SelectAlts
Wisely Managed Absolute Return Portfolios

Following the Leaders: ALFA, GURU, and IBLN

The SEC requires that all institutional investment managers with more than $100 million in equity assets under management file a list of their long equity holdings within 45 days of the end of each calendar quarter using Form 13F. This is public information that can be easily accessed through a variety of databases and provides an interesting opportunity to "look over the shoulder" of nearly any investment manager with U.S. assets under management. There is some evidence that this information can lead to market-beating investment performance.

Several ETFs focus exclusively on the strategy of mimicking the large holdings of prominent 13F filers. The basic idea behind all of these funds is the same—invest with the big, smart money—and all follow a similar process:

1. Identify leaders among 13F filers who are worth following based upon some combination of the size of their personal fortunes and/or the size of their funds.
2. Screen out leaders whose turnover is so high that a 45 day lag makes the efficacy of their 13F filing data less useful.
3. Measure the efficacy of buying their largest long equity positions over some trailing period, usually a few years, and rate them accordingly. Limit the list to those at the top.
4. Limit the number of holdings either by using a strict cutoff (30 in the case of IBLN) or a more opaque set of criteria (ALFA and GURU).
5. More-or-less equal weight all of the holdings—although in the case of ALFA, holdings that overlap a number of the managers will get a higher weighting.
6. Rebalance quarterly after the latest 13F filing data is made public.

Given the similarities in methodology, two obvious questions arise for investors:

- Are they different and if so how?
- Which one is the best one to own?

In this article I will address these questions as they apply to the three largest and most liquid of the 13F ETFs, which I call "Follow the Leaders" funds:

1. AlphaClone Alternative Alpha ETF (ALFA).
2. Global X Guru Index ETF (GURU).
3. Direxion iBillionaire Index ETF (IBLN).

There are also two newer, smaller, and less liquid 13F funds that may be worth watching: Global X Guru Small Cap (GURX) and Global X Guru International (GURI). However, I will limit my analysis to the three listed above.

13F Follow the Leaders Funds

Basic Information

Fund Ticker	ALFA	GURU	IBLN
Fund Inception Date	5/31/2012	6/5/2012	8/1/2014
Fund Assets ($ Mil.)	78.9	495.0	35.2
5 Day Avg. Bid-Ask	0.15%	0.09%	0.06%
Fund Expense Ratio	0.95%	0.75%	0.65%
Benchmark Index	ALPHACLN	GURU	BILLION
Index Start Date	2/18/2000	2/23/2009	11/14/2007
1Yr. Adjusted Beta	1.205	1.108	1.079
Median Mkt. Cap. ($ Bil.)	20.0	26.6	42.2
Average P/B	3.28	2.4	2.65
U.S. Allocation	92.8%	90.5%	93.8%
Number of holdings	84	56	31

The table above supplies basic information on these three ETFs. More information on them is widely available on the web. Some good articles have been written on them, especially at *SeekingAlpha.com.* I published an article on ALFA there last year.

Are They Different?

All three of these ETFs have quite a lot in common in addition to the similarities in their methodology. All are large enough to be quite liquid, with low bid-ask spreads, including IBLN, which has only been trading since the beginning of August. All focus on U.S. holdings.

I do not list the holdings, but among the top 10 holdings of each fund only two or three were also among the top 10 holdings of one of the other funds. This overlap is surprisingly modest, particularly in light of the methodological similarities among them.

