BlackRock Manager Research

Sourcing alpha in the new regime

April 2024

The end of the Great Moderation presents better opportunities for active managers, though alpha is not expected to increase uniformly across markets. While the challenge is significant, investors able to consistently identify the most skilled managers stand to benefit more today than at any point over the last few decades.

BlackRock.

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Key takeaways

- The increase in macro and market volatility is widening the gap between top- and bottom-quartile managers, amplifying the impact on investor portfolios.
- Alpha is scarce, and finding managers that will generate it consistently requires significant resources and expertise, both upfront and on an ongoing basis.
- The need for active managers to deliver alpha becomes ever more critical to achieving desired portfolio outcomes when market returns are muted.

Summary

Financial markets are adjusting to a new regime where the BlackRock Investment Institute expects a bigger role for active strategies in portfolios. For investors capable of identifying top-performing managers, the rewards will likely be greater than in the previous regime. However, the ability to persistently capture excess returns is more challenging than ever.

The decade leading up to the pandemic was a golden era for risk assets, where broad market returns across asset classes marched steadily higher. But the Great Moderation – an even longer stretch of stable growth and performance – is over. Macro uncertainty has surged since the onset of the pandemic, marked by the end of Quantitative Easing, negative or low interest rates, and subdued inflation. Together with accelerating secular shifts (e.g., technological disruption, geopolitical fragmentation, demographic transitions), financial markets have reflected a substantial uptick in volatility across asset classes.

A new regime is underway, characterized by greater uncertainty, volatility, and dispersion in returns. We believe this environment will produce more opportunities for alpha-seeking strategies to deliver active returns. However, not all active managers benefit equally. In fact, while the spread between top- and bottom-performing funds has expanded, the median excess performance of actively managed funds remains largely unchanged in many strategies, despite the more attractive backdrop.

Identifying top-performing managers ex-ante is difficult and labor-intensive, given the breadth of manager universes across asset classes. Vast amounts of quantitative and qualitative data need to be understood and evaluated, requiring significant resources and depth of expertise. Yet in an environment where expectations for market returns are no longer as positive or stable, active strategies that can generate strong and reliable alpha streams will provide valuable sources of excess return and diversification.

Selecting the best managers – those that will consistently outperform peers – will be paramount in this new regime. And those with the ability to find and secure investments with these managers, stand to deliver better portfolio outcomes.

Elevated volatility is driving more dispersion in manager returns

The new regime of heightened macro and market volatility has translated into greater uncertainty, leading to higher dispersion of returns. Structural mega forces, such as demographic changes and emergent technologies like artificial intelligence, are having a profound impact on corporate fundamentals, amplifying winners and losers, and increasing the magnitude of market dispersion. As a result, there is greater uncertainty amongst economic forecasters on data like inflation, which is stoking market volatility and broadening return dispersion.

With less clarity among market participants on the path forward, we see more scope for skilled managers to outperform. Yet the risks associated with, and the importance of avoiding, underperforming managers are also more meaningful. The "Greater Dispersion" chart below shows the last decade of return dispersion amongst hedge funds and illustrates how the forces of the new regime have shifted this spread higher since 2020, relative to the preceding six years. As dispersion has become more pronounced, the preference for active strategies hinges on the ability to reliably pick top-performing managers.

The scope of that challenge is significant, given the vastness of active manager universes. For instance, the number of traditional active equity and fixed income funds globally exceeds 35,000 and 20,000 funds, respectively. Among alternative managers, there are more than 8,000 hedge funds in typical indices, and the private credit space has churned out an average of 300 new fund launches over the past five years.

Understanding these universes necessitates the ability to digest substantial amounts of information of varying quality, while marrying qualitative and quantitative insights. Data may be readily available for some categories, like active equity, though analyzing large datasets of performance and portfolio positioning still requires a substantial investment of time and technological resources. The task is even more difficult in alternative strategies where data is harder to source.

The sheer breadth of funds and associated materials to ingest underscores the magnitude of this endeavor. Those adept at utilizing technology and data, together with the fundamental insights required to take informed views on manager skill, will be best positioned to reliably pick top-tier funds that can deliver strong and persistent alpha.

