

FASHION PASSES

style remains

In an investment world defined by uncertainty and volatility, portfolios need inbuilt resilience. *Davide Alfano* of Kaleidoscope Capital explains why Coco Chanel's famous quote resonates so strongly with today's selectors



Investors are not necessarily fully rational in their judgments and emotions may drive asset prices, or at least their volatility, beyond fair values. People overreact during both adverse and favourable situations, while to euphoric or panic-stricken behaviour can create market bubbles and crashes. So how do you react rationally.

Style diversification is an efficient, but overlooked way to counter these outcomes. This approach can limit portfolio drawdown during a market sell-off and optimise the capital allocation by increasing its Sharpe Ratio. This strategy is based on a simple but effective idea: style is resilient.

There is a lot of discussion about portfolio diversification in general. The number of managers usually represents the first dimension of this subject. By increasing the number of funds in a portfolio, there is an obvious expectation of reducing its idiosyncratic risk, although this happens at a marginally decreasing rate.

The number and type of asset classes in a portfolio represents another facet of diversification. Investors would expect a portfolio invested in different asset classes to exhibit more stability through the economic cycle with more capacity to capture different sources of beta drivers and risk factors.

Unfortunately, the intervention of central banks and governments has taken its toll. Managing the financial crisis and preventing deflationary forces from overwhelming the global economic system seems to have affected the traditional behaviour of asset classes, both on their own and in their interaction with one another.

According to a recent IMF report, the median correlation between traditional asset classes has structurally increased since 2008 to a level that is almost twice the previous equilibrium value. Cross-asset correlations have also risen now that market shocks in one asset class or country can spread so quickly to others.

For this reason a truly diversified portfolio should always be multi-dimensional and diversified along orthogonal

investment styles, especially during periods of market dislocation when investors over-react and irrational sentiment drives asset prices.

WHAT CONSTITUTES STYLE?

A manager's investment style reflects his academic and professional background, but it also depends on his character, risk aversion and personal history. Style develops with time through a manager's experience and track-record. It represents a unique filter developed by a manager through which he can analyse facts and invest. Style may change, but not easily, never randomly and, above all, not very quickly.

During a sharp market correction, where there is a lack of

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clarity about the fundamental causes of the retracement, a portfolio manager is likely to stick to what he trusts more: his investment style and ideas. Consequently, the portfolio will remain relatively stable and predictable from a style perspective. Therefore, during periods of market sell-off, when correlations between securities and asset classes tend to spike, correlations between investment styles are likely to remain the same or, possibly, decrease.

In this way the embedded alpha of a portfolio properly diversified by managers' styles is more sustainable and higher than the sum of the alphas generated by each fund, and sound style diversification is itself a source of alpha.

It is also worth noting that while a mix of style is a valuable tool to achieve a truly diversified portfolio, it does not

represent a constraint for the performance upside. On the contrary, style diversification improves the asymmetry of a portfolio's expected returns. The diversification gain obtained by optimising the portfolio in terms of style premia allows for a higher concentration on each single name and a focus on high-conviction ideas. In this way, more market upside is likely to be likely captured with less volatility and downside risk.

HOW TO STOCK A STYLE STABLE

At Kaleidoscope, we focus on identifying best-in-class managers with a clear investment strategy and a sustainable approach. We expect these managers to provide consistent, superior risk-adjusted returns within their specific investment niches.

Alongside this we aim to uncover uncorrelated and less conventional sources of alpha to enhance portfolio diversity.

Besides a focus on alpha, our investment universe is completely unconstrained by asset class, geographic focus and, above all, managers' trading styles.

We generally prefer niche solutions and managers at their mid-stage of business development, as we believe this is the sweet spot where we can add more value to our investors.

When investing in more established and blue chip managers we focus on those who are able to maintain a high degree of commitment. Established managers offer experience and a proven business set-up, but we look at their motivations and experience in parallel. The maturity of the investment approach has to be combined with a continuous fresh look at the world and the business.

Selecting managers using this criteria can help investors construct a portfolio that is both versatile and resilient – two qualities that are particularly relevant in today's unpredictable investment climate

Davide Alfano is founder and managing partner of Kaleidoscope Capital in London

WORKSPACE

Fund selectors reveal the tools and good luck charms they use to navigate the markets

DAVIDE ALFANO

Kaleidoscope Capital, London



iPad: We are always on the go, so we want to travel light but in a structured way. All our analysis and notes on the managers remain accessible everywhere through a private cloud and we feed them back in real time into the system.

Kaleidoscope: For us this is more than a name, it represents an attitude, of being able to see different patterns in markets through a continuous change of perspective and an open mindset. The word 'kaleidoscope' derives from the ancient Greek and might be translated as 'observation of beautiful forms'.

Bike: My red road bicycle gets plenty of use both for commuting and leisure.

CAREER HISTORY

Before founding Kaleidoscope, Davide spent 10 years at Thalia, the former hedge fund competence centre of Generali Group. Here, he was responsible for investments in the equity long/short strategy for European and Asian managers and was also a portfolio manager on Generali's flagship funds of hedge funds.

Prior to this he was an equity portfolio manager for Epsilon, a former independent boutique with a focus on proprietary quantitative investment methods. Epsilon is now part of Eurizon Capital, the asset management arm of Intesa Sanpaolo Group.

Davide holds an MSc in economics & finance from Warwick Business School and a degree in economics & social science from Bocconi University.

He has also served as an officer in the Italian Navy.

HOBBIES

'I am a curious person and am always keen to experiment and try new things but three activities occupy most of my spare time and passion:

FIRST I love listening to music, of every sort, everywhere;

SECOND I enjoy riding my bike – with friends, on my own and, above all, with my child;

LAST, BUT NOT LEAST I love sailing. "Keep moving, keep floating, wind is life." This is my main and very simple motto.'

