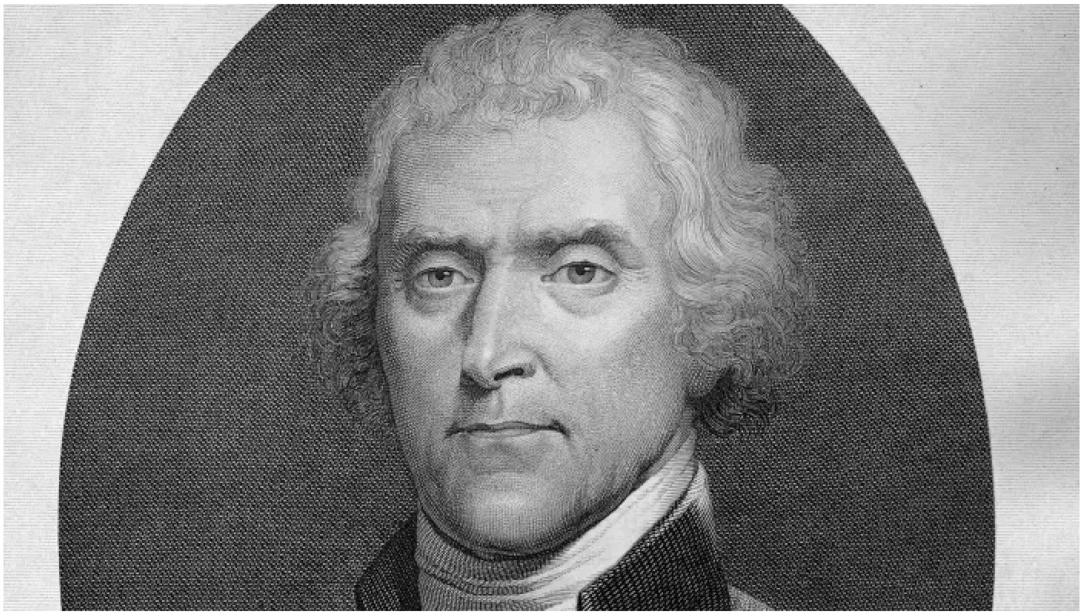
Opinion **Markets Insight**

A terrible, horrible, no-good year for quants

Many popular quant strategies are struggling but to varying degrees we are all quants now

ROBIN WIGGLESWORTH



Value investing is on its worst run since the 1826 death of former US president Thomas Jefferson © HULTON ARCHIVE

Robin Wigglesworth NOVEMBER 3 2020

The omnishambles in value investing has naturally stirred a lively debate in financial circles. The investment strategy is now on its worst run since the death of Thomas Jefferson. Yet the length and depth of its woes obscure the fact that it is far from the only casualty of the Covid-19 market environment.

Value is just one of several major investment "factors" that economists had discovered tend to lead to above-average returns in the long run. They essentially involve grouping stocks according to some defining characteristic, such as their size, the health of their balance sheet or — in the case of value — their cheapness. Systematically mining factors is at the heart of the computer-powered, algorithm-driven quantitative investment industry that has grown dramatically over the past two decades.

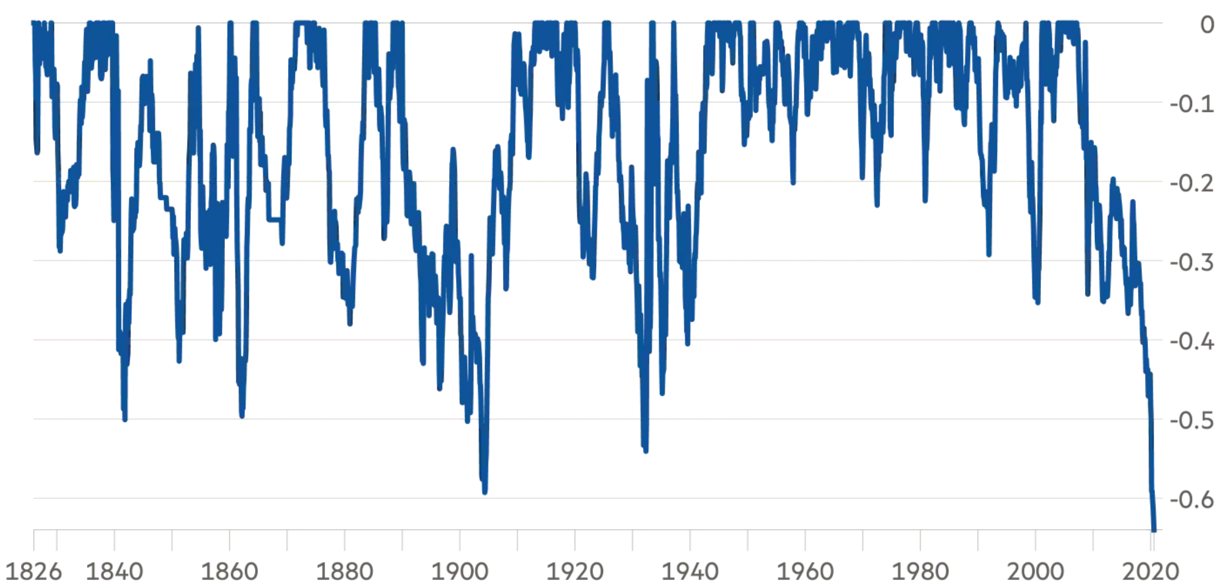
The severity of the value drawdown is admittedly extreme. However, what is interesting is just how many of the strategies based on these factors are struggling at the moment. For some quantitative analysts, it is enough to make them question their entire premise.