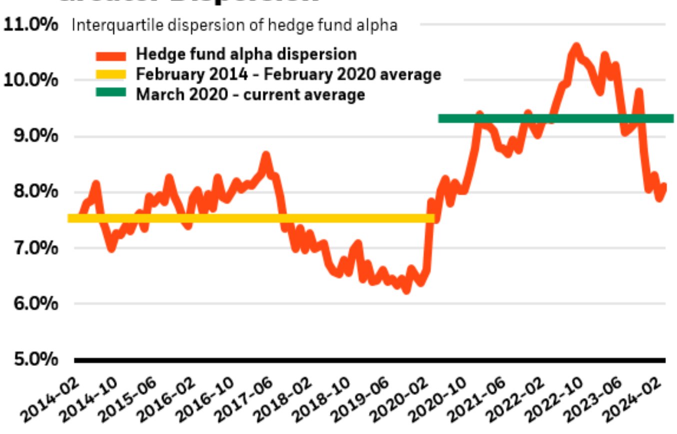
The challenge and opportunity in identifying alpha

To define alpha, it is important to distinguish among the sources of return. Our framework considers three categories: index (e.g., broad market), factor (e.g., macro and style), and alpha (e.g., idiosyncratic or market timing) returns. Within this framework, we interpret alpha as the excess return above a portfolio's benchmark that cannot be explained by broader market, macro, and style factors. In this sense, alpha describes the sources of return derived from manager skill alone and cannot be replicated using cheaper sources (e.g., low fee ETFs).

Unlike broadly investible index or factor products, alpha is scarce, difficult to identify, and subject to great variability. While alpha is ultimately a function of an investment team's skill, the ability to derive this excess return is often dependent on the efficiency of markets. Market inefficiency tends to spike in volatile and uncertain times, enabling skilled managers to capitalize on a wider array of mispricing. Sources of alpha vary, and factor or market timing can be a form of active management capable of generating excess returns; but regardless of how it is generated, alpha generally offers the most consistent source of excess return.

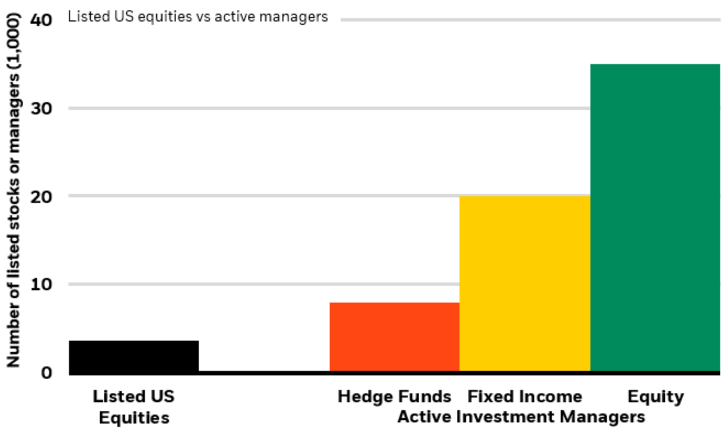
Putting these insights into a portfolio context and referencing the BlackRock Investment Institute's latest capital market assumptions (CMAs), we note broad market performance is unlikely to provide the same level of return that investors experienced over recent years. When market returns are compressed, the contribution of every basis point towards total returns is magnified. Allocating more to alpha is one way in which investors can make up some of this return shortfall.

Greater Dispersion



Source: Hedge Fund Research, ©HFR, Inc., 1 April 2024.

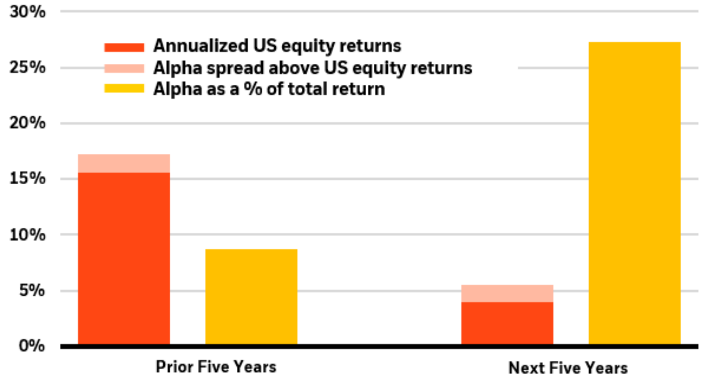
More to Consider



Sources: Nasdaq, World Federation of Exchanges, 1 April 2024.

For example, US equities annualized 15.7% over the five-year period ending December 31, 2023. However, BlackRock forecasts US equities to return 4.0% per annum over the next five years. Assuming a consistent alpha stream of 1.5% above the market return over both five-year periods, a hypothetical active manager's alpha contribution would jump from just 8.7% of total returns in the most recent period to 27.3% in the lower return environment.

