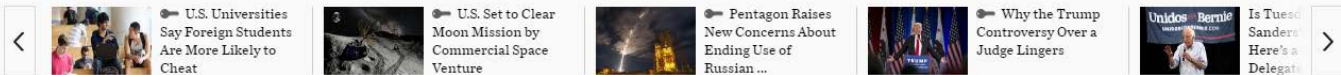


Is your strategy built for  
assets or alpha?

Let's spot the closet-indexer



THE EXPERTS | WEALTH MANAGEMENT

## Why Your Fund Manager May Not Have the Same Goal as You



A fund's size can create a conflict of interest between investors, who want to maximize performance, and managers, who just want more assets, even when this hurts their performance, says WSJ Wealth Management Expert Wesley Gray. PHOTO: GETTY IMAGES/IMAGE SOURCE



By **WESLEY GRAY**  
May 10, 2016 9:00 am ET

0 COMMENTS

*Wesley R. Gray (@alphaarchitect) is the CEO and CIO of Alpha Architect, a quantitative asset manager based near Philadelphia.*

### Observation #1

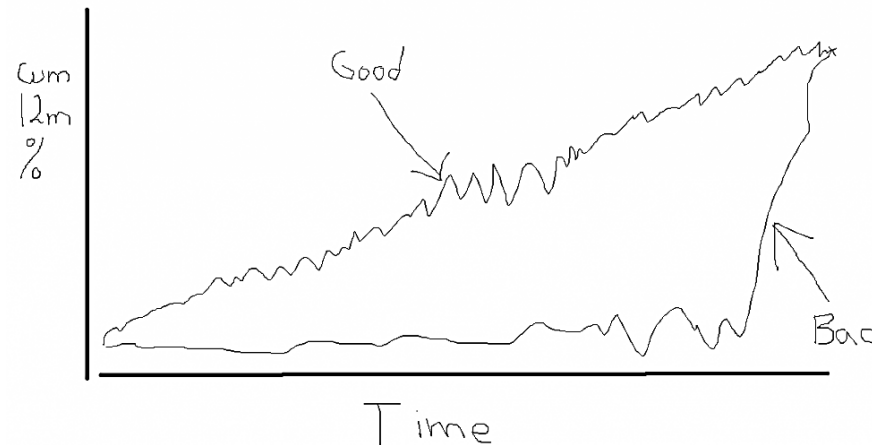
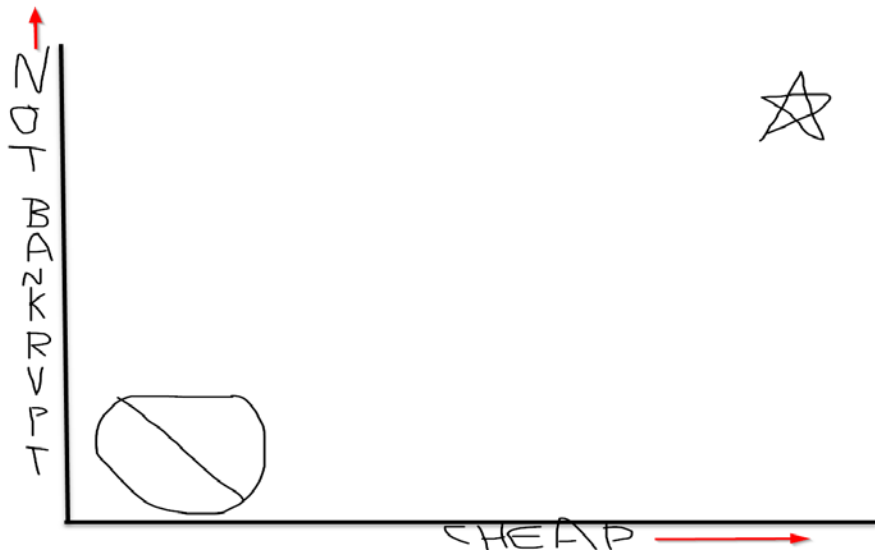
Bigger Wallet = Less E(Alpha)

### Observation #2

Closet Indexing = Less E(Alpha)