"Why I am no longer a quant," was the provocative title of a recent report from Inigo Fraser-Jenkins, head of quantitative strategy at Bernstein, a pedigreed investment research house. He argues that the original sin of quants like him is mining historical data for clues to what works in the long run, but glossing over the fact that market regimes come and go. That can mean that what worked in the past can fizzle out in the future.

"At their core, quant funds try to apply backtests to future investment decisions. But what does it mean to do quant research and run backtests if the rules have changed?" he asked. "There is a challenge to quant beyond a recent patch of poor returns. If Covid doesn't count as a regime change I don't know what does."

Two centuries of value drawdowns

Cumulative loss of value investment factor since most recent peak



* Value factor is derived from going long cheap stocks and short expensive ones.
Source: Two Centuries Investments

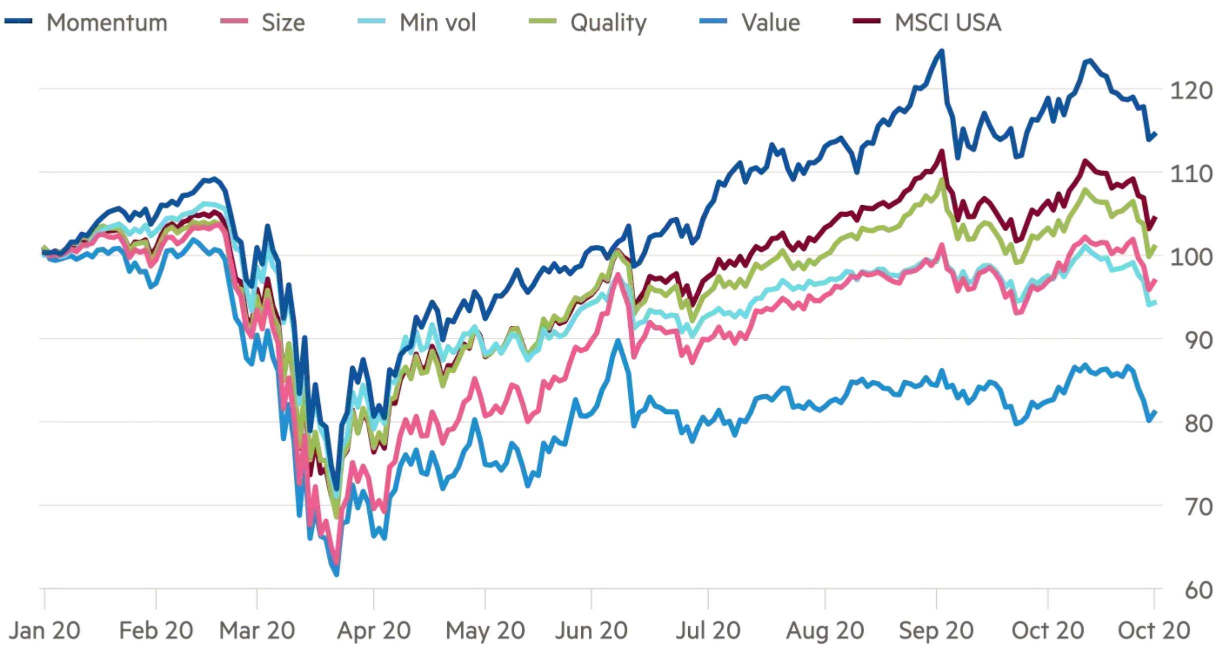
He is not alone in thinking the world has changed. Almost three-quarters of quants surveyed by Refinitiv in October said that their models had been hurt by Covid-19, and a small but eye-catching minority of 12 per cent declared that their models were obsolete.

