EQUITY RISK MODELING

BUILDING A BETTER ALPHA TRAP

Focusing equity allocations on stock selection skill maximizes the return potential of insurance portfolios. Yet while security selection is the most likely and persistent source of alpha production, identifying alpha sourced to it requires a more robust tool.

Security selection skill, when properly measured, is a significant predictor of future performance. The challenge is to separate performance due to security selection from performance due to systematic passive exposures (e.g., market, sector, and size betas) that differ from the benchmark.

The **Equity Risk Modeling** tool used by Beacon Pointe and Peer Analytics isolates security selection skill and provides a more effective system for identifying managers that are likely to deliver consistent performance and alpha.

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ISOLATING SECURITY SELECTION SKILL

The Peer Analytics Performance Analytics Platform isolates security selection return from performance, i.e., the performance a portfolio would have generated if all factor* returns had been flat. This is the estimated residual performance due to stock picking skill, net of all factor effects. Each quarter we group the top five percent of managers with the highest security selection information ratios over the prior 36 months into the Peer Analytics Expert Aggregate, a database that includes hedge funds and asset management firms, banks, endowments, trust companies, and other institutions. The Market-Neutral Peer Analytics Expert Aggregate is fully hedged to eliminate significant market factor exposure. It has been demonstrated to deliver consistent outperformance.

BENEFITS OF ISOLATING SECURITY SELECTION SKILL FROM PASSIVE MARKET FACTORS

- Eliminate any unintentional risk exposures

- Reduce tracking error while retaining the active risk worth active fees

- Avoid managers that are closet-indexers

- Avoid closet-indexing the aggregate portfolio

- Detect statistical evidence of security-selection skill likely to persist

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* Market, Sector, Size, Value, Bonds, Oil Prices, and U.S. Dollar. Global models add: Region, Country, and Currency.

IMPROVED QUANTITATIVE ANALYSIS FUELS BETTER QUALITATIVE ANALYSIS

Selecting managers based on simple analysis of absolute or relative returns won't provide the answers required. It is well known and understood that past returns are not positive predictors of future returns. In fact, managers in the top quartile in one period are more likely to be in the bottom quartile the next period than to remain in the top. This is because the impact of market randomness overwhelms return from security selection skill.

SOLVING FOR SKILL

Standard attribution and Active Share analysis, as useful as they are, are not predictive as those models assume all securities have the same levels of market risk and all securities in a sector have the same level of sector risk. In fact, security betas vary significantly. As of 12/31/2021, U.S. security market betas ranged from -0.6 to 4.3 and sector betas ranged from -1.8 to 5.1. (See exhibit, right).

Security selection skill exists and is persistent. More importantly, it can be identified. A factor risk model that analyzes portfolios on an individual security basis using passively investable risk factors accurately distinguishes between return due to security selection and return due to passive factor bets. The result is a metric identifying security selection skill that is likely to persist.

This quantitative analysis provides what we believe is a superior framework for qualitative analysis, enhancing our selection and monitoring of managers. It allows us to focus the discussion with an investment manager (as well as once the manager is engaged), on the elements of process and methodology that support persistence of positive security selection returns.
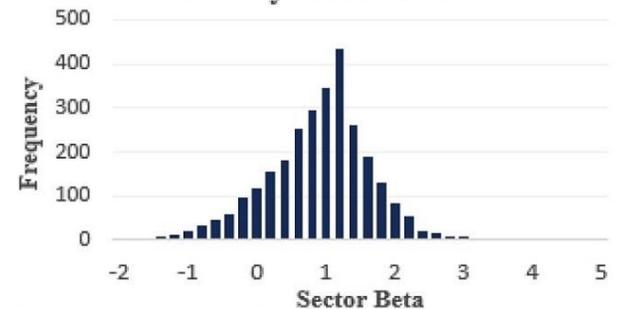
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AN INCONVENIENT TRUTH
Most manager skill analysis is not predictive

The distribution of individual security Market betas
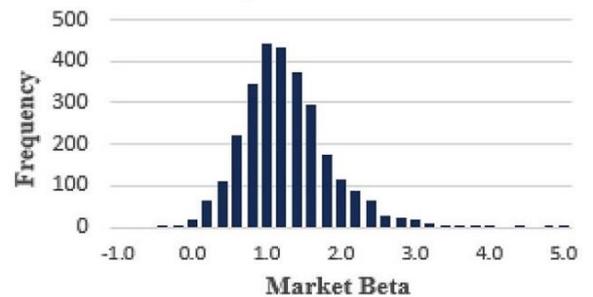
The distribution of individual security Sector betas

Standard attribution and Active Share analysis, as useful as they are, unfortunately fail to be predictive as those models assume that all securities have the same levels of market risk and that all securities in a sector have the same level of sector risk.

The ABW Peer Analytics Equity Risk Modeling solution is brought to you through a strategic alliance with Beacon Pointe Advisors and is offered in conjunction with Beacon Pointe's Institutional Consulting Services for Insurance Companies.