Bigger Impact



Past performance is not a reliable indicator of current or future results. Sources: S&P Global, BlackRock Investment Institute, 1 April 2024.

Our framework allows us to analyze the benefits of adding alpha into a portfolio, and assess the trade-offs between cost and complexity, as well as risk and return. By focusing on the measure of alpha in excess of persistent factor exposures, we can ensure the fees paid to active managers are truly a reward for their unique skill, as opposed to exposures that could be accessed through readily investible building blocks.

Managing the costs of active management is a critical part of allocating more to alpha strategies. Those capable of leveraging scale and accessing active managers early in their life cycles can negotiate preferential fee arrangements, reducing costs for investors. Similarly, the limited availability of high-quality, idiosyncratic returns relative to indexing underscores the importance of securing capacity through early access and negotiation. Securing capacity rights is particularly important in less scalable markets like small-cap and international equities, as well as many of the strategies hedge funds operate. Ultimately, it comes down to net returns and obtaining access to managers that can reliably deliver top-ranking results in line with a portfolio's objectives and constraints.

BlackRock Manager Research – experience and partnership

Identifying and evaluating managers capable of producing persistent alpha over the long run is complex and challenging. It demands a team approach backed by cross-functional expertise with personnel that have access to extensive data and insights, underpinned by cutting-edge technology. It can also be bolstered by a comprehensive understanding of the investment landscape, established professional networks, and experience across multiple market cycles.

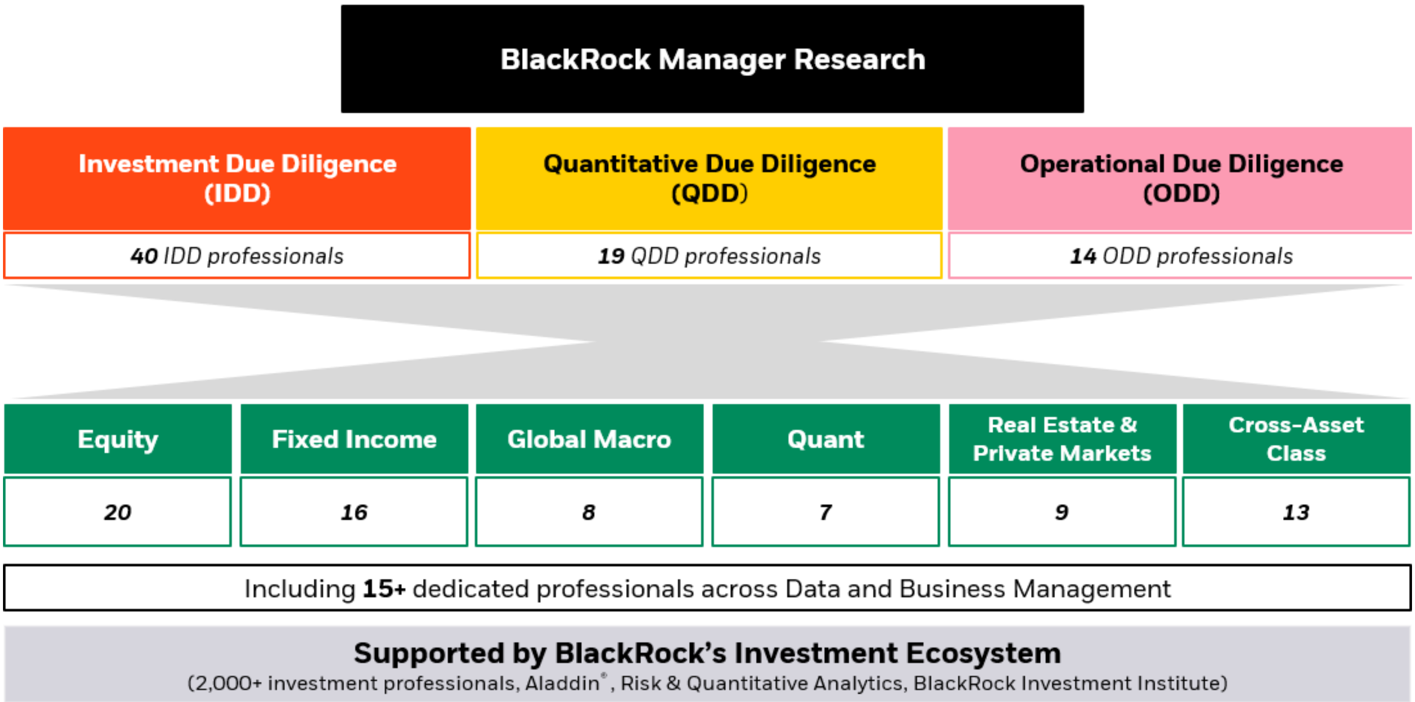
We evaluate investment managers across multiple dimensions in an effort to identify and monitor those that possess competitive advantages relative to peers. Quantitative analytics form the backbone of our investment approach. By gathering granular data (e.g., position-level detail) from diverse sources and leveraging advanced risk systems to process it, portfolios can be assessed both in isolation and across their peer universes. However, we combine these quantitative insights with fundamentally driven investment views, which allow us to build out robust forward-looking assumptions that are not predicated on historical results alone.

