Equities – Quantitative strategies: Can quants continue to deliver

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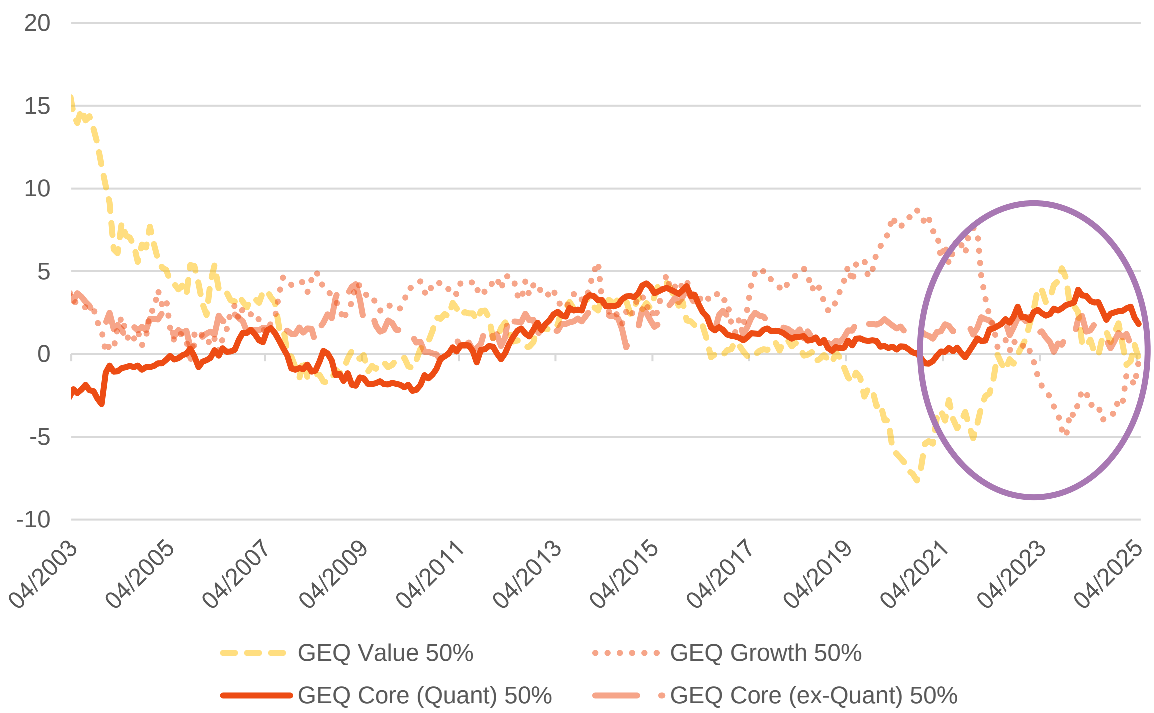
In a session chaired by Adrian Hoe, Senior Consultant at Frontier Advisors, industry experts Dr Joanna Nash, Head of Portfolio Management and Senior Quantitative Portfolio Manager at RQI Investors and Paul Crisci, Portfolio Manager in Listed Assets at legalsuper explored the role quantitative strategies (quants) play in listed equities. Against the backdrop of a challenging period for active management, the panel delved into the reasons behind the recent success of quantitative managers, their potential to navigate future market conditions, and the implications for portfolio construction.

The market backdrop: Challenges for active management

The session was opened by highlighting the difficulties faced by active managers in recent years. Market concentration and declining market breadth have created headwinds for active management performance. However, quants have stood out, navigating these challenges effectively and delivering strong outcomes.

Frontier's Global Equity three-year median excess returns across Frontier Peer Set by style (versus MSCI ACWI)



Source: Frontier Advisors, eVestment

Why have quants performed well?

Dr Joanna Nash attributed the success of quants to two key factors:

- Breadth and diversity of insights: Quants analyse a wide range of factors, ensuring the failure of one factor at a point in time does not derail overall performance.
- Risk management: Quants excel at managing risk across the entire portfolio, avoiding over exposure to specific sectors or regions. Nash likened this to a football team, where balance across all positions is crucial for success.

The increase in market concentration and narrowing of market leadership in recent years has meant that if you were to underweight or not hold these important positions, then you would miss out on the 'market beta' and get caught short on the key drivers of benchmark return.

