Quant investing

Quant investors face test of faith in 2019

Sharp reversals in market trends has hurt performance of some big quant funds this year

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Investors have been piling into computer-driven hedge funds in recent years, betting that advances in areas such as artificial intelligence and big data will help quants beat human traders. For many, 2018 has severely tested their resolve.

A year in which quant funds struggled to exploit any of their favourite patterns in markets saw many funds chalk up their biggest losses in years, ranking them among the hedge fund industry's worst performers.

"It was certainly a challenging year, there's no hiding from that," said Anthony Lawler, co-head of GAM Systematic. He attributes many of this year's problems to sharp reversals in the market in February and again in the autumn.

There has been no shortage of interest in quant investing in recent years. Investors have put a net $41.8bn into quant funds since the start of 2015, according to data group HFR, even as they pulled a net $27.6bn from hedge funds as a whole. A quant investing conference held at Goldman Sachs' London offices in September attracted about 450 people and was standing room only.

Investors have been attracted by developments in areas such as machine learning and big data, and the bet that emotionless machines can outperform human traders who have often struggled in markets dominated by central bank stimulus. Big institutional investors such as pension funds, who now dominate hedge funds' client lists, increasingly like quant funds that can demonstrate a repeatable process.

But while funds have been rapidly developing their strategies and computing power, at their heart many still rely on a few basic market factors working in order to perform. These include asset prices moving in long-running trends, cheap stocks performing better than expensive ones, stocks with stronger finances outperforming weaker ones and the ability to borrow cheaply and invest in higher-yielding assets. When these do not work, quants can suffer.

This year proved so hard for quants because many of these factors failed to work for a sufficient period of time. For instance, the strong upward trend in markets in January that was enjoyed by many quants was followed by a sharp pullback in February that caused large losses. Sectors such as technology with fast earnings growth proved to be a crowded trade, and quants struggled to capitalise on rapid changes in investor interest between sectors. Betting on cheap stocks has largely proved an underperforming trade for investors across the board for some time now.

"Honestly, nothing's working," said an executive at one quant hedge fund.

GAM's Mr Lawler said betting on rising volatility was "pretty much the only thing that worked this year" but was an expensive strategy to run.

Performance numbers largely make for sorry reading. GAM's Cantab Aristarchus fund is down 25.9 per cent this year, having gained 31 per cent last year as one of the world's best-performing hedge funds, said a person who has seen the numbers. Aspect Capital's Diversified fund has lost 15.2 per cent. Ken Tropin's Graham Global Investment fund has lost 9.2 per cent in one share class and 13.6 per cent in a higher volatility one, according to numbers sent to investors.

Leda Braga's Systematica Bluetrend fund is down 12.8 per cent, and Paris-based CFM's ISDiversified fund has lost 7.8 per cent. Amplitude Capital's Dynamic Strategy has lost 20.1 per cent, although the firm said it runs other portfolios that performed better.

WorldQuant, whose fund closely tracks the market while trying to beat it, has underperformed the market by nearly 1 per cent after losing money in October, said a person who had seen the numbers.

Funds have been hit by "choppy markets" driven by risk relating to trade tariffs and other geopolitical events, said Irene Perdomo, co-founder of Devet Capital, which is up 1 per cent this year. The fund has made money trading calendar spreads — bets on rising and falling prices on the same asset but over different periods — in gasoil.

Robert Duggan, partner at New York-based SkyBridge Capital, which runs $9.4bn and invests in hedge funds, has been largely avoiding computer-driven trend-following hedge funds since shortly after the financial crisis. Rather than acting as a diversifier, he said, such funds have been "very long equities at a point in the cycle where we didn't feel it was prudent to add directional equity risk to our portfolios".

Not everyone has performed badly. One standout performer was Gresham Investment Management's Quant Acar fund, which is up 28.1 per cent. Paris-based La Française's Vision-Premia Opportunities fund is up 3.4 per cent this year. An $800m fund run by Graham Capital has gained 14 per cent.

Osman Ali, portfolio manager in Goldman Sachs Asset Management's quant team, argues that funds that used so-called alternative data sets, which ranges from satellite imagery to credit card sales data, performed better than those using financial market data.

Quant investors now face a test of character. The removal of central bank stimulus should make markets easier to navigate, but also appears to be causing greater volatility, which brings its own dangers. This year quant funds can hide to some extent behind the wider failings of other hedge funds and investors more generally. But their clients may not be so forgiving if performance does not pick up in 2019.