In short, Mr Fraser-Jenkins thinks that the central idea of mean reversion — that old market patterns will eventually reassert themselves — might be dead in this new regime. As Ted Aronson, a value-oriented quant investor recently noted to the Wall Street Journal after shuttering his hedge fund AJO after a dismal performance stretch: "It can all work for years, for decades, until or except when the not-so-invisible hand comes down and slaps you and says, 'That's what worked in the past, but it's not going to work now, nope, not any more'."

Not every quant fund has done poorly. Quantitative investing can range from cheap, simple exchange traded funds to complex hedge funds that sift through the global economy's digital exhaust for profitable but fleeting patterns.

Only the momentum factor has beaten the broader stock market in 2020

Rebased performance of the five mainstream risk premia YTD



Source: Bloomberg
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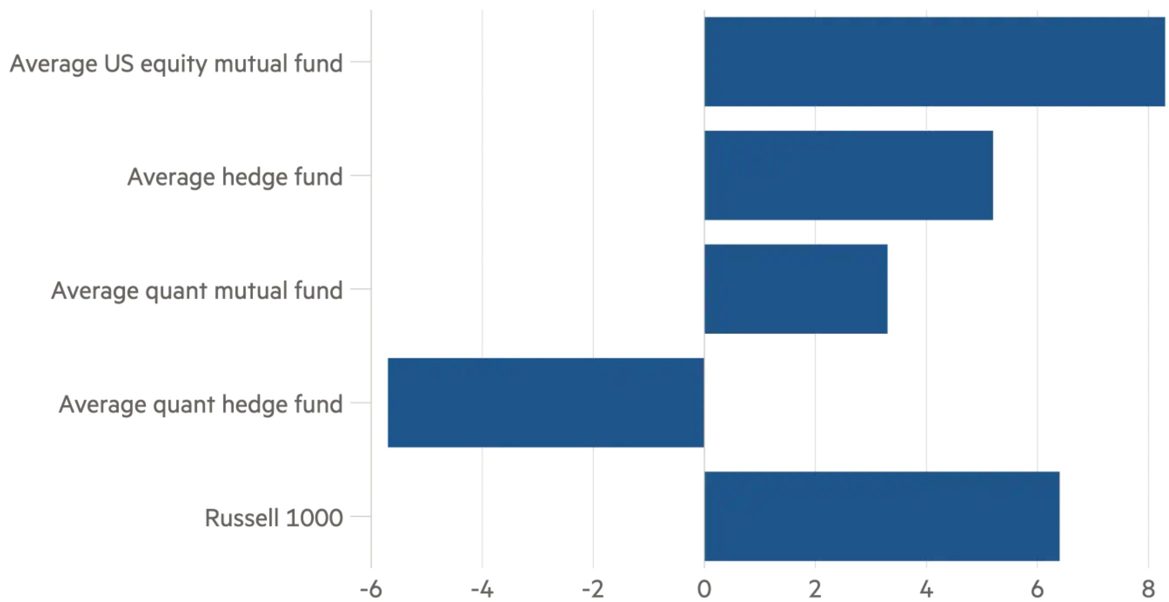
However, it is clear that quants on the whole are having a bad time. The average quant US equity mutual fund is up just 3.3 per cent in the year to end-September, compared with the average stockpicker's 8.3 per cent gain, and the Russell 1,000's 6.4 per cent return, according to Bank of America. Crucially, what is more unusual about the current predicament is how many factors are fizzling out at the same time.

Higher-octane strategies have done even worse, despite leaning less on well-established mainstream strategies. Weighted by assets, the average quant hedge fund lost 5.7 per cent in the year to end of August, compared with the average hedge fund's 5.2 per cent gain, according to Aurum Fund Management. In fact, Aurum says the rolling three-month performance of the most popular quant strategies is as bad or worse than during the "quant quake" of August 2007 and subsequent financial crisis.

Quants have struggled in 2020

Performance in the year up to the end of September (%).



Source: Bank of America, Aurum

However, there have been many market regimes in the century of data upon which most major investment factors are based. It may just be that the unique nature of the Covid-19 shock was perfectly designed to short-circuit many of them — and the effect will fade as the pandemic eventually recedes.

The big technology "growth" stock boom accounts for much of the underperformance of everything else this year. It is no coincidence that the only major quant factor that has performed well this year is the trend-surfing momentum, as winners have won big and losers have been left for dead.

It would be a brave person who declares that the sun has set on quantitative investing. One could argue that the entire money management industry is — to varying degrees — nowadays driven by quantitative research in some form or fashion. This is a trend that is only likely to accelerate in the coming years. We are all quants now.

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