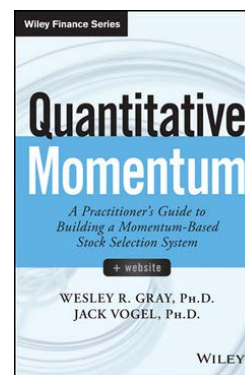
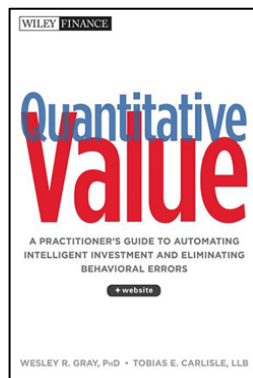


# Two open secrets: value and momentum



We seek to buy the **cheapest** **highest quality** value stocks

We seek to buy stocks with the **highest quality** momentum



# Long-only generic momentum portfolios

EW CAGRs								
		Number of Stocks Selected each month						
		50	100	150	200	250	300	500
Holding Period for each Stock	1	18.69%	17.72%	17.28%	16.74%	16.11%	15.58%	14.60%
	2	17.93%	17.39%	16.58%	16.01%	15.54%	15.09%	14.40%
	3	17.61%	16.79%	15.95%	15.42%	15.06%	14.73%	14.18%
	4	16.79%	16.03%	15.36%	14.92%	14.68%	14.43%	14.00%
	5	16.59%	15.70%	15.15%	14.67%	14.44%	14.25%	13.93%
	6	16.00%	15.24%	14.77%	14.40%	14.20%	14.01%	13.77%
	7	15.42%	14.85%	14.46%	14.17%	13.98%	13.81%	13.62%
	8	14.81%	14.49%	14.13%	13.89%	13.74%	13.61%	13.48%
	9	14.14%	13.98%	13.70%	13.54%	13.44%	13.33%	13.28%
	10	13.49%	13.49%	13.29%	13.22%	13.16%	13.09%	13.09%
	11	12.75%	12.97%	12.89%	12.84%	12.83%	12.79%	12.90%
	12	12.09%	12.43%	12.48%	12.48%	12.51%	12.50%	12.69%

- ➔ Closet-Indexing **Decreases** Expected Performance
- ➔ Closet-Indexing **Decreases** Career Risk



\*The results are hypothetical results and are NOT an indicator of future results and do NOT represent returns that any investor actually attained. Additional information regarding the construction of these results is available upon request. Sample is from 1970 to 2014. Results are associated with a generic 2-12 momentum index strategy. Indexes are unmanaged, do not reflect management or trading fees, and one cannot invest directly in an index. All returns are total returns and include the reinvestment of distributions (e.g., dividends).

