Quant or trad: How fundamentals can drive both

Federated Hermes

Federated Hermes MDT Advisers

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Key takeaways

- **Quant investing and bottom-up fundamental approaches have more in common than is often assumed. Manager intuition and skill can be a feature of both.**
- **Fundamentally-driven quant strategies can enjoy the additional advantages of greater diversification that comes from greater depth and a far broader investment universe — all within a systematic approach.**
- **Likewise, good quant managers can demonstrate what factors they use have worked — and show why they've worked. Think 'glass box' rather than 'black box'.**

For many investors, traditional, fundamental, bottom-up strategies are seen as inherently opposed to quantitative strategies. Those who favor a fundamentally driven approach to investing often characterize quant strategies as opaque, overly complex and vulnerable to systematic bias — in contrast to the skilled, patient and painstaking approach of the bottom-up active manager. In addition, traditional, bottom-up approaches are often considered to be more intuitive than quantitative approaches.

For both trad and quant managers, two things matter here: their degree of skill and the number of times that they can implement it within their investment universe.

But we don't believe this distinction is justified — at least as far as it applies to those quant strategies that focus on fundamental data rather than market anomalies and arbitrage opportunities. By fundamental data, we mean metrics such as price/book and price/earnings ratios, cashflows and debt coverage, along with qualitative assessments of managements, supply chains and the like. Here, the distinction should not be drawn between fundamental and quant but between traditional and quant.

Many quant strategies are just as fundamentally based and bottom-up as the most traditional active approach. One could consider these quant strategies as simply mathematical expressions of the same fundamental insights employed by traditional, bottom-up approaches. They use the same metrics as a traditional manager: price/earnings ratios, cashflow, debt coverage and the like.

Breadth, depth and skill

The broad distinction between traditional bottom-up and fundamental quant rests on an instinctive yet subjective approach deployed by experienced traditional investors. On the other hand, it involves a systematic, objective approach deployed by experienced investors who combine a keen understanding of investing with strong mathematical and technological skill.

Essentially, we are distinguishing between the systematic implementation of a well-researched and tested approach and an approach that allows a manager to take a deeper dive into all the elements that might drive a company's business. This deeper dive often comes at the expense of the manager's ability to cover a broad universe — which is why so many traditional bottom-up approaches tend to be quite concentrated. Meanwhile, the systematic quant approach can still offer meaningful insights into the prospects for a given company's share price while allowing coverage of a much broader universe.

A glass box, not a black box

Another common charge laid against quant strategies is that they rely on a 'black box' – an opaque and mysterious means of decision-making that keeps investors from understanding what exactly they're buying into.

But that's not necessarily the case with fundamental quant. Rather, fundamental quants can work with a 'glass box' – a transparent process that allows you to see what's going in and what's coming out. Rather than being mysterious about their processes, fundamental quant managers can demonstrate what factors they use have worked — and show why they've worked.

That's not to say that all quant strategies take this approach. It's important to maintain the distinction between fundamentally driven quant approaches and other quant strategies such as statistical arbitrage (stat arb). Often, stat arb and other short-term or high-frequency strategies are much less transparent, relying heavily on closely guarded proprietary algorithms and automated trading systems.

But it's important not to paint fundamental quant with the same brush. This approach is driven by fundamental factors and manager intuition – the same factors that drive traditional bottom-up approaches. The difference is simply that those factors are addressed systematically.

Another key consideration with both trad and fundamental quant approaches is manager skill. This can be measured by the information coefficient or IC. The IC is defined as the cross-sectional correlation between a manager's predicted returns and actual returns over a given period. A score of +1 represents a perfect correlation between predicted and actual returns. Meanwhile, a score of -1 shows that there is no relationship between the predicted and actual outcomes.

Traditional approaches often work by exploiting their managers' in-depth knowledge of a relatively small universe of stocks. That's both a strength and a weakness of the trad approach: a small team of managers may have difficulty achieving the required depth over a huge universe, given the efforts involved. These may involve visiting sites, talking to staff and management, and contacting various companies along the supply chain.

