
PRACTITIONER'S DIGEST

The “Practitioner’s Digest” emphasizes the practical significance of manuscripts featured in the “Insights” and “Articles” sections of the journal. Readers who are interested in extracting the practical value of an article, or who are simply looking for a summary, may look to this section.



THE LINK BETWEEN INFLATION AND THE VALUE OF PLANT

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Jack L. Treynor

It has been argued recently in these pages* that changes in the inflation rate are linked to changes in the real wage. But investors know that the real wage is determined by the productivity of the marginal plant: if the central bank wants to change its inflation rate, it needs to change the marginal plant’s identity. But scarcity rents, the basis for investment value, are measured relative to the marginal plant.

*The Work Force and Inflation, Case Study, JOIM Vol. 11, No. 3, pp. 100–102.

MUTUAL FUND OUTPERFORMANCE AND GROWTH

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Gregg S. Fisher, Philip Z. Maymin and Zakhar G. Maymin

Mutual fund managers earn fees based on their assets under management, but are seldom compensated with incentive fees. For this reason, many observers believe that fund managers have little incentive to pursue innovative investment strategies that may generate excess returns. This paper demonstrates that this belief is a misconception. In fact, the authors demonstrate that, statistically, managers in nearly every asset-class category who generate wide outperformance relative to peers are rewarded with a sudden jump in assets (and thus compensation) within a year following the excess performance. Therefore, even managers lacking traditional incentive fees are rewarded for increasing investment returns, even if they are already beating their own benchmarks or counterparts.

THE SHADOW PRICE OF LIQUIDITY IN ASSET ALLOCATION— A CASE STUDY

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Bac Van Luu, Yazid Sharaiha, Nikolay Doskov, Chirag Patel and David Turkington

The question of illiquidity risk is relevant to investors who consider including alternative assets in their portfolios. While institutional investors often opt for a portfolio of liquid, publicly listed and easily

tradable equities and bonds, some of these investors may be in the position to bear some illiquidity risk. In deciding whether and how large a share of illiquid assets to take on there is a need for a coherent conceptual approach that takes into account the benefit from being invested in liquid assets and the cost of being tied to illiquid assets.

We apply a framework for estimating the investor-specific value of liquidity which can be used to inform asset allocation decisions. The shadow price of liquidity is a central concept in this framework. It expresses the utility gains an investor obtains from using the liquid assets in terms of the additional return that we require to hold illiquid assets. We use the framework in a case study where an investor considers including alternative assets such as private equity, real estate and infrastructure. In quantifying the shadow price of liquidity, we assume that the investor derives two principal benefits from her liquid portfolio: the ability to rebalance and the ability to engage in market timing.

Given the assumptions made on how this investor uses portfolio liquidity, we find that the shadow price of liquidity is less than 1 percent. In other words, the additional return required for taking on illiquidity risk is not very demanding for the case in question, but may be higher for other investors.

RESTORING VALUE TO MINIMUM VARIANCE

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Lisa Goldberg, Ran Leshem and Patrick Geddes

A long-only investable minimum variance strategy outperformed the S&P 500 over the four decades from January 1973 to December 2012. Through the lens of a factor model, we show this outperformance can be largely attributed to implicit style bets. Specifically, minimum variance has thrived by tilting away from size and volatility and toward value. As funds have poured into minimum variance in the wake of the financial crisis, and plausibly as a consequence of this trend, the value tilt has disappeared and a momentum tilt has emerged. This suggests that the cost of entry to minimum variance is at an historic high. We show how the value tilt can be restored to minimum variance by targeting specific exposures, and that there was a substantial long-term benefit to the restoration at most recent points of entry to the strategy.

Our analysis illustrates the insight into a complex strategy that a factor model can provide. In the example at hand, a factor model enables a value-oriented investor to make an informed decision about minimum variance. More generally, factor models can provide insight into subtle opportunities and unintended bets implicit in investment strategies.

This example also demonstrates the utility of a factor model as a tool for portfolio customization. An investor who is interested in a low-risk portfolio but who does not want to wait for market valuations to revert to historical norms can still enter the minimum variance strategy at any time by incorporating a value tilt. While investors may not be able to predict with certainty, which factors will succeed, they can control their exposures.

DOES FACTOR TIMING EXPLAIN HEDGE FUND ALPHA?**PAGE 40***Hyuna Park*

Consistently positive alpha is rare among mutual funds, but it has been observed more often among hedge funds. Mutual funds mimicking hedge fund strategies have outperformed traditional mutual funds but underperformed hedge funds. Why do we observe a positive alpha more often in hedge funds even after adjusting for the high fees they charge? Is it mainly because incentive fee attracts managers with selection skills or because hedge funds are better positioned for market timing?

Hedge funds can change their loadings on systematic risk factors more freely than mutual funds because they are less regulated in terms of using leverage and short sales. That is, hedge funds are in a better position to generate alpha using factor timing than mutual funds, but does factor timing really explain hedge fund alpha?

To answer this question empirically, this paper decomposes the excess return of hedge funds into the timing, selection, and risk premium components using the new method developed by Lo (2008). Portfolio-level tests show that security selection explains most of the excess return generated by hedge funds during 1994–2009, and the contribution of factor timing is small. Fund-level tests find significant evidence of both positive and negative timing, but the excess return of positive timing funds is not significantly higher than that of the other funds. These results show that factor timing is not the main source of hedge fund alpha.