The diversified nature and tight sector and regional constraints of multi-factor quants has protected them from much of this underperformance.

The role of quants for institutional investors

Paul Crisci shared his perspective on why he is considering introducing a quant strategy into legalsuper's portfolio. He highlighted several advantages:

- Adaptability to macroeconomic and geopolitical risks: Quants are well-equipped to navigate complex market environments.
- Regulatory compliance: Their ability to manage regulatory requirements, such as the Your Future, Your Super (YFYS) tests, is a significant advantage.
- Cost efficiency and resiliency: Quants offer controlled tracking error, competitive fees, and robust portfolio construction.

High tracking error strategies have proven less efficient in highly concentrated market. Crisci identified quants as a critical tool for building efficient and resilient portfolios, particularly in today's complex market environment. He emphasised the importance of aligning any incoming managers with clear objectives; considering factors such as risk and fee budgets; contributions to tracking error; correlation of portfolio drivers; skewness of returns; and overall portfolio consistency. Citing these considerations will help ensure quantitative approaches are tailored to meet specific investment goals while maintaining a disciplined focus on risk management.

Since joining legalsuper a year ago, Crisci has shifted from pursuing broad performance outcomes that are highly volatile to constructing a more risk-controlled portfolio. He highlighted high tracking error solutions are less efficient in concentrated markets and has generally favoured core-like strategies to manage risk effectively.

Additionally, Crisci believes it is time to move away from the traditional approach of balancing value and growth managers, instead focussing on strategies that better align with the evolving market landscape and investor needs.

Crisci's ideas around the role of quants to legalsuper's portfolio were not too dissimilar to what Nash has observed from interactions with her clients and the broader investment community. Specifically, she outlined the following trends in client usage of RQI's strategies:

- Impact of YFYS regulations: These have driven a shift from RQI's long running value strategies to their newer diversified alpha approaches with low tracking error.

- Increased interest in multi-factor strategies: Allocators are favouring strategies that combine multiple factors, such as RQI's Diversified Alpha Fund.

Reservations about quants

Despite their advantages, Crisci also outlined some reservations about adopting quant strategies:

- Cyclicality and performance profile: Quants have experienced periods of underperformance, such as the "Quant Winter" of 2018 to 2020 where traditional factors fail.
- Overcrowding and information decay: The risk of too many managers chasing similar insights remains a concern.
- Risk model quality: Crisci stressed the importance of proprietary risk models tailored to align alpha signals with risk, as opposed to off-the-shelf models.

Reflecting on the Quant Winter, Nash noted the crisis was partly due to overcrowding and reliance on similar data sources. Since then, quants have evolved, incorporating diverse data sets and advanced techniques like natural language processing and machine learning – resulting in greater differentiation between the quants, as no two are looking at the same data set in the same way. These innovations have improved risk insights and reduced the likelihood of similar crises.

Can quants continue to deliver?

The panel discussed whether quants could sustain their performance in the future. Nash acknowledged quants thrive in markets with breadth and cross-sectional volatility, but struggle during market turning points. However, she emphasised that RQI, among other quants, remains committed to managing risk regardless of market conditions.

Crisci expressed optimism about quants' ability to adapt to shorter time frames and leverage advancements in artificial intelligence and machine learning. He also highlighted the challenge of discerning valuable signals from the growing volume of data.

Both panellists agreed that timing styles is challenging for quants. Diversification and portfolio construction are key to addressing this limitation.

Building portfolio resiliency

The session concluded with the following key takeaways:

- Market concentration: Rising concentration levels have pressured active management, particularly concentrated strategies.
- Cyclicality: Active management outcomes are inherently cyclical.
- Timing challenges: Predicting market regime shifts remains highly difficult.
- Diversification: Frontier advocates blending styles (e.g., value and growth) and approaches (quantitative and fundamental) to build resilient portfolios.

Next steps

Frontier offers tools and expertise to support investors in navigating these challenges and building a resilient portfolio. These tools include:

- Portfolio risk analysis: Insights to enhance risk management strategies.

- Style-based manager data: Nuanced performance benchmarking and manager assessment.
- Fund manager reviews: Detailed evaluations to align with portfolio objectives.

In a complex and uncertain market environment, Frontier's guidance can help investors construct robust, diversified portfolios that perform across cycles. Get in touch with Senior Consultant, Adrian Hoe at ahoe@frontieradvisors.com.au.