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Quants – a difficult pill to swallow

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Quantitative funds. The phrase is seen as taboo to investors in the South African market. To the extent where the job title 'quantitative analyst' is a rare sight, with most preferring to use the job title 'research analyst'. Why is it the case that something globally accepted, has so little traction in South Africa thus far?

Global and local view of quants

In the United States of America, quantitative funds make up a decent portion of the actively managed funds, to the extent that opportunities based on certain factors that show strong predictive power, have been completely arbitraged out. Yet in South Africa, quantitative funds make up a very small percentage of the total assets under management. This scarcity in quantitative-type funds presents an opportunity in the South African market as factors with predictive power are yet to be arbitraged out, meaning there is still potential for alpha to be generated in factor investing.

There are certain investment styles that have shown relatively consistent predictive power over the last 25 years in the South African market and although all investment styles have periods of underperformance, the integration of multiple investment styles into a single long-only portfolio has been shown to improve the probabilities of outperforming the benchmark over the long term. Along with this, quantitative-style funds tend to have a lower management fee compared to actively managed funds, as they do not require the same level of manpower and additional costs to manage once they are up-and-running.

The data set is also continually growing, allowing for longer-period back tests to determine which factors truly have consistent predictive power. Quantitative funds also enable managers to test factors on a bigger data set, such as the MSCI World Index, which has over 1500 shares. With a larger group of shares to test the factors on, managers can determine, with more confidence, which investment styles have consistent predictive power. Managers are also able to include factors based on the consensus of research analysts covering specific shares, known as sentiment factors. This allows managers to include the views of research analysts into a desired factor model.

Removing biases

Furthermore, due to the increased availability of data, there is a plethora of factors that can be tested. With each new factor found, that shows predictive powers, adding to the alpha-generating abilities of the fund. This leads to ever-improving models and as a result more accurate predictions of the right shares to hold. In theory, if a factor has shown consistent predictive capabilities over the past 25 years, there is a good chance it will continue to do so in the near future. There is obviously no guarantee of this, but that is the reason for combining multiple predictive factors into a single portfolio. Rather than investing in clever human beings or gut feelings, this investment process is based on a set of fixed rules, which avoids behavioural biases.

So again, I ask, why does this investment style leave an unsavoury taste on most people's pallets? One of the main reasons for this seems to be around the idea of the 'black box' investment approach. In other words, the process is often complex and cloaked in mystery. Furthermore, the use of complicated technical jargon such as "Orthogonalisation of vectors" and "Winsorisation of outliers" causes further avoidance of what is otherwise a straightforward concept.

We're all creatures of habit

Another reason why this investment style has remained widely unaccepted may be due to people being stuck in their ways. Even when there is empirical proof that something works, humans, by nature, are stubborn and would prefer to stick with the comfort of their current ways, rather than change. However, in an age where there is so much data available and increased transparency of data in a large global scale, those who do not adapt and grow with their environment could be left behind.

It must be noted that underperformance can still be experienced over short periods, as no factor has a 100% track record of picking the winners. However, having exposure to a percentage of your overall portfolio allocation, and some exposure to a fund which is run without human feelings being involved, seems like a logical diversification of risk.

The work done by quantitative analysts is not limited to factor-based or smart beta-oriented funds. Quantitative analysis can be used as a filtering device, allowing portfolio managers to avoid or flag shares that have a bad ranking, based on a factor known to have strong predictive power. The use of this, could identify some underlying risk that the portfolio manager may have overlooked or allow a portfolio manager to narrow down the investible universe to a smaller group of shares, thus they will have to do an in-depth analysis on less shares, which could save valuable time and energy.

More informed investment decisions

Quantitative analysis can also be used to do a more in-depth analysis of a fund and allows managers to understand what styles the portfolio is exposed to and whether this is in line with the views of the portfolio manager. This is a helpful tool, as it may highlight certain exposures or biases to a specific style that is unintentional and could be avoided. This better understanding of our own biases can lead to us making more informed investment decisions.

Change is good

Analysis of large data sets is the key to understanding what drivers are truly behind the performance of shares. However, the process of cleaning and analysing data is no small feat and can seem like quite a daunting task to the untrained. Fortunately, universities and private education organisations have recently started offering courses, such as Data Science Engineering, that provide the skills required. As a result, the opportunity to take advantage of these data sets is becoming more realistic and manageable for every asset manager and investor alike, if they are willing to accept that sometimes a bit of change is a good thing and may just lead to better performance over the longer term.

Glacier Research would like to thank Shaun Van den Berg for his contribution to this week's Funds on Friday.

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