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TOPICS OF INTEREST

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Costs Ate My Alpha: Why Investors Should Believe In (And Protect Against) Fairies

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It's easy to dismiss costs as de minimis when thinking about investment returns – especially when you compare those costs to the total plan value, or the total return of the market. However every basis point of costs incurred takes away a basis point of alpha that might otherwise have been added: and making sure that we avoid excessive costs is a lot easier than trying to create and harvest alpha. We believe that it's better to compare costs to the potential alpha from the investment portfolio: and when you make that comparison costs become a much bigger part of the picture. In this brief note we explain why investors should think hard about costs, and give suggestions for how they might do that.

Things Run in Threes

Things often run together in threes: marriages, births, deaths and Stooges for example[1]. Sometimes that's simple selection bias, of course, but perceiving the fact that three particular events or stories are somehow alike can often be our brain's way of calling attention to an important underlying message. That's what I think has been happening with three stories that have crossed the tape recently. As I've read and thought about them the similarities between them have resonated with me. I thought that sharing them might cause them to resonate with others too. The particular thing that it's made me focus on is the long term impact on portfolios of even quite small costs, and how we might think differently to help ourselves avoid them.

Story 1: Trading Scandal on Wall Street Shock!

The first is the ongoing series of stories talking about inappropriate and possibly illegal behavior in the markets: first suggestions that the LIBOR rate was distorted through collusion, then suggestions that the same happened with the FX fix (the key pricing mechanism for benchmark foreign exchange trades), and elsewhere suggestions that FX indirect trading performed by custodians on behalf of large institutions was sometimes priced in ways that didn't reflect the true market price. The details of each story are slightly different, whether it involves dealers allegedly conspiring to set prices, or custodians allegedly providing sub-optimal pricing to customers that expected different results, but the theme is the same: frictional costs that appeared likely to be minimal turned out to be larger than expected, and possibly unethically so.

Story 2: Conflicted Structures Sometimes Produce Conflicted Results

The second is the ongoing series of reports of mispricing, and allegations of illegal behavior, that have been surfacing in the transition management business. Certain providers, with a business model that allowed them to buy or sell securities or assets as a direct counterparty of the client rather than trading everything as agents through the market, are said to have done so in ways that at times may have involved illegal behavior (and illegal overcharging of clients). Not every provider with that business model has done anything inappropriate, and the safe assumption is that most of the time, for most of the clients, nothing inappropriate happened. Again, though, the theme that appears to be underlying this is that of costs incurred by a client turned out to be higher than an expected very low level (and often it requiring a combination of very hard work, persistent questioning and detailed knowledge on the part of the client for the mispricing to be able to be identified).

Story 3: Market Structures Can Sometimes be Gamed by Smart, Quick People with Computers

The third is the recent attention paid to the questions of High Frequency Trading and market structure caused by the publication of Michael Lewis' new book "Flash Boys". In this book he draws attention to the wide variety of ways that technology has changed the trading of stocks, and in particular to some of the approaches that some firms have adopted that allow them to (or at least to appear to) get in front of real investor orders, potentially causing those investors to suffer slightly higher trading costs than they otherwise might have done. Again, he's clear to point out that technology has been broadly used in the interests of clients, and that not everyone in the market has been behaving inappropriately – but it rings the same theme again, one of costs (even small ones) mounting in unexpected ways and unexpected places. The firms involved invest hundreds of millions in aggregate every year in technology to create the mechanisms used – the costs being paid by the client base as a whole must be large enough to justify that expenditure.

But These are Details, Aren't They, Not the Big Picture?

This brief note is not, of course, on any one of these particular issues in detail – and these details are about investment manager trading costs which are difficult for investors to investigate or manage directly. While I'd be delighted to talk in detail about each one of the topics I'm also aware that each individually might appear of only slight interest to the typical institutional investor and that few rational humans have the same degree of interest in the details of market structure that I do.

And anyway: don't the clients of Verus hear on a regular basis from us that they should focus on the long term? Aren't we constantly turning to the big picture? After all, aren't most of our outcomes determined by the risks that exist in our portfolios (and shouldn't we primarily be focusing on risk dimensions rather than asset class return forecasts)?

Of course the answer to all of these questions is yes. To a large extent.