## Long-only generic **value** portfolios

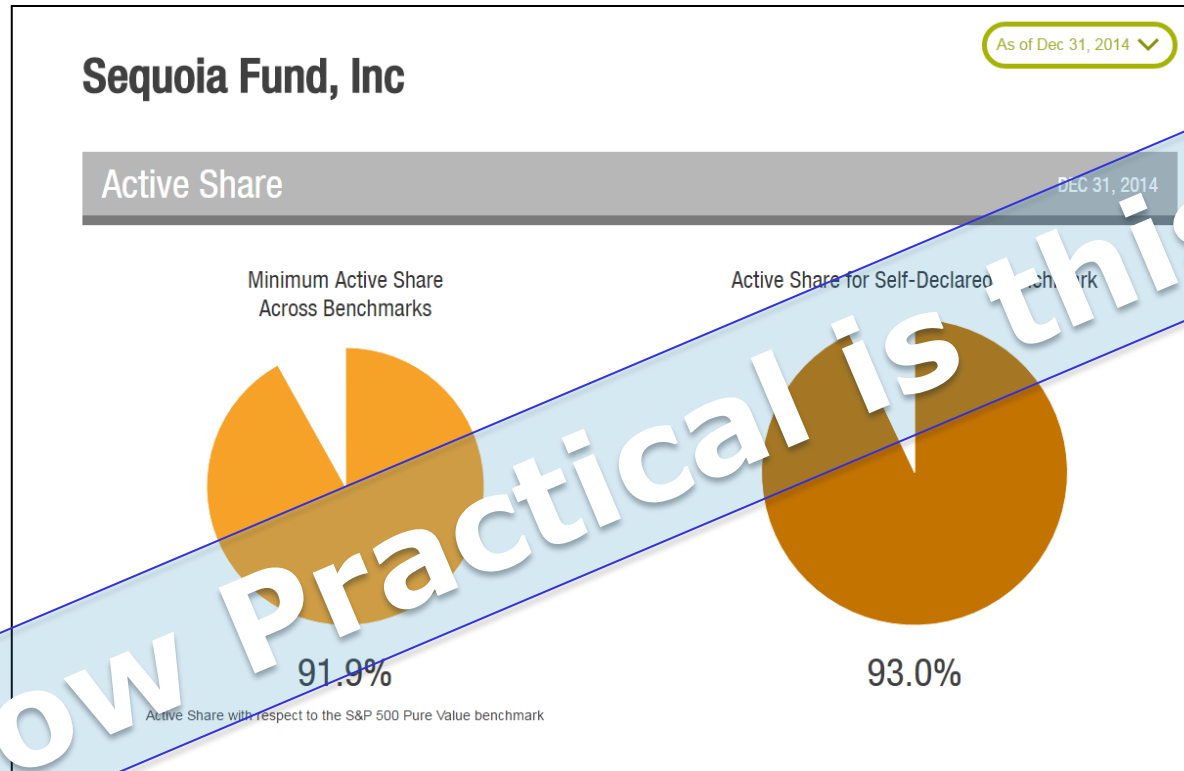
EW CAGRs								
		Number of Stocks Selected each month						
		50	100	150	200	250	300	500
Holding Period for each Stock	1	17.41%	17.22%	17.12%	16.61%	16.31%	15.86%	14.69%
	2	17.00%	16.72%	16.63%	16.21%	15.95%	15.64%	14.56%
	3	16.99%	16.50%	16.42%	15.99%	15.83%	15.54%	14.51%
	4	16.48%	16.32%	16.20%	15.86%	15.71%	15.47%	14.51%
	5	15.99%	15.98%	15.93%	15.63%	15.53%	15.34%	14.46%
	6	15.63%	15.72%	15.70%	15.41%	15.36%	15.22%	14.43%
	7	15.34%	15.53%	15.58%	15.36%	15.28%	15.15%	14.42%
	8	15.26%	15.47%	15.54%	15.31%	15.25%	15.12%	14.44%
	9	15.27%	15.42%	15.48%	15.25%	15.20%	15.09%	14.46%
	10	15.36%	15.45%	15.47%	15.24%	15.22%	15.07%	14.48%
	11	15.37%	15.45%	15.46%	15.25%	15.22%	15.07%	14.49%
	12	15.43%	15.48%	15.46%	15.24%	15.20%	15.07%	14.49%

- ➔ Closet-Indexing **Decreases** Expected Performance
- ➔ Closet-Indexing **Decreases** Career Risk



\*The results are hypothetical results and are NOT an indicator of future results and do NOT represent returns that any investor actually attained. Additional information regarding the construction of these results is available upon request. Sample is from 1970 to 2014. Results are associated with a generic cheap decile EBIT/TEV index strategy. Indexes are unmanaged, do not reflect management or trading fees, and one cannot invest directly in an index. All returns are total returns and include the reinvestment of distributions (e.g., dividends).

# How to spot the closet-indexer?



How Practical is this?