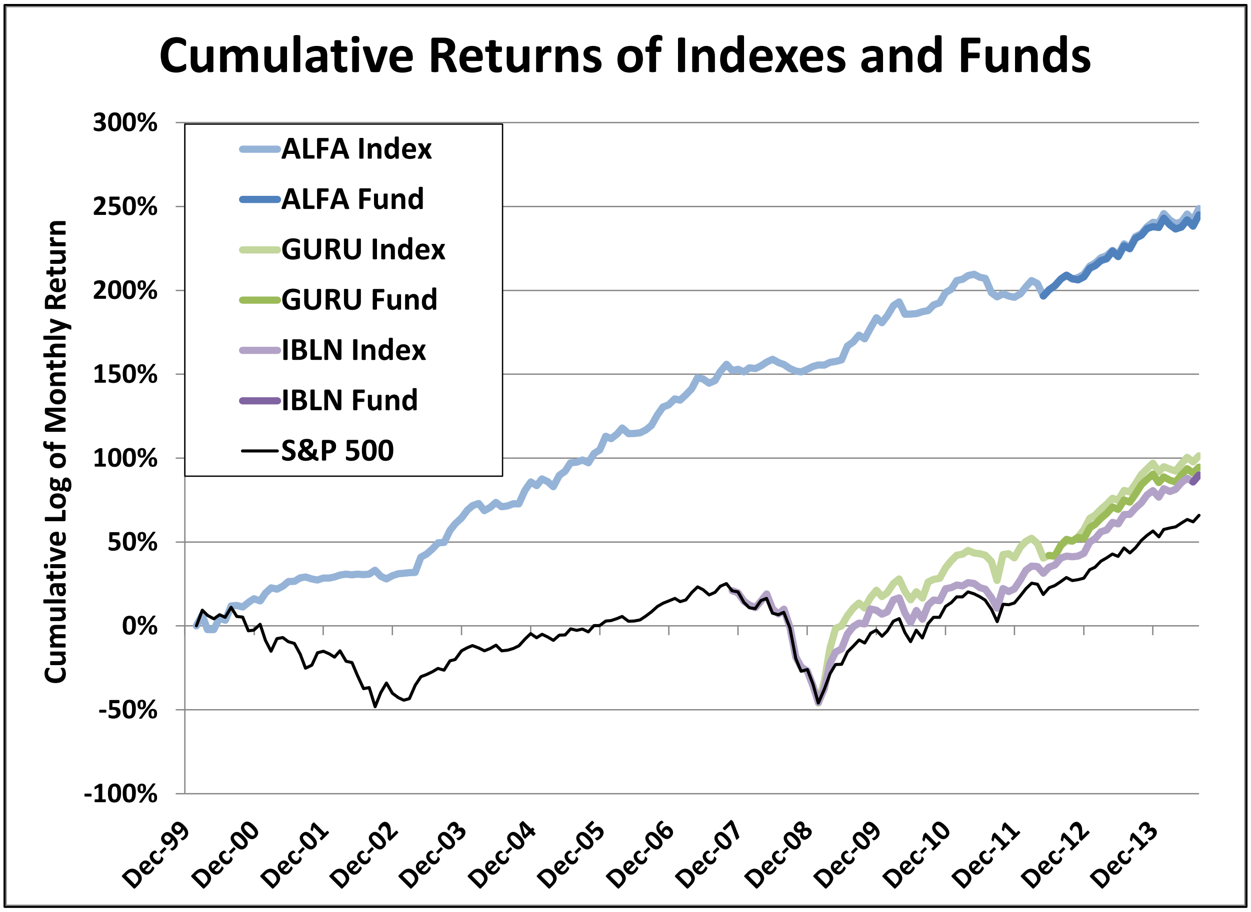
A quick look at the table above will reveal some subtle differences among the three ETFs. ALFA has the lowest median market capitalization, the highest price/book value, and the largest number of holdings.

At the other end of the spectrum is IBLN. Its 31 holdings are all drawn from the S&P 500, and not surprisingly it has the highest median market capitalization.

Of course, holdings analysis is dependent upon the outcome of the latest quarterly rebalancing of each fund. A more sweeping look across time would be preferable, but past holdings data is difficult obtain and tedious to analyze. An alternative method, which I prefer, is to analyze returns over time.

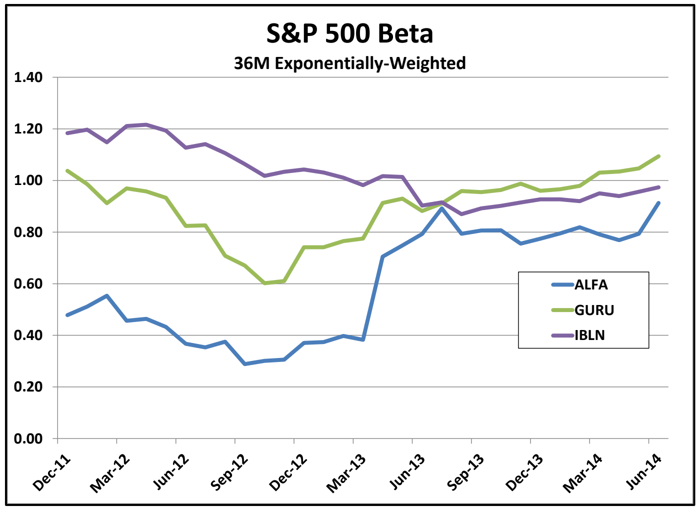
One of the problems with trying to statistically analyze the returns of ETFs is that many of them have a limited return history. An extreme case is IBLN, which only started trading on August 1, 2014.

