford to lose the amount of leveraged exposure.

Skill—Experience, Judgment and Timing

Realizing alpha depends on having an investment manager with the experience, judgment and insight to act on profitable opportunities and take measured risks. Not every investment manager or every investment style is positioned to produce excess returns. Even talented investment managers repeatedly experience phases of underperformance against a specific benchmark, declared absolute return target or competitor, caused by style drift or other factors.

Distinguishing talented investment managers requires thorough research and interviews with key members of the investment team and senior management to evaluate the company's resources, technology, and business model. Uncovering good managers involves asking questions such as:

- Is this manager's investment process well-aligned to uncover the marketplace mispricings?
- Does the process capture a large portion of the mispricings on a consistent basis?
- Has the manager shown past success in understanding market dynamics?
- Is their edge durable and long-lasting?

Still, finding skilled managers, particularly ones who have strong records of a deep understanding of market dynamics, is difficult. George Soros is a well-known investment manager who built a legendary name for himself through his instinctual ability to make big market timing calls. In 1992 he bet against the British pound and in 2007 gained 32 percent from trading currencies and Chinese and Indian stocks.[9] However, deploying such strategic tactical shifts is a risky way to generate alpha. Even the most skilled investment managers—Soros included—can get it wrong from time to time. For example, in 1998 Soros' investments in Russia yielded a loss of $2 billion when the country defaulted on its currency. In 1999–2000 Soros' fund lost close to $3 billion when he traded on his instinct that the technology bubble would collapse, but his timing proved to be too early.

Market Efficiency Theories and Research

The landscape of active investment management is competitive, filled with many motivated and competent players. Skilled investment managers must work to efficiently identify and exploit any obvious profitable trading opportunities created by regulatory and institutional rigidities, lack of transparency or other market imperfections.

In finance, the Efficient Market Hypothesis (EMH) asserts that excess returns are not achievable because the stock market instantly reflects fair prices and relevant information as it develops. Although this theory is a fundamental assumption in analyzing stock market behavior, a large body of academic research disputes the assertion, and proposes three versions of the hypothesis:

- Weak EMH. Trading prices reflect all historical public information.
- Semi-Strong EMH. Prices reflect all publicly available information and instantly change to reflect new public information.
- Strong EMH. Prices can even instantly reflect hidden or insider information.

While some evidence exists both for and against the Weak and Semi-Strong EMHs, it is notable that there is significant evidence against Strong EMH.[10] The May 6, 2010, flash crash, when the Dow Jones plunged nearly 1,000 points and then rebounded all within an hour, is an example of how trading prices can temporarily decouple from fair value even without the catalyst of new information. From a longer-term perspective, the 2008–2009 financial crisis reflected an environment where companies were trading near or below their break-up value at the market bottom, also demonstrating the possibility that mispricings can persist for months at a time.[11]

Such negative evidence against Strong EMH bodes particularly well for skilled active investment managers because alpha is realized in conditions when there are relative dislocations or inefficiencies in the market. However, alpha can also be realized when there is limited competition to exploit price discrepancies. In developed markets, such as the U.S., opportunities to generate alpha may be fewer and require greater skill than in less developed markets.

Value and Opportunity in Inefficiency

Market inefficiencies take many forms and offer opportunities for investment managers to profit from differences in price and real value. In general, more illiquid, less transparent and less observed markets are deemed to have the greatest inefficiencies to exploit, but they also require the most careful attention to risk management.

Periods of extreme market volatility, when trading prices temporarily decouple from real values, is one example of market inefficiency. Market volatility has experienced a significant increase over the past decade as represented by the VIX index, which reached 90 during the 2008 financial crisis, in contrast to its long run average of 25 since inception.[12] These cycles can last minutes, hours, days or persist for months depending on the market conditions.

Seeking Alpha: When Is it Appropriate to Take Calculated Investment Risk?