So, while traditional bottom-up managers typically have a high degree of skill (IC), they may only be able to implement it in a relatively limited universe. In other words, the more companies these managers cover, the less they may know. Although they may theoretically cover a large universe of stocks, that universe will be distilled down to a much narrower range by a simple screening process. The insights that active managers can offer will not be applied across the original large universe.

By contrast, quant managers may, individually, have slightly lower ICs. They do not get to know companies inside and out in the way that a veteran bottom-up manager can, and so they will not achieve the same depth of knowledge.

But that lack of depth has to be taken together with the potential advantage in breadth. Quants can apply their skillsets over a much broader universe of stocks than traditional managers. And — crucially — they experience little or no decline in their ability to analyze stocks as that universe expands.

This means that quant managers can apply their insights over thousands of stocks, rather than having to narrow the universe to a human scale. This can bring advantages, such as broader diversification and, as a result, the potential for lower volatility and better risk-adjusted returns.

Also, while quants may not achieve the same degree of depth as trad managers, they do apply their insights systematically, reducing the risk of biases creeping into the decision-making process.

Technical questions

Fundamental quant processes often make use of price-based factors (technicals). This can be seen as straying from a bottom-up focus — and this is sometimes used to argue that these quant strategies aren't genuinely fundamental in nature. But technicals do ultimately reflect fundamental insights, and their use can provide quant managers with an additional edge.

Take price trends for instance. Although they reflect sentiment and so may appear to lie a little outside the scope of a pure fundamental approach, we would argue that they really act as an encapsulation of all of the fundamental information available. This includes those aspects of a business that haven't yet been — or can't ever be — observed through a conventional fundamental lens.

Financial statements provide a good example of this. They are, inevitably, reported with a lag: they describe what happened in the previous quarter or year. On the other hand, mergers and acquisitions can be announced but may not have a financial impact for many quarters or years while we wait for the deal to close and the company to report on its financial position. While financial statements look backwards, technical factors can reflect these developments in real time.

This can be particularly important with technology-oriented companies; you don't see what's going on very clearly if you confine yourself to financial statements. There are intangible aspects that don't end up on balance sheets: the contracts that are being signed, the number of subscribers and so on. The revenue that arises from these developments will be reported in the future, but it's not available as the developments that will drive it unfold.

So, price trends can act as a kind of catch-all mechanism for understanding and evaluating this sort of information. Technicals thus allow quants to incorporate real-time fundamental information that might otherwise be invisible to them.

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Fundamentally driven quant managers do care about what they own – and why the particular characteristics of those businesses make them well suited to their clients' goals.

Fundamental at heart

The greatest commonality between traditional bottom-up approaches and fundamental quant is that both are interested in the strengths of the companies in which they invest. At heart, both approaches are concerned with identifying good companies.

That's not necessarily the case with many other quant approaches. Many non-fundamentally driven quant strategies are indifferent to whether they are investing in good companies or bad. Instead, they're concerned with exploiting trading inefficiencies and making money from market movements — whether that involves holding shares for days, hours or a fraction of a second. They essentially serve as market-makers and providers of liquidity.

Market-making is a useful function, and these strategies have their place in the financial ecosystem. But what they do is very different from the approach that fundamentally driven quant strategies take: being long-term stewards of their clients' capital and looking to produce an edge over broad equity indices.

Fundamental quant's place in your portfolio

Both the traditional and quant approaches to fundamental investing have their merits. Traditional managers can offer advantages through their depth of insight and their ability to interpret tactical signals. On the other hand, fundamental quant managers can generally offer greater breadth, more rigorous discipline and more broadly based diversification — all within a systematic approach.

Ultimately, we believe that investors who are comfortable with traditional bottom-up strategies should be equally comfortable with a fundamentally driven quant approach. They can consider fundamental quant as an attractive alternative to traditional investment vehicles.

Those investors may even come to prefer the systematic strengths of quant, with its potential for alpha generation and the greater diversification that comes with an unnarrowed universe. A well-run quant strategy can offer transparency and consistency of process, the elimination of behavioral biases and an unremitting focus on stock fundamentals — all characteristics that may have considerable appeal to traditionally minded investors.

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