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INSIGHTS FROM CFA SOCIETY SINGAPORE

Better than Alpha: An optimal way to think about alpha

Christopher M Schelling's book provides the tools investors need to save time, resources, and energy to improve investing outcomes



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BETTER than Alpha: Three Steps to Capturing Excess Returns in a Changing World, by Christopher M Schelling, is a valuable resource for investors and practitioners seeking a more thorough understanding of alpha, including what it is, how to identify it and what they should be focusing on instead.

Schelling is head of the US-based investing firm Windmühle Funds and former director of private equity investing for the Texas Municipal Retirement System.

The author's 3-step framework of behaviour (policy setting and strategic allocations); process (manager selection and tactical allocation); and organisation (types of authority, oversight/attribution, and delegation) provides an optimal way of thinking about alpha.

Rather than simply attempting to beat the market, investors should make decisions that heighten the probability of achieving their investment objectives.

Behavioural alpha (smart thinking) is the excess return that investors can earn by beating their behavioural biases, as opposed to beating the market.

Humans employ 2 primary sys-

tems of thinking. System 1 is a quick, intuitive process that favours efficiency and speed but often leads us astray. System 2 is a more deliberate and logical process but is also much more effortful.

Since System 2 is far more energy-intensive than System 1, our natural proclivity is to bypass it. We all have limited time, resources and mental acuity.

According to the author, we can mitigate the failings of our System 1 thinking when making investment decisions without simultaneously over-exerting the limited resources of System 2 decision making, simply by not using System 2 as much.

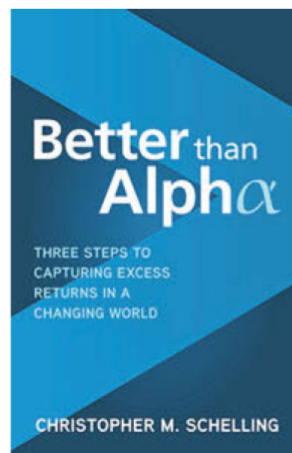
Investors should prioritise the biggest, most impactful decisions and systematise as much of the rest as they can. For example, rational investors should not allocate the same mental energy to a US\$1,000 business expense and a US\$100 million private equity investment.

Streamlining decisions

One strategy provided by the author that allows greater parsimony with System 2 is simply to make fewer big decisions.

The less frequently a decision gets made, the more appropriate it is to implement System 2 thinking. The more frequently a decision gets made, the more likely System 1 is to hijack the thought process at some point, regardless of one's intentions.

Highly impactful and infrequent decisions, such as setting policy



Rather than simply attempting to beat the market, investors should make decisions that heighten the probability of achieving their investment objectives. In *Better than Alpha* (left), author Christopher M Schelling's advises investors to prioritise the biggest, most impactful decisions and systematise as much of the rest as they can.

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and selecting the asset allocation, deserve System 2 decision-making efforts.

Process alpha (development of smart habits) is obtained from high-quality knowledge that facilitates selection of managers with comparatively high probability of meeting investment objectives. Smart habits include systematising as much of the investment process as possible and automating what works in order to become more effi-

cient and accurate.

Examples include the use of intelligent checklists to help screen managers more efficiently and informed rebalancing methods that take the emotion out of maintaining the portfolio in line with long-term objectives.

These smart habits limit opportunities for cognitive blind spots to affect the portfolio adversely and help drive successful outcomes.

Behavioural alpha and process

alpha are about being the architect of one's investment behaviour rather than its unwitting victim.

Finally, organisational alpha (smart governance) is the improvement in investment performance that proceeds from better organisational decision making. Governance means properly ensuring that an institution has the right people in the right positions to make the right decisions. In order for an investment organisation to be successful, the most qualified person should decide and the best ideas need to win.

Eliminating inefficiency

According to the author, if the organisation cannot get experts into hierarchical positions, it should push the actual authority to the relevant experts, internally or externally, and make sure they are doing their job.

In this way, an institution will have a better chance, compared to more hierarchical, bureaucratic structures, of meeting its total policy and investment objectives. Inefficiency has a real cost; eliminating it is how organisational alpha can be easily achieved.

In summary, this book provides the insights and tools investors need to save time, resources, and, above all, mental and emotional energy to improve their investing outcomes. Rather than acting as ghost hunters chasing alpha, investors should focus on making decisions that create a higher probability of meeting their investment objectives.

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