While we believe there are opportunities to generate significant alpha from strategic tactical shifts, this strategy should be reserved for portions of the portfolio that can afford to pursue a longer-term view and more risk. As highlighted in the example of George Soros, gains and losses from trying to time the market can produce inconsistent and unpredictable returns, even for the most skilled investment managers. We suggest that clients think about investments in a portfolio as fitting into three buckets, with the investment types detailed in this paper falling into the third bucket—Aspirational.

The Liquidity Bucket. This is the part of the portfolio that we have often referred to as the number. Your number is the amount of cash or cash-equivalents needed to satisfy the next several months of cash flow and liquidity requirements in order to meet your basic needs. In addition, it is the cash over and above the amount to meet these needs that offers you a sufficient cushion to stick with your long-term investment plan during periods of market volatility.

The Lifestyle Bucket. This part of the portfolio generates growth of principal over time and meets the bulk of an investor's lifestyle needs. Importantly, this part of the portfolio also provides the potential for higher income over time through the growth of income-generating principal. Income components can include equity dividends or real estate income from assets that may increase in value. This is the core part of the portfolio that addresses the longer-term needs of the investor.

The Aspirational—or COILS—Bucket. This part of the portfolio is where investors can do relatively well if either their worst fears come true or the opportunities they have identified are realized. This aspirational portion of the portfolio typically includes complementary strategies such as hedge funds, private capital, real assets and other alternative investments. Other strategies that investors may want to consider in this bucket are those that provide tactical views on currencies, commodities, and can go long or short, or hedge some of the risks in the markets.

Conclusion

Most of the concepts discussed in this paper address investment solutions, such as hedge funds and private capital funds, which may be appropriate for qualified investors only. An investor must have a sufficiently high tolerance for risk to accept the potential periods of heightened uncertainty associated with such solutions. Also, the concepts described within this paper are intended to be designated to the portion of a portfolio that an investor can afford to lose. As outlined within each section, these methods may be valuable tools to generate alpha; however, each has magnified risks that should be carefully understood prior to investing.

We recommend that you discuss these concepts with your Abbot Downing relationship manager to determine whether they are appropriate for your specific circumstances.

Endnotes

1 *Equity Asset Valuation*, Second Edition, CFA Institute Investment Books, January 2010.

2 Lawrence H. Summers, "Does the Stock Market Rationally Reflect Fundamental Values?" *The Journal of Finance*, Vol. XLI, No. 3, July 1986.

3 Lawrence Benveniste, Dennis R Capozza and Paul J. Seguin, "The Value of Liquidity," December 22, 2001.

4 *The Economist* print edition, May 11, 2000.

5 *"New Facts In Finance,"* John H. Cochrane, "New Facts In Finance," 1999 http://faculty.chicagobooth.edu/john.cochrane/research/Papers/ ep3Q99_3.pdf.

6 "Archimedes ca 287–212 BC." Mackay, Alan Lindsay (1991). "Archimedes ca 287–212 BC." A dictionary of scientific quotations.

7 LTCM's leverage ratio is based on the fund's balance sheet on August 31, 1998, which included over $125 billion in assets, and on the equity capital figure of $4.8 billion on January 1, 1998.

8 Report of The President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," April 1999.

9 *"Soros Says U.S. Recession is 'Almost Inevitable.'"* Bloomberg Finance LLP, January 23, 2008.

10 Lawrence H. Summers, "Does the Stock Market Rationally Reflect Fundamental Values?" *The Journal of Finance*, Vol. XLI, No. 3, July 1986.

11 "Buy or Sell-Is ING's Break Up, Cash Call Priced In?" *Forbes*, October 28, 2009 http://www.forbes.com/feeds/afx/2009/10/28/afx7054785.html.

12 VIX is the ticker symbol for Chicago Board Options Exchange Market Volatility Index, a measure of the implied volatility of S&P 500 index options, and is commonly used as a barometer of investor fear. The VIX was introduced by Professor Robert E. Whaley in 1993.

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