Fortunately, passively managed ETFs often provide some return history for their benchmark indexes. Because these funds normally stick very close to their benchmark indexes, this information can be potentially useful in that it provides a longer return history than the live fund. One the other hand, because in many cases the ETF managers created the benchmark index themselves, there is a lot of opportunity for gamesmanship. The rules of index construction can be fine-tuned to optimize performance during the historical backtest period. Consequently, one must use this backtested index history with a healthy dose of skepticism.



The graph above depicts the cumulative return index for each three ETFs and their respective benchmark indexes since inception. (I use the logs of the monthly returns so that the slope will have the same meaning all along.) The live fund is in the darker color and the benchmark index in the lighter shade. The fund returns diverge slightly from the benchmark indexes over time because of the return drag of the expense ratio, as well as other implementation costs.

ALFA has a much longer index history than the other two. It is also the only one of the three that will hedge out some of its equity market risk. Its hedging discipline is straightforward: if the S&P 500 ETF (SPY) closes below its 200-day moving average on a month-end rebalance date, then 50% of ALFA will be invested in the inverse S&P 500 ETF (SH) as a hedge. It will be taken off at the next month-end rebalance in which the SPY closes above its 200-day moving average. This hedge is why the ALFA index was so flat during many of the negative periods for the S&P 500, and why its S&P 500 beta (shown above) was until recently so much lower than was the case with the other two. Of course, this is all based on hypothetically applying the rules of a recently constructed index to history, including its hedging rules. If future market declines are sharper and more short-lived, these hedging rules may not help. Also, if the in the future the market behaves more in a whipsaw fashion rather than a trending fashion, these hedging rules could detract from return. On top of that, it may be that an investor would prefer to implement his or her own hedge. For good or ill, this hedging feature is the most important distinguishing characteristic of ALFA.



Monthly Return Correlations Benchmark Indexes 3/2009 - 8/2014				Monthly XS Return Correlations Benchmark Indexes 3/2009 - 8/2014			
	ALFA	GURU	IBLN		ALFA	GURU	IBLN
ALFA	1.00			ALFA	1.00		
GURU	0.54	1.00		GURU	-0.36	1.00	
IBLN	0.62	0.91	1.00	IBLN	-0.18	0.44	1.00

The two correlation tables above use the overlapping historical returns of the benchmark indexes beginning in March, 2009. The left panel is based on raw returns, and the right panel on excess returns, calculated by subtracting the S&P 500 return from the raw return each month. The historical distinctiveness of ALFA shows up clearly, even in the raw returns of the left panel. By contrast, the raw returns of GURU and IBLN are 91% correlated. However, as a rule, all long-only equity funds tend to have very high correlations because of the commonality of the market return. The correlations of the excess returns (right panel) are far lower. ALFA's excess returns are negatively correlated with the other two, and GURU and IBLN have only a 44% correlation in their excess returns. My conclusion: although ALFA is more distinct because of its hedging aspect, even GURU and IBLN are somewhat different.

Which One is the Best?

The table at right displays the average monthly excess returns and standard deviations (excess of the S&P 500) of the three funds and their underlying indexes, along with their return/risk ratios. The index return/risk ratios are similar, but as mentioned above, one should take this with a grain of salt.

Index vs. Fund Excess Returns (over S&P 500)
Inception through 8/2014

	# of Months	Annlzd. Average	Annlzd. Std. Dev.	Return/ Risk
ALFA Index	174	12.1%	14.3%	0.85
ALFA Fund	27	0.8%	7.0%	0.11
GURU Index	66	7.3%	8.7%	0.84
GURU Fund	26	4.7%	5.4%	0.86
IBLN Index	81	3.8%	5.3%	0.72
IBLN Fund	1	3.4%	N/A	N/A

