cio investment club

Roundtable #4 July 2024

Quant Investing Roundtable: Big data? Go quant

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sean.thompson@cioinvestmentclub.com
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Quant Investing Roundtable: Big data? Go quant

Regulation is de facto the greatest asset allocator in the world. And so, it is worth pondering how regulations governing long-term investors, notably pension funds, have been a boon and a drag for quantitative investing.

Policies to ensure pension plan participants are getting value for money have pushed pension boards towards passive investing, the quant strategy that dominates equity investing today.

The transparency of index-tracking is perennially attractive but cost is the key lure. More and more boards and their investment committees are reluctant to seek outperformance with the additional risk and fees involved.

Where does this leave active quant? Simpler strategies had their moment in the sun last decade with the rise of smart beta and factor investing. Some of the most successful products overpromised; clients ignored essentials such as the variability of signals. More sophisticated strategies today face various headwinds: winning an outsized portion of the risk budget; distinguishing themselves from naïve factor-based strategies; justifying their efficacy in a world of responsible investors.

That last point is an interesting one: given that standards of ESG data are still developing, quant houses should have advantages over their fundamental peers in sorting information by meaningfulness. Much of the investing world currently relies on a few third-party providers of ESG data whose scoring methods do not correlate strongly. Insourcing some of the analysis would require capex but then so does the whole realm of AI. Data is the new oil.

The good news is that quant shops are a natural home for data scientists. Where before university academics in finance would have been the talent to hire, asset managers will look to programmers to search for new information sets for signals on sustainability and pricing.

Understanding clients will back active quants in this evolution, believing that the most ambitious will maintain their edge. A moot point, as ever with quant, remains comprehension. Data is expensive to buy and therefore jealously guarded once organised in proprietorial systems. But communication about those systems and how they generate investment insights is essential in preserving the faith of clients.

Keeping competitors in the dark but clients in the light will be a balancing act.

Active

Active quant managers are benefitting most from the increasing power to analyse data and find profitable patterns. They are flexible in adjusting strategies to suit risk tolerance. But the cio investment club roundtable found that they still battle to persuade some institutional investors away from passive.

The cio investment club's Quant Investing Roundtable 2024 began by asking the consultants, insurers, fiduciary managers and asset managers present whether active quant was suitable as a core investment strategy? The majority response was 'yes', albeit with caveats.

Pete Drewienkiewicz, CIO at Redington, a pension fund consultancy, said that clients in the wholesale channel had tended to pay a bit more than institutional investors for passive management. He saw this as an opportunity for active quants to offer an alternative to passive here. But he qualified that for this opportunity to be realised, the active quants, at least in their off-the-shelf offerings, might want to lower current fees.

Patrick Egan, senior portfolio manager at Russell Investments, which runs multi-manager strategies, said active quants in theory lend themselves well to core strategies because they quantify risk and return and optimise portfolios in order to control the risk. He warned, however, that history has shown that there are episodes when active quants behave in a cluster. "So we would combine them with complementary managers which are not quant," said Egan.

Noel Evans, senior research specialist at Phoenix Group, the UK's largest long-term savings and retirement business, has been 'walking the walk'. With colleagues he has been gradually shifting core equity exposures from fundamental to active quant management since 2017. His team has awarded £14bn in UK equities to three active quant managers, seeking 75-100 basis points of outperformance. European equities are next in line to be moved to quant.

Greg Bond, CEO of Man Numeric, an active quant manager, questioned how we define 'core'. He recalled the style box much used in the US, wherein Value, Growth, Large Cap and Small Cap flank core in the centre square. Bond recognised that every ten years or so there is a big sell-off of the factor complex. He referenced the 'Value winter' that marked the final years of the last decade as the latest. Such shocks can test investors' faith in quants' ability to deliver core returns. Bond reckoned, however, that the set of models used by active quant managers have become more diversified in order to manage better both drawdowns and periods in which factors are strongly positive.

