Ideas @ Edelweiss Multi Strategy Funds – The Financial Gravity Approach to Portfolio Construction

In one of the previous editions of Ideas @ Edelweiss Multi Strategy Funds, we outlined the law of financial gravity which states that it is not possible to deliver 1) consistent outperformance 2) at a large size 3) without compromising liquidity or taking on tail risk 4) or without violating some legal or ethical norm. In essence the law of financial gravity states that alpha is bounded by time or an ability to deploy capital and that all returns have to be seen in the context of the period over which they were delivered and the size of assets on which they were delivered. The original law was a framework designed to evaluate manager and strategy performance and in some sense was a tool of post-facto analysis. In this month's Ideas @ Edelweiss Multi Strategy Funds, we discuss how the law of financial gravity can be used as a tool of pre-facto analysis - as a way to construct better portfolios.

Classic portfolio construction techniques taught in academia range from the simple like equal weighting or market cap weighting to the more complex like risk parity or minimum variance. The one common thread between all these techniques is that at some level, they are built with a "beta-mindset" not an "alpha-mindset". In part this month's Ideas @ Edelweiss Multi Strategy Funds is inspired by studying and observing some of the greatest hedge fund managers and capital allocators and how they think about investment opportunities in practice.

The financial gravity approach to portfolio construction starts with an all cash portfolio that yields the risk-free rate. We then approach opportunities in descending order of risk-return desirability and deploy as much capital that liquidity can permit. Once opportunities run their course, capital is returned to cash. We still operate with constraints on diversification and stock, sector and opportunity limits. A portfolio built in this manner may be very concentrated if we had to deliver returns over a short-period of time or on a very small base (you would prefer pure rate-of-return arbitrage situations) but will get more and more diffuse as the time-period or the asset size increases. At the other end of the spectrum - if you had to deliver returns over a very long period and on large assets, a portfolio may start to look like the market portfolio. In the middle, portfolios can look diversified and yet concentrated - with a large number of positions but with a high marginal contribution to risk in a few best ideas. This is what you see in the portfolios of many of the best active managers and something that no finance treatise has been able to capture so far. Incidentally, that is also how some of the best corporate capital allocators in charge of holding companies (like Warren Buffett) think.

Financial gravity portfolios do not lend themselves to mechanical construction but have a sense of pragmatism that makes them invaluable in an investor's arsenal.