But not entirely.

What You Compare Something to Changes How You See It

The problem that we have comes from the comparison we use. When we're thinking about the effect of costs on our portfolio we tend to make a comparison of the total costs expended to either the total value of the portfolio as a whole, or the total return generated from the portfolio.

That's where I think the problem lies.

Rather than doing this comparison I suggest that we would be better thinking about costs in the context of alpha.

Investors typically spend a huge amount of time thinking about and reaching for alpha. Most investors still have significant amounts of active management in their portfolio, and they spend a lot of time and resource selecting and monitoring those active managers. All of this effort is despite the fact that many (or indeed most) investment managers will produce zero alpha (or worse) over the medium term. That difficulty has led to investors reaching outside the long-only space and hiring hedge funds, with significantly higher fee schedules, to try to produce differentiated alpha. Even there, the amount of alpha achieved in a successful portfolio in the long term is likely numbered in the tens to low hundreds of basis points after fees[2].

So alpha is small, expensive and rare.

This is a more effective comparison whenever we're thinking about costs, then. Every basis point of costs incurred takes away a basis point of alpha that might otherwise have been added: and making sure that we avoid excessive costs is a lot easier than trying to create and harvest alpha. We can't directly control manager trading costs – but we can control other costs. How hard should we focus on that process?

What Do the Numbers Say?

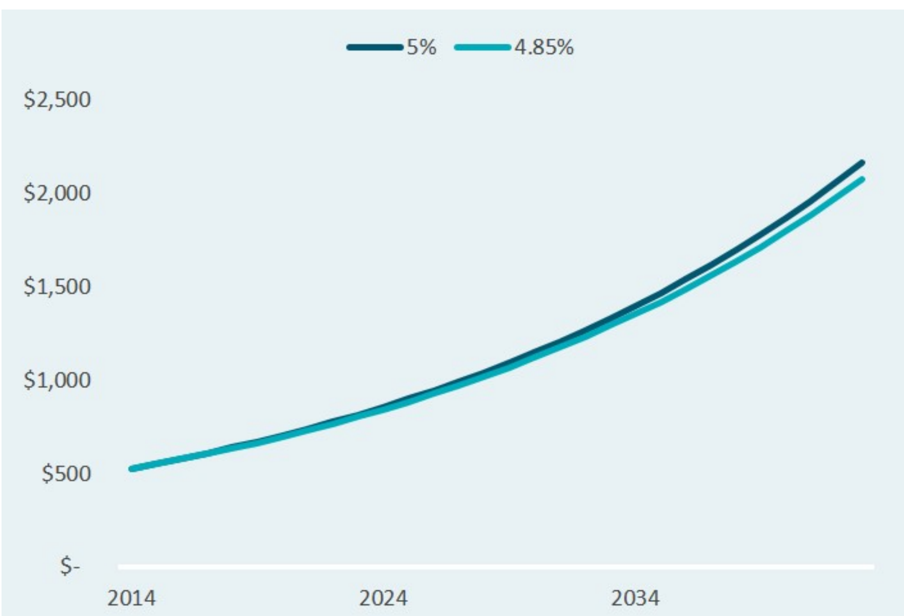
The table below tells the picture clearly, comparing costs against returns for different strategies[3]. For simplicity it uses excess return rather than alpha, but the point being made is the same. It shows the results achieved by the median manager in a number of asset classes: both the benchmark return they delivered and the degree to which they added value.

10 year annualized ending 12/13	Total Return	Excess Return	15 bp Cost As % of Total Return	15 bp Cost As % of Excess Return
Domestic Equity	9.24%	1.84%	2%	8%
International Equity	8.50%	1.10%	2%	14%
EM Equity	12.69%	1.17%	1%	13%
Domestic Fixed Income	5.00%	0.46%	3%	33%
Global Fixed Income	5.08%	0.93%	3%	16%

When we compare a 15 basis point cost[4] to each column it's immediately clear that our perspective on costs shifts. What looks like a minor effect at the total return level becomes much more significant at the excess return level: and yet every dollar spent on costs is a dollar less excess return able to be captured.

Put another way – a domestic fixed income investor might care only a little about a frictional cost of 15 basis points if they think of it as being only 3% of their total annualized return. If they thought of that as 33% of the total excess return they might expect to achieve from the strategy they might think harder about its importance.