$$\text{Active Share} = \frac{1}{2} \sum_{i=1}^N |w_{fund,i} - w_{index,i}|$$



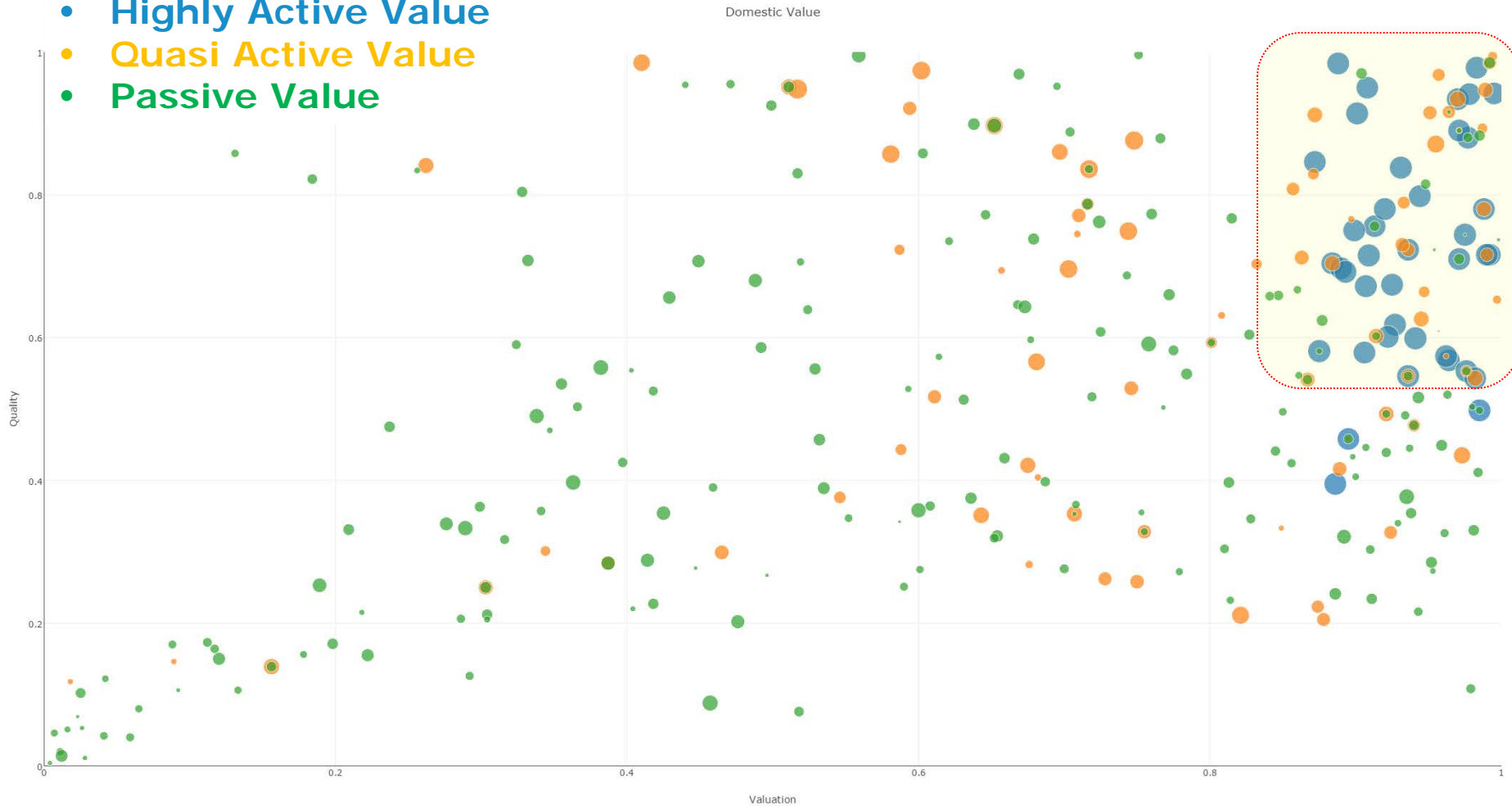
A picture is worth...

