Investment update

30 November 2011

Ian Heslop heads OMAM's quantitative strategies team. He joined OMAM in May 2004 and has over 13 years investment experience (9 years quantitative investment experience), including OMAM and BGI.

The team includes specialists in portfolio construction, research and systems development. The investment process is designed to exploit market inefficiencies and is based on a proprietary multi factor return model. The process calculates a forecast return for each stock and the resulting portfolio is optimised in terms of risk, cost and return.

Time for reconsideration?

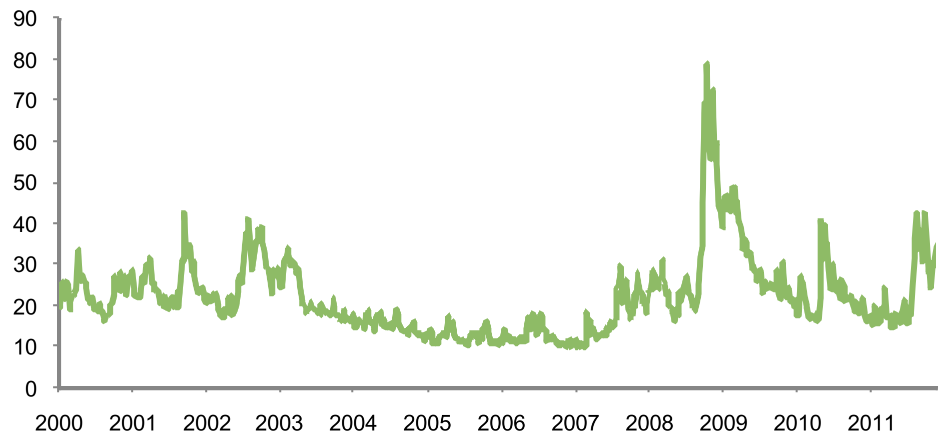
Quantitative strategies disappointed in the crises of 2008, but performed well in similarly volatile markets this year?

Following a period of underperformance following the financial crises of 2008, quantitative investment strategies developed a reputation as 'black boxes' whose contents no one properly understands. As a result, many investors shied away from them.

Things have moved on and the question now might be if this is still a justifiable approach? Or is it a case of throwing the baby out with the bath water? Are there attributes of a quantitative approach which investors should seek to capture in their pension scheme's portfolio to reduce risk and enhance return?

This past summer – reminiscent of 2008 – was not a very restful season for investors. The VIX equity volatility index reached levels normally associated with periods of economic or financial crisis. From a near-term peak on 7 July to the trough on 10 August, the FTSE All Share fell 17.1%, while the MSCI World fell 19.3% (to its trough on 19 August) – a considerable correction in any context

Figure 1: Volatility in July/August reached levels associated with a major crisis



Source: Bloomberg

A difficult period, but one intriguing point emerged. Quantitative equity strategies in many cases did well relative either to the market or to mainstream funds. This was especially interesting in that it was contrary to what happened in the crisis periods of 2008/09, when quantitative funds tended to underperform.

Quantitative equity strategies evolved over the last 10—15 years as robust, live, statistically consistent data started to become available across global markets, mainly through MSCI and FTSE. Simultaneously, cost-effective processing power emerged, allowing fund managers to track, screen and analyse thousands of stocks

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As quantitative strategies developed, they tended to be built on investment processes which focused on evidence of long-term returns. This makes intuitive sense and to some extent it was successful – until the crises of 2007/08 showed up two essential weaknesses. One was that quantitative equity strategies, using similar data to pursue similar objectives, had become overly homogenised.

The other was a failure to see the wood for the trees. Fund managers – and their clients – became so fixed on the returns evident in long-term trends that they lost sight of the potential damage of short-term events. As is now better understood, not least through popularising works such as The Black Swan: The Impact of the Highly Improbable, by Nassim Nicholas Taleb, a single, high-impact event can have significant long-term affects. In the extreme – and by definition unusual – volatility of 2007/08, quantitative strategies formed around long-term data struggled to cope.

This summer we saw another sharp correction. The absolute decline was of a similar magnitude to the first quarter of 2009, and at a sector level the entire market was negative. A difference might have been that correlations could have been expected to be even tighter, as the range in the levels of decline was especially narrow, from around 10% to 20%.

If the conditions in July/August 2011 were comparable to those in 2008/09, why were the outcomes so different? The short answer is that good quantitative managers have learnt from recent history. A key shift has been to introduce factors which recognise the merits of what might be called a 'dynamic' investment process, one designed to take account of changes in the market environment quickly and efficiently, and to respond appropriately.

A critical issue is to recognise that investors behave differently in 'normal' times than in periods of extreme market stress. The accepted research shows clearly that over the long term – if long-run averages can be said to represent the 'normal' – stocks with low valuations and strong earnings growth will tend to outperform. During periods of extreme stress, however, investors will be uncertain as to the ongoing fundamental value of the assets held by a business, leading them to question assumptions underlying forecasts of earnings growth.

If growth rates and fundamental valuations are perceived as 'at risk', the relative attractiveness of a company becomes difficult, even impossible to assess. Characteristics such as 'cheapness' – which outperform over the long term – can become detrimental in the short to medium term as they are seen to indicate risk.

This behaviour is not irrational. On the contrary, it displays a high degree of logic. In a time of uncertainty, investors are selling risk, in the form of potential earnings, and buying safety, or realised earnings, as embodied by solid balance sheets.

Companies with strong balance sheets and other characteristics which tend to be resilient in times of stress are often described as 'quality'. But what precisely those characteristics are is hard to define and quality measures need to be used with caution. Their associated returns are variable, as are the ways in which they interact with other investment strategies.

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True quality stocks may not be cheap on valuation measures, but they will tend to be resilient in a negative environment. It may be a challenge to identify them, but they will be there. In the 7 July – 19 August period, over half the stocks in the MSCI World outperformed the index, while 4.5% had positive returns, in some cases in high double digits.

Devising a metric to capture quality, or investor sentiment, is one way a quantitative equity strategy can distinguish itself in a bear market. Others may emerge. What is clear is that the market volatility in the summer showed that quantitative strategies are alive and well and that in many cases they deserve fresh consideration.

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