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CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

Jack L. Treynor, Senior Editor

CLOSET INDEXING

Many institutional stock funds are managed in the following way:

(1) no short sales
(2) purchases based on ideas from Wall Street
(3) as soon as ideas get into price, alpha goes to zero
(4) but the stock isn't sold until the fund manager needs cash for another purchase.

The latter stocks (item 4) contribute to the fund's diversification, but not to its alpha. Result: what some clients call closet indexing. Some clients pressure closet indexers by measuring performance by the ratio of alpha to beta. Here's the story of how one fund manager responded to that pressure.

Although Joe wasn't clear on exactly what its product was, he knew that, in recent years General Renditions had been growing rapidly and now had operations all over the world. His boss emphasized that, to attract and keep such clients, it was important to be responsive to their concerns. GR was worth a little extra effort.

Unlike Joe's other clients, who used the Sharpe Ratio, GR measured performance by the ratio of alpha to beta. His other portfolios typically turned over about once a year. But if he simply doubled the size of his bets, he could almost double the size of GR's alpha.

Doubling the size of his bets would halve the time stocks stayed in the portfolio. But if alphas were realized in a few months, stocks probably stayed in the portfolio well past that point. With portfolios turning over once a year, most of Joe's positions were consequently passive, rather than active.

If he doubled his bets, he could simply increase the active portion at the expense of the passive portion. But since stocks didn't change their beta when they went from active to passive, the beta of the portfolio wouldn't change merely because the proportions changed. And because beta measured sensitivity to an undiversifiable risk it wouldn't

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be affected by the number of positions in the portfolio.

Questions

In performance measurement, is it important to allow for luck?
In order to generate alpha, doesn't Joe have to incur residual risk?
Doesn't beta measure the wrong kind of luck—i.e., sensitivity to market risk?
In order to allow for luck, doesn't GR need to focus on the correct risk?
Doesn't GR need to distinguish between its performance measurement problem and its closet indexing problem?
Can you blame Joe for the way he responded?

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