*One  
thousand  
words...*

Visual Active Share

# Let's spot the value investing closet-indexers

- **Highly Active Value**
- **Quasi Active Value**
- **Passive Value**

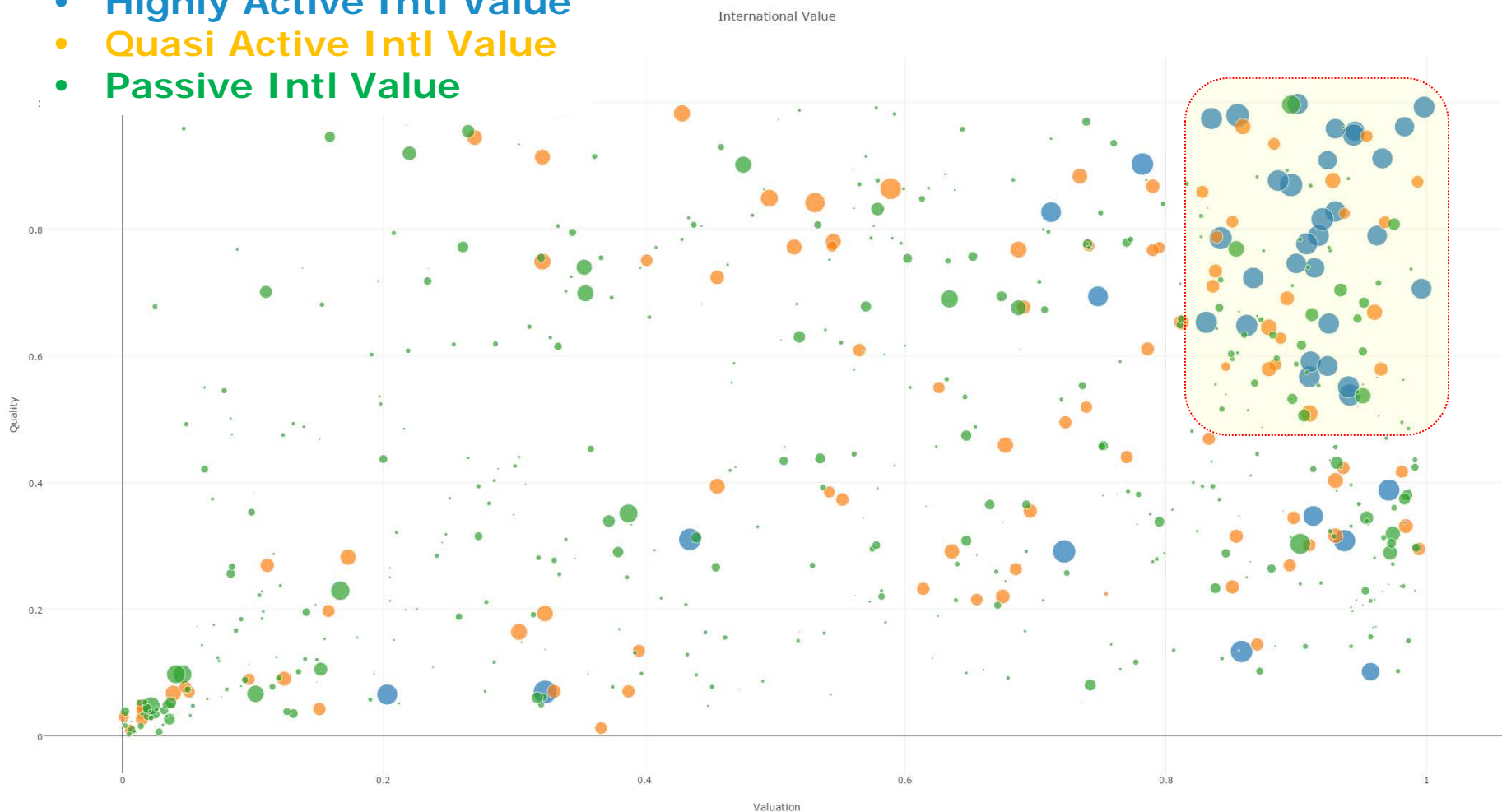


Cheap, High Quality



# Let's spot the value investing closet-indexers

- **Highly Active Intl Value**
- **Quasi Active Intl Value**
- **Passive Intl Value**