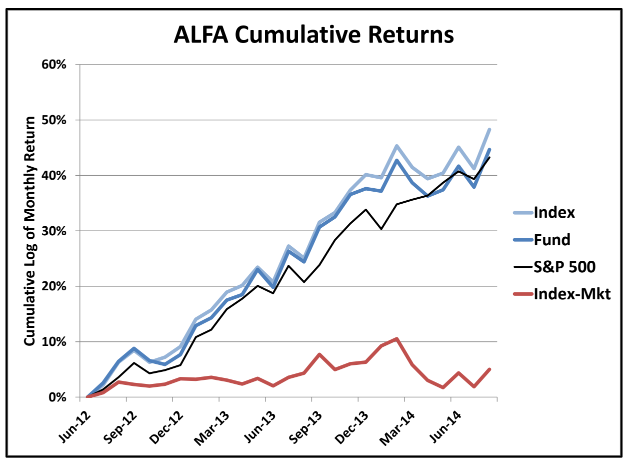
The return/risk ratio of ALFA's live returns has been quite a bit lower than GURU's over a nearly identical return history. It is possible that during some of its live history ALFA may have had the hedge on, although ALFA's relatively modest excess return of 0.8% per year indicates that it wasn't very helpful in enhancing return. ALFA's hedging discipline is likely to reduce both return and volatility over time, as well as lower its correlation with the S&P 500. Many investors find this characteristic desirable.

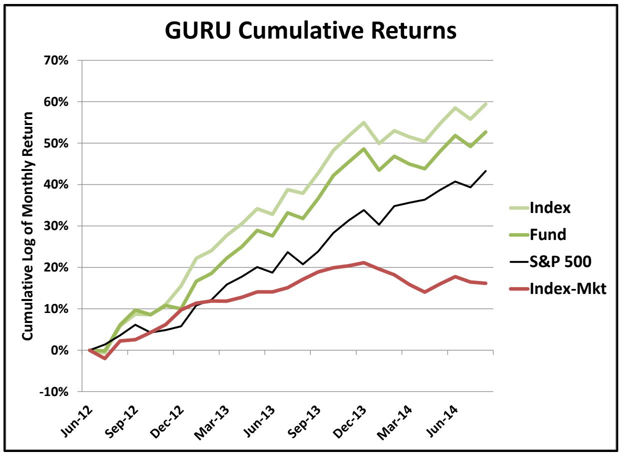
GURU has had a very successful run since its inception, trouncing the S&P 500 by an average of 4.7%, a truly impressive feat. Little wonder that it has gathered nearly $500 million in assets.

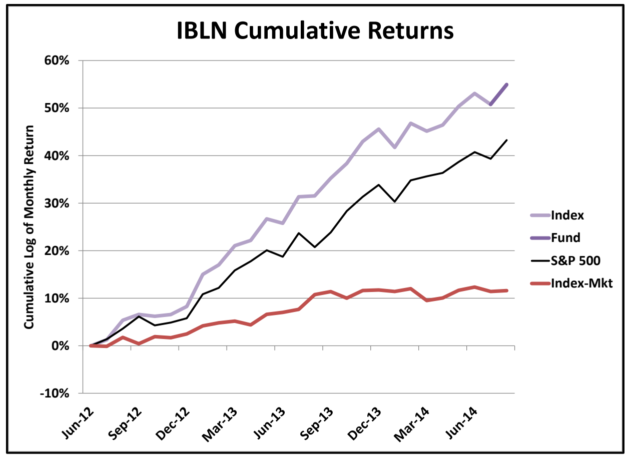
IBLN has only one month of live return history. The historical characteristics of its benchmark index are attractive, but may reflect significant look-ahead bias, since the index was constructed after the backtest period had ended.

The final three graphs depict the cumulative returns of the three ETFs since June 30, 2012. Both ALFA and GURU had live returns starting then, and IBLN's index returns go back at least that far, facilitating an "apples to apples" comparison over this time period.

Interestingly, all three saw their cumulative excess returns peak in the first quarter of 2014 and flatten, if not falter, after that. This may show the commonality of the underlying methodology. Despite the fact that there is a reasonably low correlation among the three excess returns, as indicated in the correlation table above, they share a recent episode of all failing to provide any excess return.







Conclusions

1. There appears to be some genuine alpha here. All three funds show it in both their benchmark index histories and in the case of ALFA and (especially) GURU, in their live fund performance.
2. ALFA may be a good choice for those who desire an alternative investment that will provide periodic hedging of equity market risk and a thus a lower correlation with and better diversification of the stock market.
3. GURU has the strongest demonstrated excess return (alpha) in its live history, and at 4.7% per year, it is a very impressive level. At present, if pressed to choose just one, GURU would be my choice.
4. IBLN is still unproven, and its rule of limiting holdings to S&P 500 constituents may prove somewhat restrictive.
5. ALFA and GURU have a fairly low correlation and thus may diversify each other to some extent, although both have stumbled thus far in 2014, perhaps illustrating the similarity of the underlying return generating mechanisms. I like both and at times have owned both for myself and my clients.

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SELECT ALTERNATIVE INVESTMENTS LLC

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