Kurt Livermore, portfolio manager at Lazard Asset Management, said that within the universe of active quant managers, you do see a bias towards Value in many strategies. So, Egan had a point, especially in the US, this bias has been punitive – in contrast to Emerging Markets or global developed ex-US.

Livermore also noted a small-cap bias among some active quants. He suggested that quants with value and small cap biases may need to be paired with Large-Cap Growth to bring the overall style exposure back to core.

He noted that plenty of quant strategies are available in packaged form from investment banks. Moreover, many of the most sophisticated asset owners have developed their own internal quant management. These developments matter because active quants will want to know how popular their signals are. Imitators will ultimately erode the efficacy of any signal. With investment bank products, Livermore said it was hard to tell the volume of assets following them.

In assessing the risks of imitation, one needs to be aware of what a portfolio manager is referencing as the investable universe. So the cio investment club panel was then asked which benchmarks worked best for active quant equity. The general observation was that the broader the benchmark, the more opportunities for active quants to explore and exploit.

> *active quants in theory lend themselves well to core strategies because they quantify risk and return*

Bond said that more and more clients were asking for tweaks and customisation. Certain of these, such as investing in alignment with a 2C rise in temperature this century, required little adjustment to the investment model. But he said the most important thing was to be on the same page as the client and consultant so that all parties were clear about how any ex-ante alterations or exclusions affected the investment model. "Ultimately, we're happy because this is a way of deepening the relationship with key clients," said Bond.

Egan said Russell Investments offers clients customised solutions, taking the model portfolios from active managers and then adjusting them quantitatively to clients' wishes.

Evans said that Phoenix is transitioning to customised benchmarks, designed with FTSE, excluding tobacco, and Net-Zero Carbon-aligned. There had been discussions with one active quant manager regarding how performance fees would be calculated using the new indices.

Jason Becker, head of DC Investment Consulting at Capita Pension Solutions, asked the active quant managers how they had fared over the last 12 months, given the S&P500 was up c.26%. Becker feared that active quants had done well on diversification but not relative return.

Drewienkiewicz pointed out that active management, quant or fundamental, doesn't tend to work well in concentrated markets. "Meaningfully overweighting any of the Magnificent Seven tech stocks currently dominating the US stock market is difficult in terms of risk management," he said. "It could also rub up against UCITS regulations [which put a cap of 10% on any single holding in the fund].

"Some people will tell you that you should have a benchmark but that the manager should be able to use shorts and longs around that, e.g. 130/30, where you can extend the alpha potential," added Drewienkiewicz. "This gets away from under and overweights."

But he admitted that you don't see a lot of long/short strategies. "The problem comes back to costs. Off-the-shelf active quant looks too expensive to a be a core strategy," said Drewienkiewicz. "Prices are similar to full-fat fundamental. If we are trying to educate people away from passive, that needs to change."

Livermore replied: "My perspective is that if you achieve the same excess return outcomes, then you should be charging the same fees. If the unit of alpha gets achieved at a high tracking error, however, that is less efficient. People spend tracking error foolishly. Fundamental managers with narrow 40-stock portfolios have not all been successful. Conversely, a low tracking error makes sense if the Information Ratio is high. Plan sponsors rightly assume manager risk is a bit more predictable than excess return.

His team's US equity strategy has outperformed the US equity market in each of the last three years. Livermore claimed that one contributing element was good selection among the Magnificent Seven tech stocks. But either because or in spite of a low tracking error, he said it has proven difficult to get US pension plan sponsors to move away from passive.

On 130/30 strategies, Livermore said there were folk who remain scarred from the quant meltdown of 2007. He added that the governance structure required to monitor 130/30 was greater: "You start introducing a prime broker: the Hedge Fund team inside a large asset owner wants to be involved."

Education

Drewienkiewicz emphasised education and communication. Redington had to do a lot of work in 2018-19 when Value was underperforming. “We lost one client,” he admitted.

Redington tends to stick with the established Fama-French factors and the behaviouralism that grounds them. Drewienkiewicz said clients warm to this and then find quantitative approaches comforting.