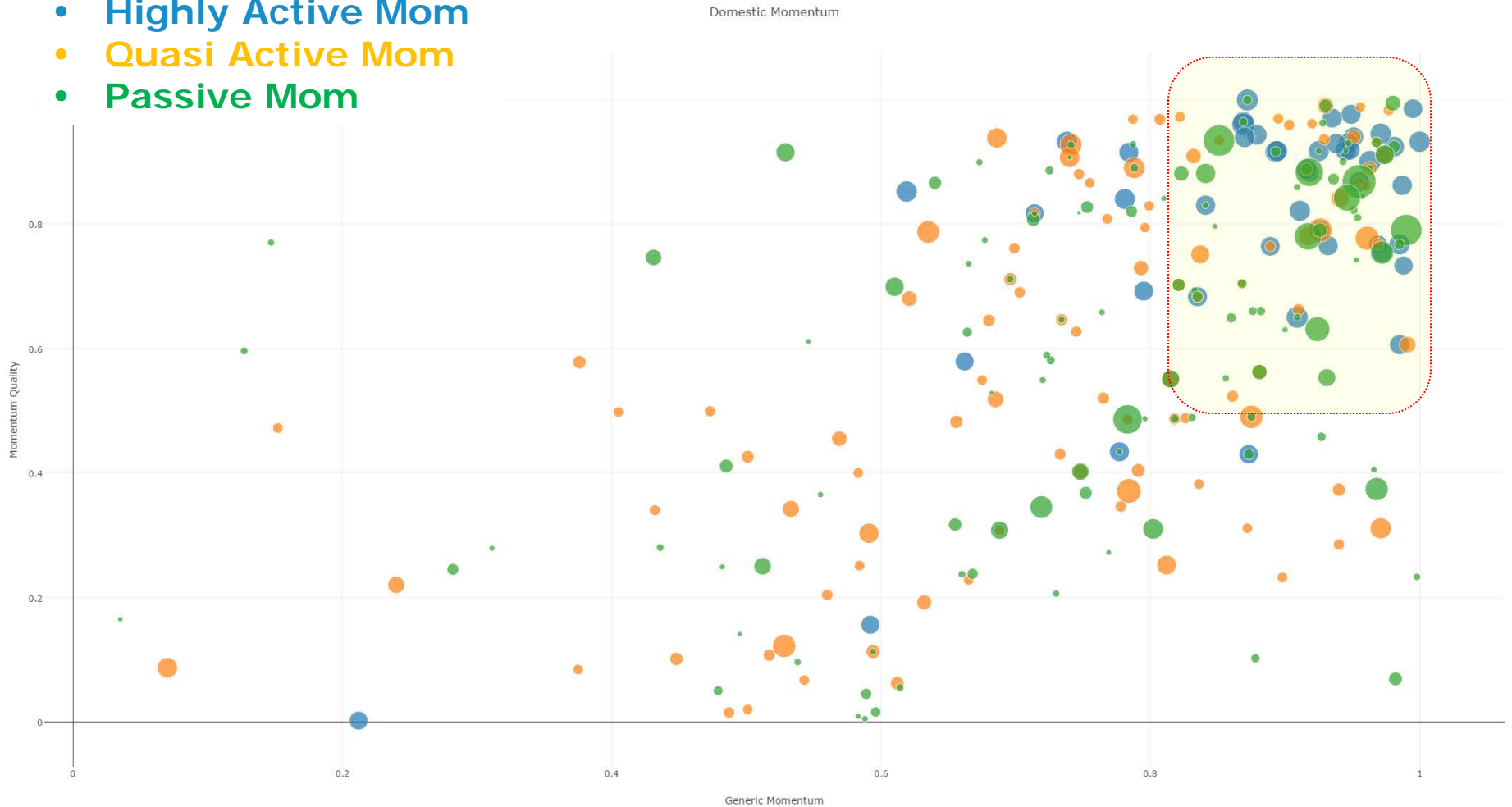


Cheap, High Quality



# Let's spot the momentum investing closet-indexers

- **Highly Active Mom**
- **Quasi Active Mom**
- **Passive Mom**

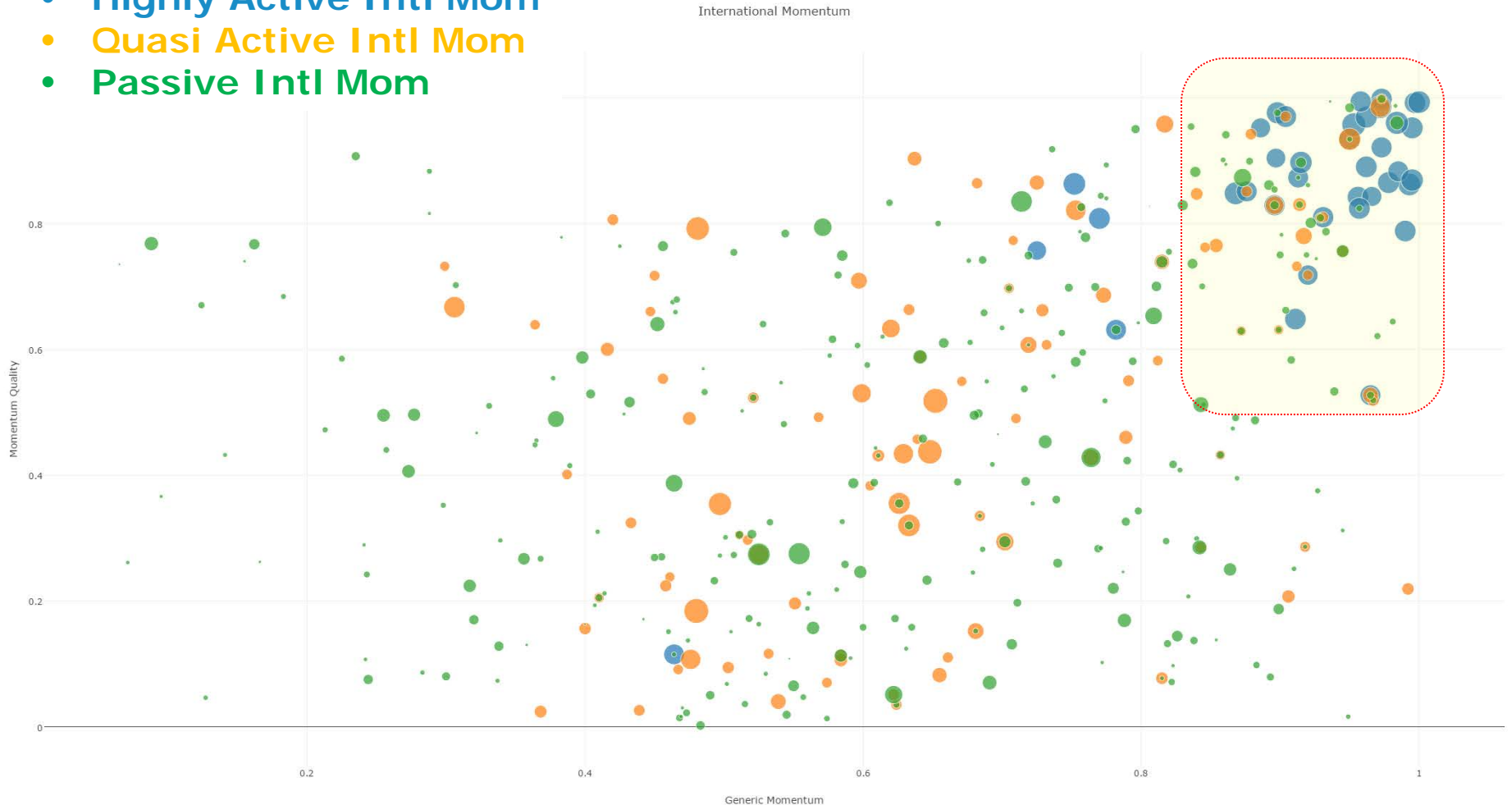


## High Quality Momentum



# Let's spot the momentum investing closet-indexers

- **Highly Active Intl Mom**
- **Quasi Active Intl Mom**
- **Passive Intl Mom**



## High Quality Momentum



# APPENDIX



## Disclosures

Performance figures contained herein are hypothetical, unaudited and prepared by Alpha Architect, LLC; hypothetical results are intended for illustrative purposes only.

Past performance is not indicative of future results, which may vary.

There is a risk of substantial loss associated with trading commodities, futures, options and other financial instruments. Before trading, investors should carefully consider their financial position and risk tolerance to determine if the proposed trading style is appropriate. Investors should realize that when trading futures, commodities and/or granting/writing options one could lose the full balance of their account. It is also possible to lose more than the initial deposit when trading futures and/or granting/writing options. All funds committed to such a trading strategy should be purely risk capital.

Hypothetical performance results (e.g., quantitative backtests) have many inherent limitations, some of which, but not all, are described herein. No representation is being made that any fund or account will or is likely to achieve profits or losses similar to those shown herein. In fact, there are frequently sharp differences between hypothetical performance results and the actual results subsequently realized by any particular trading program. One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or adhere to a particular trading program in spite of trading losses are material points which can adversely affect actual trading results. The hypothetical performance results contained herein represent the application of the quantitative models as currently in effect on the date first written above and there can be no assurance that the models will remain the same in the future or that an application of the current models in the future will produce similar results because the relevant market and economic conditions that prevailed during the hypothetical performance period will not necessarily recur. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the preparation of hypothetical performance results, all of which can adversely affect actual trading results. Hypothetical performance results are presented for illustrative purposes only.

Indexes are unmanaged, do not reflect management or trading fees, and one cannot invest directly in an index.

There is no guarantee, express or implied, that long-term return and/or volatility targets will be achieved. Realized returns and/or volatility may come in higher or lower than expected.



QUESTIONS?

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