Ideas @ Edelweiss Multi Strategy Funds – Financial Gravity

Past performance is the primary metric used to evaluate active managers in spite of prominent warnings against this practice. The principle of financial gravity is simply that no manager can deliver outsized returns: 1) Consistently and 2) At a large AUM and 3) Without compromising liquidity or tail risk and 4) Do it legally. Let us apply this principle to a few examples of active management.

For a large mutual fund to consistently deliver outsized returns it has to either trade frequently or keep buying into the same positions. Both expose the fund to liquidity risk. In case volumes dry up, both approaches are likely to fail and lead to under performance. In the case of a statistical arbitrage or HFT arbitrage strategy, it is possible to deliver consistent outsized returns but strategies are capacity constrained by market level volumes and open interest. Another popular investment avenue among the ultra-wealthy is high yield debt. High yield debt can deliver outsized returns consistently through accrual income and do so at a large AUM but it is not without the occasional default that wipes out principal. Private equity has the potential to deliver outsized returns on a large corpus and without taking liquidity risk because of its close ended nature. But the returns are unlikely to be consistent on a monthly or quarterly basis.

Finally, if a manager promises consistent outsized returns, manages a large corpus and offers you daily or monthly liquidity – be wary. There are either tail risks you don’t understand or this could be another Madoff.

What are the implications for advisors and clients? First, it is important to evaluate past performance alongside the AUM it was delivered on. Capacity issues are likely to show up in the largest funds. Unfortunately, these also happen to be the most widely held and have the longest and best track record among their peers. Second, it is important to look under the hood and understand risk from portfolio holdings not just past returns or historical simulations. Holdings that are a large percentage of daily volume, open interest or free-float market cap and assets that have uncharacteristically smooth payoffs are likely to be potential booby traps. And third and most importantly, understand the manager’s investment process and where they believe their edge lies. The best critiques come from competing managers and praise from a competitor is the ultimate form of validation. The principle of financial gravity applies to all active strategies across the world and is a powerful framework picking the best managers and funds.