Another way of looking at the impact of this type of cost can be seen in the chart below. This shows the effect on a hypothetical $500 million portfolio of a 15 basis point difference in costs. The return expectation of this portfolio would have been 5%, but in fact turns out to be 4.85%.



The difference in value is tiny to start with but over the period from the start of 2014 to the end of 2044 the difference in end value is more than 4% of ending total plan value, or a value of somewhere more than $90 million: not irrelevant by anyone's calculations. That difference translates to real underfunding, and constrained opportunities to the sponsor, the beneficiaries or both.

Costs are Always a Drag

There's one other element that is important to remember about costs, but that it's sometimes easy to forget. We spend so much of our time dealing with questions of risk and return where the distribution of outcomes roam both side of the zero line – sometimes positive, sometimes negative. That can help train our brain to partially discount negative results: to stay on target at a plan level we have to make sure that whenever we see a short term negative outcome we remind ourselves that the risks we're running are supposed to be compensated. We'll get that money back, we have to tell ourselves.

That's a good approach most of the time, and it helps avoid the danger of excessively conservative allocations. But costs are different from the other negative experiences we have: there's no upside. They only ever reduce return.

A mental image might help fix this to help overcome the natural bias to discount negative results. Imagine the tooth fairy has an unpleasant sibling: the Cost Fairy. Like his relative the Cost Fairy will come into your room at night if you leave a tooth under the pillow and take it away. Unlike his relative, though, he'll not leave anything for you. And sometimes the Cost Fairy will break into your house without you expecting it – and if he doesn't find a tooth under your pillow he'll just take one you were still using... There's no return from the Cost Fairy – only downside.

I sometimes suspect the Cost Fairy is on the staff of some of the firms that feature in the three sets of stories I described at the start of this piece.

So What to Do?

It's all very well outlining the problem – but what should you do about it?

I think we'd suggest three things.

The first is to take costs seriously at every step of the investment process. There are a whole range of frictional processes involved in running investment portfolios and the cumulative result on outcomes can be big enough to matter, even if the individual costs involved look small. Always ask questions about costs – never accept a brush off as an answer. Know how your service providers make money. Even more important, know the ways they could make money if they wanted to, especially if that involves being able to take the other side of trades you are making.

The second is to think hard about the more operational and administrative parts of the portfolio management process: custody, transition management, commission recapture and management, FX trading, stock lending and so on. If you don't focus on those areas but instead either ignore them or allow them to happen in the background you can be sure that someone else will be paying attention. And that person is likely to be someone who will find a way of making sure the costs involved are higher than they might be – and that they end up in their firm's account. Costs are easier to control than investment return is to generate, and the time spent on them should reflect that. Compound friction is as powerful as compound interest.

The third is to participate (and / or support colleagues or peers that participate) in mechanisms that govern the market structures that your money flows through. If the end client isn't represented then the only people at the table will likely be people representing their own interests, and those interests are likely not to align with yours. To ensure fair markets clients of all types need to be represented: even relatively small ones. Getting educated (your consultant can likely help on this) can help here, and shouldn't take too much time. Submitting responses to consultations, reaching out to regulators or markets when they ask for input and speaking to service providers when asked all have their place, and your voice is needed in those conversations.

A final point to remember, however, which contrasts with much of the content above. Although you should be worried about the things I've outlined above, it's important to keep perspective. Most providers are working hard on your behalf, and most participants in markets are honest ethical people working to do the right thing. So don't worry too much: but ask questions as though you were just the same.

And lock your bedroom window carefully. You never know when the Cost Fairy might want to visit

Notes & Disclosures

1. Lists in research notes, however, sometimes come in groups of four.
2. For more on this relationship, including the most extreme situations where all of the alpha generated and more from the median portfolio sticks with the manager in terms of fees, rather than going to the client, see the Verus Active Management Environment published December 2013.
3. Source: eVestment Alliance
4. 15 basis points was chosen as a representative cost here as a rough guide. It's easy to imagine across the entire portfolio management process a number of different places with costs that are individually small enough to be ignored, but that easily cumulate to this level. It goes without saying that specific details will vary widely up or down by investor.

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