Attributes that tend to set higher-quality managers apart are often qualitative. This requires a fundamental understanding of an investment manager's strategy and competitive advantages relative to peers. A qualitative assessment is crucial to the overall and ongoing evaluation of a manager, as their success is primarily a function of the caliber of their people and processes.

At BlackRock, our dedicated Manager Research team is organized across investment functions and located around the world in order to canvas the vast universes of active managers across geographies and asset classes, both public and private. We have a substantial and diverse team that is generally grouped by three key investment functions:

- **Investment Due Diligence:** assesses the investment efficacy of a manager through sourcing and underwriting potential investment opportunities, then continuously monitoring and evaluating existing managers where capital has been deployed.
- **Quantitative Due Diligence:** assesses a manager's key risk drivers and sources of return by assimilating portfolio information that substantiates a qualitative understanding with quantitative metrics through position-level analysis, factor attribution, and forward-looking stress scenarios, among others.
- **Operational Due Diligence:** assesses the operational durability of a manger's processes and capabilities to ensure they meet the complexity of the strategy, including evaluations of expertise amongst personnel, trading and financial infrastructure, and the quality of the service providers engaged.

While we have groups dedicated to specific areas of focus, we emphasize the importance of integrating perspectives and collaborating on investment decisions across our areas of specialization. This commitment to close collaboration allows our team to challenge each other and arrive at joint conclusions.



Source: BlackRock, reflecting team headcount as of 31 March 2024.

A comprehensive approach to manager diligence

We believe investment insight and expertise will be more important today than in the past several decades.

In hindsight, indexing strategies were the right choice in the decade following the Global Financial Crisis, a period of relatively stable market conditions and broad appreciation across asset classes. In such an environment, the benefits of simplicity and low fees for indexed strategies were undeniable, while the alpha impact on total returns was generally less meaningful. However, the investment landscape has shifted.

We see more opportunity for alpha generation in the new regime and the potential for that excess return to make a larger impact on portfolios. Active management comes with a cost, but net returns should ultimately be the benchmark of success and the potential return on resources allocated to alpha-seeking strategies is more compelling today.

In order to deliver better portfolio outcomes, selecting the most skilled managers will be critical. Given the breadth and depth of investible universes, as well as the dispersion within them, there is a substantial need for data and a high-caliber team to evaluate that information. Having the resources to access and process the multitude of underlying datapoints, combined with the investment expertise to put that information into context, is ultimately what is required to make an informed, initial decision. But the work does not stop at the time of initial investment. Ongoing monitoring necessitates the need to consistently re-underwrite allocations, as markets evolve and new information comes online.

All of this calls for a comprehensive approach to manager diligence. Such a framework should be thorough yet selective, with a keen focus on top-quartile managers. This requires an array of touch points, including initial prospecting, onsite meetings, and ongoing portfolio updates. For instance, over the past five years the BlackRock Manager Research ("BMR") team has conducted an estimated 40,000+ meetings, with over 5,000 unique organizations, to identify and continuously monitor best-in-class managers.[1]

BMR has decades of experience successfully partnering with clients to identify and invest in what we believe are the most skilled, active managers within their areas of specialization. This success is rooted in our dedication to a rigorous and robust investment process. We apply a combination of quantitative and qualitative lenses to better understand the true alpha potential for active managers. Our disciplined approach requires significant scale, which is gained from our team of 90+ professionals, specializing and working together across investment functions, as well as the full support of the broader BlackRock organization. BMR's position within BlackRock provides access to extensive data, unique insights, and proprietary technology to go beyond validating claims and, instead, proactively select the best expression of risk to maximize the likelihood of excess performance. Our team and resources are critical to shaping our unique views, which we believe result in better informed decisions to identify managers that consistently anticipate and capitalize on idiosyncratic sources of return. It is these managers that we expect to outperform and persistently generate alpha irrespective of how markets evolve.

[1]Source: BlackRock. Data as of 1 April 2024.

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