

Principal Equities

Beyond the funnel: A convergent, uncorrelated approach to alpha idea generation

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In a recent paper we outlined the importance and value of idiosyncratic risk and return in active investment portfolios. One of the conclusions was that finding, prioritising and combining idiosyncratic investment ideas into idiosyncratic risk-dominated portfolios is challenging. In this paper we argue why the traditional funnel-based approach to this problem can be an impediment to such idiosyncratic outcomes. As such, we utilize an alternative approach across Principal's Equity strategies which we think is a more productive approach in today's markets.

Introduction

The **traditional funnel framework** is a cornerstone of institutional investment processes, praised for its structure, discipline, and scalability. It provides a linear path from idea generation through screening, research, and security selection — ensuring analysts and portfolio managers remain focused on a manageable set of potential investments.

However, in today's increasingly crowded, data-rich, and consensus-driven market, the funnel approach is **showing signs of structural limitation**. Its reliance on more commoditized inputs and conventional filters leads to convergent thinking, crowded trades, and fewer opportunities to generate stock level alpha.

This paper highlights an alternative model utilized across Principal Equity strategies built around **independent and uncorrelated sources of alpha idea generation**. Rather than filtering a broad universe down to a shortlist of investable names, this approach generates investment opportunities from diverse, distinct, and unconnected research — and prioritizes those securities where multiple conclusions converge.

While this method is perhaps less efficient in terms of resource utilization, it offers a significantly higher potential hit rate and more differentiated investment outcomes. A trade-off we think is in the best interests of generating superior client outcomes.

The traditional funnel approach: a brief overview

The traditional funnel model is well understood across the industry. It begins with a broad investable universe — often the entire market, a sector, or a defined index. From there, it applies a series of filters and screens designed to identify potential opportunities often based on quantitative metrics such as valuation, growth, quality, or momentum.

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Only securities that pass these screens are subjected to further analysis in the middle of the funnel, where analysts build financial models, assess industry dynamics, evaluate management teams, and estimate intrinsic value.

The bottom of the funnel sees these ideas prioritized against each other to order the highest-conviction ideas selected for inclusion in the portfolio.

This framework is prized for several reasons:

- It is **systematic**, making it easy to replicate across teams and sectors.
- It is **efficient**, allowing analysts to quickly eliminate what the screens define as low-potential ideas.
- It aligns with **traditional workflows** in sell-side and buy-side research.

The Problem with the funnel

While the funnel offers efficiency and simplicity, it comes with inherent limitations that are increasingly problematic in today's market environment.

First, the approach tends to rely heavily on **backward-looking and widely available data**, such as accounting metrics, valuation ratios, and historical price performance for its initial screens. These inputs, while useful, are not anticipatory in isolation — and are increasingly commoditized by algorithmic and passive strategies.

Second, many investors use similar screens and filters making the funnel approach subject to **crowded positioning**. When multiple market participants are analysing the same subset of securities with the same tools, the likelihood of uncovering truly differentiated alpha shrinks considerably. An example of this would be the widespread search for “quality” as both a filter and characteristic.

Third, the process assumes the best ideas are those surviving multiple layers of filtering. However, this **presumes the filters themselves are optimal** and that important signals are not discarded along the way. This is particularly risky in markets where qualitative, thematic, or forward-looking drivers are more important than current static characteristics.

Finally, the funnel can lead to a **narrowing of intellectual diversity**. By pushing everything through the same lens, it limits the role of creativity. The result is to ignore promising perspectives not neatly fitting into a pre-defined screening process.

An alternative framework: independent and uncorrelated alpha sources

As an alternative, at Principal we utilize a **convergent signal framework** grounded in the idea of **independent and uncorrelated alpha idea generation**. Rather than beginning with a broad universe and filtering downward, this model sources ideas from multiple, diverse sources which, importantly, are all grounded in fundamentally driven security analysis.

Our idea generation and research sources are three distinct groups:

- **Fundamental Research Analysts**: industry specialists who are expert in their field of coverage
- **Portfolio Managers**: experienced cross-sector allocators of capital
- **Advanced Research and Development Team**: utilizing fundamentally-grounded systematic measures

Across these sources we possess a purposely broad opportunity set from which to begin, that is without predetermined bias, recognising the price dislocations we seek to identify and take advantage of occurrences in many guises.

The primary idea is not to filter from one large pool to a smaller one, but to **identify convergence** — instances where two or more uncorrelated sources independently highlight the same investment opportunity.

This approach is **akin to triangulation**: if one source suggests a stock is mispriced, it may be noise. If three unrelated sources do the signal is significantly more compelling.

Key to this approach is **a clear understanding of the mis-pricing these signals seek**. For us at Principal this discipline focuses on unrecognised future free cash flow growth. Superior forward free cash flow yield possesses proven efficacy in driving consistent above-market stock price returns (see Empirical Research Partners data chart in Paper 1 of this Series – The Importance of Idiosyncratic Risk and Return).

Accepting the trade-off: efficiency versus strategic advantage

It should be acknowledged this alternative approach comes with an important trade-off: **it requires more effort - is less efficient - than the traditional funnel**.

Specifically, it requires:

- Greater investment in **research infrastructure and data sourcing**
- Broader **domain expertise** across multiple types of insight
- More **qualitative judgment and synthesis**, which is not easily automated nor outsourced
- A more **flexible and decentralized** research workflow

In short, the process is more resource intensive. For firms used to processing hundreds of names per quarter through a linear research pipeline this may seem like a drawback but at Principal it is a cost we embrace in the pursuit of superior investment outcomes.

In a marketplace saturated with efficiency and standardization, we think the **ability to operate differently becomes a source of alpha in itself** and the benefits of this convergent, uncorrelated alpha strategy significantly outweigh the efficiency drawback:

- 1. Higher Hit rates:** Ideas supported by multiple independent and uncorrelated sources tend to have higher success rates. Each source reduces the likelihood the opportunity is a false positive or based on biased inputs.
- 2. Diversified Perspectives:** This model draws from a wider range of fundamentally-orientated and behavioural information types leading to more holistic investment theses and better risk management.
- 3. Human Insight as a Differentiator:** Quantitative screens are now largely commoditized. What remains scarce is the ability to synthesize disparate information, think laterally, and draw connections others miss.
- 4. Differentiated Outcomes:** Because the process is rooted in uncorrelated idea generation, the resulting portfolio is **less likely to overlap with consensus or benchmark holdings** offering the potential to create unique portfolios generating differentiated alpha.
- 5. Hard to Replicate:** This framework creates a **defensible competitive edge** as it relies on a proprietary mix of data sources, insights, and analyst interpretation — all of which are difficult to mimic using public tools or standardized models.

In this way, the greater resource intensity required is not a flaw but a key enabler allowing the investment process to drive the idiosyncratic outcomes representing the real benefit of an active management approach.

Conclusion: from filtering to triangulating

As market complexity increases and traditional sources of edge erode, **investors must rethink not just in what they invest but how they source, research and select ideas.**

The funnel model served a purpose in an era of data scarcity and information asymmetry. But in today's landscape where data is abundant and investors frequently employ the same tools, we think **the edge lies in a different direction.**

By embracing a framework drawing upon independent, uncorrelated sources of alpha and focusing on convergent signals, we **shift the emphasis from filtering down to triangulating in.** This approach is more resource-intensive — but it is also more selective, resilient, and ultimately more rewarding.

In a world where everyone is trying to filter faster, we aim to see differently — and **act only where the opportunity is strongest.**

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