Swedroe, Larry E., Berkin, Andrew L. – The Incredible Shrinking Alpha

BAM Alliance Press, 2015 [Equity Investing] Grade ★★

The Incredible Shrinking Alpha´s core purpose is to show that active management is futile and as "alpha has become beta" those futile odds have been lowered even more compared to the 1950s. One of the authors, Larry Swedroe is a well-known proponent of investing in ETFs, while Mr. Berkin works at Bridgeway, an active user of ETFs within their products. A disclosure is justified here. This reviewer has a day job of gracing the savannah of active equity management. But while the books with related topics by John Bogle and Charles Ellis have resonated with me and added to the thinking around indexation, this book merely comes across as trying to make a quick buck.

A large part of the book is spent on how returns over time have morphed from alpha to beta. For those of you who have not kept up with this battle of brains throughout the years, it has got to do with the following: After publishing the theories behind the efficient market hypothesis (EMH) other academics later produced studies that disproved this. These discovered "anomalies" to the EMH were later reclassified as rational "risk factors", such as the small cap factor, value factor, momentum factor, quality factor and counting. All this is of course in hindsight, after the fact. But the book treats them as predictable stating "*once again alpha becomes beta*".

So decades after Warren Buffett, Peter Lynch and lesser-known peers have produced superior results, they are removed by the stroke of a pen as "just exploiting a factor". Did Buffett make his 1967 acquisition of National Indemnity in an afternoon because he recognized that the P/BV-factor would be the best anomaly to exploit during the next 50 years? Or Coca-Cola in 1988 because of the Gross Profitability Factor that was to be "discovered" by Novo-Marx in 2012? An active manager "exploiting a factor" is now as the authors see it turned into an "*evidence-based, transparent and systematic*" strategy under the hood of an ETF. Where were the momentum-, value- and quality EMH:ers in 1981 when the size-factor was discovered? And what alpha-returns of today will later be labeled beta?

The format of the book goes something like this: one chapter each on problems at hand ("No more alpha to chase for active managers"), why it was not a problem before, details about the problem and finally what the solutions are ("here is how we can help"). This runs to 90 pages, and the rest is a series of appendices on related studies, references and various advice.

The main problem with the book is the blending of correlation and causation, facts and fiction, ex-post and ex-ante and just large-scale confusion of whom this book is really for. These shortcomings are a pity, because the main point of harder relative competition for returns are likely correct. This ought to have serious implications on work processes and utilization of fundamentally based active management. In this the bigger picture is lost: Whether or not it is active managers searching for alpha or EMHers launching smart beta ETFs, we should all look for maximum real returns! Our fiduciary duty are toward the final saver, and whereas the capital market is a relative zero-sum game it is certainly not so in an <u>absolute</u> sense. Just ask any Argentinean and she will tell you all about it. As index-vehicles just return what the corporate averages give them, there is no God-given right to the highest possible return. There is no consideration of the Darwinian effects of capital allocation, business ethics, creating new profit streams & employment – all affecting the public return from equities. The end game of an all-indexed world is perhaps the most obvious problem of the free-rider status of passive funds.

The authors do the little investor no favor by luring them into vehicles like ETFs where the lower cost potential are eaten for breakfast by overtrading. And the book is frustratingly long on stripping the performance records of Buffett, Swenson et al, and very short on discussion points on how to maximize real return over time.

Henrik Andersson, April 19, 2015