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Fireside Chat

Your Monthly Update from KCS

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Is Quant Investing Dead? All Hail Quant!

There are thousands of investment management "firms" and a multitude of investment products with various wrappers that investors can choose. Given that breadth of offerings, it becomes obvious that there isn't one way to invest in the markets. But is there an investing approach, tool or set of skills that improves one's odds of beating the averages? YES!

Investing through fundamental and / or quantitative techniques is a continuum, not an all -or- nothing game. Even the most successful firms / strategies will underperform from time to time whether they emphasize quantitative techniques or more fundamental approaches. Many external factors play a critical role in the ongoing success or failure of each approach, such as capacity, trading, willingness to consistently challenge one's key inputs, personnel and its stability, availability of unique data, risk management, fees, etc.

However, we would suggest that the average quant strategy is better than the average fundamental approach, and that it is easier – ***yes, easier*** – to evaluate a quantitative approach than one that is more fundamental in nature.

Inside This Issue

What It Is

Quantitative - or systematic – investing traces its roots back to at least the 1920's where it is believed that Benjamin Graham's Graham-Newman Corporation first began to systematically approach investing.

According to Wikipedia, quantitative investing is "an investing technique typically employed by the most sophisticated, technically advanced hedge funds. These firms employ fast computers to find predictable patterns within financial data." Also, these strategies are "typically… implemented by people who have spent time in the physics, math, computer science, or statistics disciplines. The process consists of thorough examination of vast databases searching for repeating patterns—persistent occurrences of a phenomenon, correlations among liquid assets or price-movement patterns". This seems to us to be a bit narrow, especially as it pertains to its focus on "hedge funds".

If you weren't crazy about this last definition, how about this from Rishi Narang, from his book, *Inside the Black Box*. Narang suggests that a quant

What It Is (cont'd)

fund "systematically applies an alpha-seeking investment strategy that was specified based on exhaustive research". What makes a quant strategy comes down to how the insights are conceived and **implemented**.

Any investment approach's success or failure ultimately comes down to the personnel responsible for the idea generation and implementation. Quantitative / systematic processes are built by humans, not robots. Just as fundamental processes have to overcome behavioral biases that exist in all of us, so do quant funds. However, their bias lies in the insight development and data acquisition, which differs from fundamentally based products once the process begins to run (computer is turned on).

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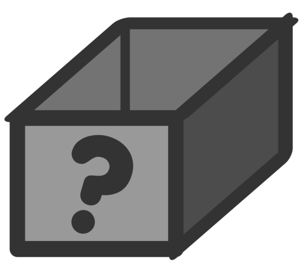
Are all Quants the Same?

The investing community, including plan sponsors, consultants, and investment managers, has done a good job recognizing that all fundamental processes are not the same. However, they haven't done as good a job realizing that systematic shops are like snowflakes, too, with no two being identical.

During my tenure at Invesco, I was frequently reminded of this fact because there would be equity searches of all kinds based on style, capitalization, tracking error, and benchmark, and then there would be a quant search, which usually focused on the enhanced index space. Rarely did you see a consultant searching for a large cap, value-oriented quant or a momentum-based quant. They were just quant searches.

Well, as August 2007 and all of 2008 would highlight, there were major differences among institutional, long-only managers in the quant space, with those firms emphasizing value being impacted more negatively than those firms, such as Invesco, which had a more balanced model (more momentum).



Of course, quant shops are different, just as the fundamental shops are unique. Each quant shop will have different personnel, emphasizing different investment insights, using various data sets, optimizers, risk tools, trading platforms, average holding periods, etc. It is up to the investment firm, along with the plan sponsor / consultant to identify the unique characteristics of each firm. Unfortunately, transparency has not been a hallmark for most systematic shops – hence the term "black box".

Positives of a Systematic Approach

Given how difficult investing is, we believe that a systematic approach improves the odds of success. One of the key attributes of using a quant approach is the removal of emotions from the process. As one knows, most investors allow their emotions to take control of their heads, which frequently results in the investor buying high and selling low.

Positives of a Systematic Approach (cont'd)

While some would argue that they've never seen a bad "simulation", historical simulations - potential warts and all - do provide a framework for what should be expected from a risk standpoint. Importantly, without this knowledge of what might be expected, how does one know when a perceived normal event is not normal at all or vice versa? One way around the issue of the legitimacy of simulations is to deeply haircut the output. How do you simulate a fundamental approach with any degree of confidence?

"One of the key attributes of using a quant approach is the removal of emotions from the process…which frequently results in the investor buying high and selling low."

From the standpoint of investment insights brought to a process, quants are frequently criticized as not being "fundamental". However, that criticism may not be fair depending on which investing insights are being used. Many of the best quant teams have more traditional investors imbedded with their quant talent so that the process receives more of a 360 degree view. These individuals may have the same educational pedigree, but they have also spent time in the markets gaining important insights along the way. In those cases, the quant teams may be organizing fundamental information more efficiently.

From a business standpoint, systematic approaches are more repeatable. The key insights gleaned from key personnel are "captured" within the process. Therefore, you can have greater confidence in the maintenance of the investment integrity and continuity of the process. In a more fundamental process, key personnel go up and down the elevator each night.

Potential Quant Process Issues

The concept of an opaque "black box" causes much consternation for consultants and their clients. Without transparency into a model / process, it is understandable why there might be a reluctance to use a systematic approach or more than one at a time. Return patterns might provide you with an understanding that there is a modest correlation between two or more providers, but it doesn't explain why.

A systematic approach is only as good as the concepts and data being fed into the computer. Put garbage in and you will get garbage out. Throwing reams of data at a computer and looking for "patterns" without an investment concept to support the idea in the first place is not research. The output might suggest some correlation, but one doesn't truly know if that correlation is sustainable. One's ideas need to be validated through rigorous research.

Even with rigorous research, factors or investment ideas can lose their effectiveness over time. There are too many smart people in this industry chasing every good idea and causing one's stock selection criteria to become overused. Too much money chasing too few good ideas can overwhelm a process.

Potential Quant Process Issues (cont'd)

The quants of the early 2000s weren't any smarter than the systematic approaches of 2007-2008. Too much money flowed into the quant shops (estimated at $1.4 trillion in long-only equities at the peak). Once the flows peaked, and larger players were forced to liquidate holdings in stocks that they continued to own for the balance of their clients, the forced selling put downward pressure on those stocks and the factors that supported their selection in the first place.

Final Thougths

"It is highly unlikey in today's investing world that even the most fundamental of processes isn't using computers to assist in their process, even if it is limited to culling a universe of stocks to get a working list of potential research candidates."

Quants have been around for a long time. Their products' roles within defined benefit plans may be eroding faster than desired. However, since long -only, low tracking error, large capitalization products are in limited demand, there is still a role for systematic approaches. Many of the quant shops have experience in alternative products, such as market neutral and long / short. These strategies continue to be in high demand, not only within traditional DB plans, but within the Endowment & Foundation, retail and family office market sectors.

This article was neither intended to have the whole fundamental investing community irritated with KCS nor was it a warning to more traditional managers not to call on us for introduction purposes. It was intended to highlight positive attributes of a systematic approach that are often overlooked because "investors" can't get by the "quant" name. Furthermore, it is highly unlikely in today's investing world that even the most fundamental of processes isn't using computers to assist in their process, even if it is limited to culling a universe of stocks to get to a working list of potential research candidates.

There's More to Learn - Reach Out!

We have more to share on this topic! Please contact us to receive additional information and data regarding the material presented in this *Fireside Chat*.

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