weekly digest

momentum

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Recipe for "quantamental" strategies

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Fetch a cauldron and fill it with equities. Add some chopped fundamental analysts, a few cups of quantitative analysts, a couple of sliced IT wizards and enough computational power to blend things together. Slow-cook until the ingredients are al dente and get ready to enjoy the perfect "quantamental" strategy, ideal to add some alpha on top of your usual meal. Abracadabra. Serves all types of portfolios.

> *"Serves all types of portfolios"*

In the last thirty years, academic and professional research papers have increasingly pointed in a common direction: a large proportion of active managers' relative performance is attributable to exposure to various rewarded risk factors, while the actual manager alpha is a smaller and often illusory part. In a previous article[1] we discussed how to sift through the hundreds of claimed factors that have been identified to isolate the most robust and meaningful ones. So, the natural next step would now be to address how we access and take advantage of them.

Quantamental strategies make use of quantitative models on company fundamentals to systematically build equity portfolios. They incorporate data from balance sheets, income statements and cash flow statements and integrate it with style factor analysis and price/trend information to measure the exposure of each stock in their universe to various risk premia. The most common families of fundamental factors are value (e.g. book-to-price, dividend yield, earnings yield, cash flow yield), growth (e.g. of earnings, sales, margins), quality (e.g. high return-on-equity, return-on-invested capital, earnings stability or low leverage) and momentum (in earnings revisions or market price) which are often integrated with less common factors such as liquidity, volatility and residual risk exposures. This factor decomposition feeds into the stock selection and portfolio construction phases, based primarily on factors expected returns, risks and cross-correlations.

> *"use of quantitative models on company fundamentals to systematically build equity portfolios"*

Sounding familiar? This is simply what most traditional active managers have been doing for a long time, but in a systematic, automatized way with human intervention only occurring at the model development, execution oversight and risk management stages. This in turn allows such strategies to have lower costs, faster execution, greater consistency and less behavioural biases. Clearly, there are many high-conviction active fundamental managers that are able to add robust outperformance over and above what comes from their typical factor exposure. However, they are hard to find and poor selection proves costly, with higher costs being incurred on performance that may lag the returns from the factor exposure alone.

'Smart beta' products, be it indices or exchange traded funds (ETFs), share the same research foundations supporting quantamental strategies but exploit factors in a highly simplified way whilst focusing on implementation efficiency. Their main advantages are even lower costs, higher transparency of methodology and holdings and widespread availability. On the flip side, smart beta strategies sometimes lack sophistication, focus on overly simplistic and broadly used factor definitions (increasing concentration risk and lowering harvestable returns) and rebalance at publicly known fixed dates, quarterly in most cases, thus being exposed to front-runners.

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As always[2], we shop for the best ingredients at the lowest cost. We do not rule out investing in any of the above categories and we are happy to explore all universes in the relentless search for what is most appropriate for our portfolios. We invest in traditional, fundamental active managers (sometimes at higher costs) where we see high quality and expect solid outperformance, as well as quantamental or smart beta strategies where their value-add is the best among all possible alternatives. We keep an open mind, as our only fixation is delivering on (and over) clients' outcome targets.

[1] "Interrogating the backtest", Stephen Nguyen, Momentum Weekly Digest, 03 September 2018

[2] "Shopping for information ratio", Lorenzo La Posta, Momentum Weekly Digest, 30 July 2018

Market Focus

- Upward pull in government bond yields
- Global manufacturing remains sluggish
- Brent crude fell 3.1% ending the week at $65 per barrel
- Gold declined 2.6% to $1298 per ounce

US

- US GDP grew at an annual rate of 2.6% in the fourth quarter of 2018, exceeding forecasts of a 2.3% gain
- The ISM Manufacturing PMI fell to 54.2 in February from 56.6 in January, below market expectations of 55.5, and remains in expansion territory
- Core PCE, the Fed's preferred gauge of inflation, rose 0.2% and 1.9% on a monthly and yearly basis, respectively, in December
- US President Trump met with North Korea's leader Kim Jong Un in Hanoi. The meeting was cut short after they failed to reach a deal following differences on removing sanctions and denuclearisation
- Longer-term Treasury yields moved higher on the week, with the yield on the benchmark 10-year note increasing 10.1 basis points to 2.76%
- US equity indices were mixed with the major gauge returning 0.4%

UK

- British Prime Minister Theresa May has scheduled a parliamentary vote for the 12th March on the Brexit withdrawal agreement. PM May confirmed that should her deal be rejected on March 12th, then the PM will put forward the choice to MPs of a no-deal Brexit vote on March 13th and should that be rejected, then a vote on extending Article 50 will be put forward on March 14th
- On growing expectations that the UK will avoid a hard Brexit the British Pound rose 1.0% to $1.32 against the US dollar and UK gilts sold off. UK Gilts declined 1.4%, with the yield on the 10-year Gilt rising 13.8 basis points to 1.30%
- Jeremy Corbyn, the leader of the UK's opposition Labour Party, said that his party would back a second referendum on Brexit
- UK equities declined 0.9% last week

Europe

- The euro area manufacturing sector entered its first downturn since mid-2013, as the manufacturing PMI fell to 49.3 in February from January's 50.5. The 50-mark separates growth from contraction on a monthly basis
- German retail sales rebounded more than expected as they rose 3.3% in January after a weak December. The yield on the 10-year Bund increased by 9 basis points to 0.18%
- Continental European equities advanced 1.0% on the week

Rest of the World/Asia

- China's manufacturing sector contracted for a third consecutive month in February. The country's official manufacturing PMI fell to 49.3 in February from 49.5 in January
- Following MSCI's announcement that it will increase the weight of Chinese A shares in its widely used global benchmark indices this year and positive trade rhetoric, Chinese equities advanced 6.8% on the week
- Emerging Latin American equities declined 4.3%, dragged down by heavy losses in Argentina and Brazil

Past performance is not indicative of future returns.
Source: Bloomberg, returns in local currency unless otherwise stated.