He said that Redington doesn’t drill into the nitty gritty of quant models with clients. Instead, for them it is a risk target. “There is no substitute for going through a cycle with a client, seeing some downside and consistent outperformance when things return to favour. With a tracking error of 3-4%, you can have a 6% outperformance year and a 6% underperformance year. It won’t be a lovely smooth ride; there will be bumps in the road.

“We lean on the managers for education. It’s then not about pointing fingers. They are our partners. It’s a tripartite relationship with client, consultant and manager.”

Becker asked how active quants present their strategies. In the DC space, he said he is working with employers who do not understand or have experience of investing.

Bond said Man Numeric uses a lot of visualisation tools to present investment concepts graphically.

Bond then addressed the cost issue. He said that Man Numeric had traditionally been a one-size-fits-all house. “There was nothing but the off-the-shelf strategy, with 3-4% tracking error – ‘take it or leave it’.”

That has changed over time. “We like to talk about alpha times assets. We are indifferent to how we package that. We work with clients to apportion the fee appropriately as we add more scale.”

Bond’s bugbear was that scaling alpha by assets is perceived as lower quality. “It’s the same alpha model,” he underlined.

“We lean on the managers for education. It’s then not about pointing fingers. They are our partners. It’s a tripartite relationship with client, consultant and manager.”

Model Development

The cio investment club panel then turned to the ongoing development of quant investment processes, including incorporating Big Data and Artificial Intelligence (AI). Livermore observed that the domain of human judgment can be more and more systematised. "That has opened up advantages from the likes of natural-language processing (NLP)," he said. "We have been getting ideas from colleagues at Lazard on the fundamental teams - not implementing their buy and sell ideas but quantifying how they think about the world."

He said it was hard to justify any cutting edge if your strategy is just basic implementation of Fama-French factors. He claimed Lazard's active quant strategies are differentiated from such naïve approaches and had different types of return stream.

Asked how Lazard used data to achieve a cutting edge, Livermore said his team preferred datasets that are messy. "Then we tidy them up. Someone selling us a clean dataset is invariably going to be selling that to all our competitors; it will get arbitraged away. We prefer broad datasets; with insights for a range of stocks rather than just one cluster or sector."

Bond agreed that managing by academic factors is easier; it was incorporating models designed to harvest idiosyncratic premia that is harder. "We have to show that anything idiosyncratic adds value, but also whether it is genuinely new."

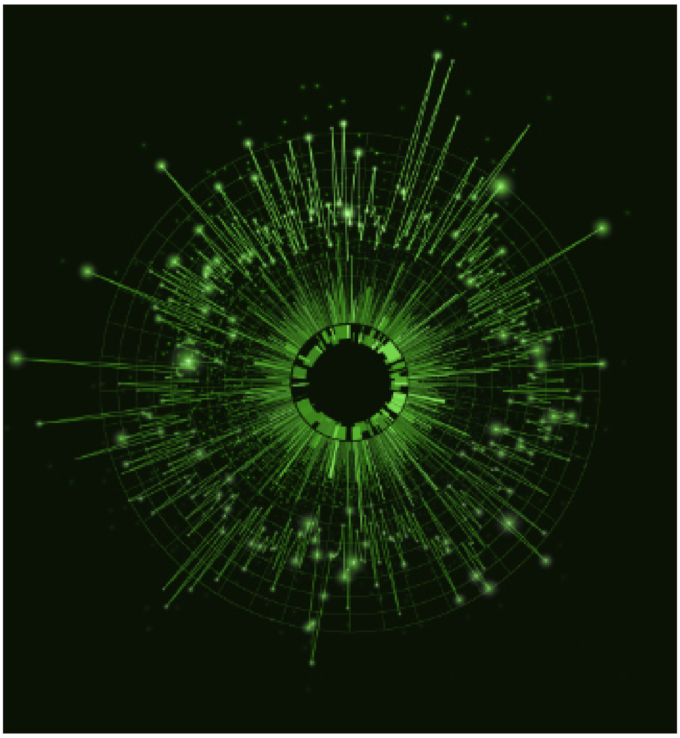
Bond explained that part of the problem is that when the salient academic factors made a strong recovery, as after the Global Financial Crisis, the business case within an asset management firm for researching and incorporating new signals wanes. "People can argue: 'Where's the need? Why alter something that's working?'

