

Capturing alpha from non-traditional sources

The RBC Global Equity team



Many people who have managed portfolios for as long as I have feel that there has been too much change. I don't think there has been enough.

Stock picking has always been about trying to predict financial results, based on the assumption that financial results drive share prices.

When I first started in the industry there was a substantial return to hard work and diligence. If one was willing to gather all the accounting data of a group of companies and analyse it one could identify trends in financial performance. Assuming persistence of these trends, one could predict future results and hence drive out-performance.

However technology has made financial data commoditised. In addition what used to take days to process and analyse can now be achieved in a matter of seconds. The process of financial analysis has been industrialised.

This has spawned a new breed of portfolio manager. The quant manager will process a huge amount of financial information on a vast number of companies in a fraction of a second. Their sophisticated algorithms categorise businesses by country, sector, industry, momentum, size, value, etc. enabling them to better predict the companies' financial performance. These insights are used to build portfolios that are well diversified and that can capture much of the traditional manager's outperformance.

How can the humble stock picker compete? You would have thought that these rational analysts would have packed up their pencils and gone home. However, the industry for traditional stock analysts continues to thrive.

This has led many asset owners, consultants and advisors to believe that markets are now highly efficient. However, data suggests that there remains a huge variation in share prices. The problem is that the stock picking investment community has failed to turn this variation into consistent outperformance.

It is clear to me that future financial performance is driven by more than past financial performance. We need to find new and better ways of predicting future financial performance. Assuming that the financial data has been squeezed dry, we need to find new sources of out-performance – new insights to deliver alternative sources

of alpha. As someone who has been picking stocks for years I have found many instances where two businesses of similar size, location, using similar people and processes to produce identical goods or services that are sold to the same customers, have produced dramatically different financial returns over the long run. Same industry, same inputs, same outputs, different financial outcomes...why?

In my opinion it is down to intangible or non-financial data. These intangible data include things like corporate culture, employee and customer engagement, effectiveness of R&D and a willingness to place a high degree of importance on Environmental, Social & Governance (ESG) factors. These are typically long term intangible assets that can have a short term financial cost, but will pay off handsomely over the longer term. These intangible assets are hardly ever found in the report and accounts. Information on them is hard to access, assimilate and conclude upon. But they are nonetheless a very powerful predictor of long term financial performance.

These are alpha sources that asset owners are not accessing but can play a very valuable part in their portfolios. Not only do they lead to investments in better businesses with a better ESG footprint, lower portfolio turnover and reduced transaction costs but, crucially, the out-performance derived from non-financial sources is idiosyncratic in nature and has a low correlation to more traditional systematic, quantitative sources. They are a different flavour of outperformance, or true alpha, and so including these alpha sources can diversify the return stream of a portfolio.

Importantly we, the Global Equity team at RBC Global Asset Management, believe that the pursuit of these alpha sources must be an integral part of the investment process and enshrined in a manager's philosophy. It is not enough merely to add on a screen or a rating once the traditional form of analysis has been concluded. Factors such as ESG should comprise a non-negotiable, essential component of fundamental stock research. As a team we make a judgment on management and ESG as part of our assessment of every company we invest in.

While this might sound attractive there are of course significant practical challenges. These fall into two categories:

First, alpha generation. One needs a philosophy, process, tools, skills and expertise to gather and collate the

relevant information, analyse it and then draw conclusions from it. Given that this information is non-standard, not necessarily comparable, consistent or complete - the task of drawing relevant conclusions from it is far from trivial.

Second, alpha capture. Identifying a group of companies that is likely to produce superior long term financial results is one thing. Combining them into a portfolio that outperforms due to these alpha sources is another challenge altogether. Correlations between stocks will cause unintended concentrations which may lead to large positive or negative returns that may overwhelm the alpha associated from good stock picking. Hence it is critical to have an alpha capture framework that is able to isolate the

impact of these alpha sources and to control the impact of unintended systematic exposures.

In conclusion, just as the out-performance potential from financial data has been industrialised by computers and quantitative algorithms, I believe there are a number of alternative sources of alpha that are available to the stock picker to drive out-performance. These alpha sources are non-financial in nature and are powerful catalysts of long term financial results. Accessing and analysing these alpha sources requires a philosophy, process and team that are sensitive to this non-traditional information, and different skills and expertise whilst efficiently capturing this alpha is an added challenge.

ABOUT THE AUTHOR

Habib Subjally

Head, RBC Global Equity
RBC Global Asset Management (UK) Limited

Habib leads the RBC Global Equity team of 11 global equity specialists (sector, portfolio and risk management) and has more than 20 years of industry experience. Before joining RBC Global Asset Management in 2014, Habib and his team spent eight years together at First State managing Global equities. Previously, Habib was Head of Small & Mid Cap Research at Credit Suisse and Head of the Global equities team at Invesco. Habib began his fund management career at Merrill Lynch Investment Managers where he was Head of North American and Global equities research and Manager of the Mercury Global Titans Fund.

Habib is a Certified Chartered Accountant and holds the ASIP designation with the CFA Society of the U.K. He holds a BSc (Hons) from the London School of Economics.



This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell any security, product or service in any jurisdiction. This document is not available for distribution to people in jurisdictions where such distribution would be prohibited.

RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, RBC Global Asset Management (Asia) Limited, and BlueBay Asset Management LLP, which are separate, but affiliated subsidiaries of RBC.

In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe this document is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong.

This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate, be distributed by the above-listed entities in their respective jurisdictions. Additional information about RBC GAM may be found at www.rbcgam.com.

This document is not intended to provide legal, accounting, tax, investment, financial or other advice and such information should not be relied upon for providing such advice. RBC GAM takes reasonable steps to provide up-to-date, accurate and reliable information, and believes the information to be so when printed. RBC GAM reserves the right at any time and without notice to change, amend or cease publication of the information.

Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions.

Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index.

Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

© / TM Trademark(s) of Royal Bank of Canada. Used under licence.

© RBC Global Asset Management Inc., 2020

Publication date: (November, 2015)

GUK/20/032/JAN22/A