Bond's summary was that there is never a good time to make changes. But Man Numeric emphasises the need to add new content into its investment process each year.

How that content is judged worthy of inclusion can begin with a standard process of running any model through a BARRA risk factor analysis (a multi-factor model that uses the overall risk associated with a security, relative to the market) to ascertain what is sufficiently diversifying to be of additional value. But Man Numeric then convenes members of several departments on an expert panel. "Researchers love to make changes. Portfolio managers tend to not," Bond observed. The panel includes folk from both departments plus technical experts from risk and IT, the people who build any new capability. These panels anonymously reach judgement about what is worth building and incorporating.

Both quant managers at the roundtable emphasised that having multi-disciplinary teams fostered better outcomes. "The idea of these groups is to bring the human side of quantitative into the design," said Bond.

"Markets are made up of people. Investing is a social science," observed Livermore. "So we have people with academic backgrounds and those who have spent time in finance. We expect to learn from each other because there are lots of decisions that are neither quantifiable nor knowable. He remembered that quant strategies that ignored this truth had got into trouble in the past. "Before AI, we had machine learning. That was incorporated into some strategies. In essence, they relied on Momentum, and so did really well when markets were going in one direction," observed Livermore.



Smart Beta

Drewienkiewicz said that basic factor investing is Smart Beta, or unsophisticated quant. He noted that it did not necessarily have to be a public methodology. It could be predicated on some specialist analysis, such as the historic effect of intangibles on corporate balance-sheets. Understanding this proprietorial model would be the basis of a sensible conversation with the manager.

What Drewienkiewicz did not want was hollow claims that a strategy was 'all-singing, all-dancing' when in fact it was much less. "Investment banks will throw up anything and see if it sticks," he said. "We don't want choppy performance."

Livermore said he was fascinated by the essential role of backtests in Smart Beta or factor-based indices. He said that if Fama-French factors were accepted as an index, any move away from that led to some form of backtesting. He wanted to know how many times Smart Beta managers would run calculations in order to get the historic performance they desired.

For Phoenix, Evans said he was looking for the sensible evolution of a quant process over time predicated on behavioural factors. "We had one manager that introduced a Vaccine factor in 2021; we thought that was just a short-term trade."

On backtests, Noel said that one manager had a glittering backtest but poor short-term live performance. When challenged on this disparity, the manager then produced a backtest including the period of live performance that was better than the actual track record.

Regarding transparency, Egan said that over the last 20 years, some active quant managers had become more guarded about what they reveal about their process.

"How much can you tweak standard factors? I think that's the realm of Smart Beta," he said.

The conundrum, Egan pointed out, was that if it the methodology is transparent, then what's to stop others copying it? He said that the much higher fees charged by active quant than Smart Beta was supposed to pay for hard-to-replicate technical inputs, such as using

> *We've definitely had meetings with clients and consultants where the question has come from another manager*

unique datasets and/or machine learning, that ultimately manifest themselves as a benefit to clients.

On the guardedness of active quants, Drewienkiewicz acknowledged that it was difficult for these managers because the biggest asset owners globally have built in-house capability by hiring ex quant employees; and by quizzing active quants in research meetings to the point where the asset owners have gleaned sufficient detail to figure out how to replicate the strategy.

“Regulatory and media pressure on fees pushes big asset owners to explore these strategies,” said Drewienkiewicz.

“One worry for active quant managers is that something proprietary will slip out to the broader industry as a result of a meeting,” said Egan.

“We’ve definitely had meetings with clients and consultants where the question has come from another manager,” said Livermore.

The cio investment club roundtable closed on the topic of AI. “I use Large Language Models (LLMs) every day,” said Livermore. “I use AI to help with coding to free up time for other time-intensive research. It does a great job summarising.” His team is not, however, using LLMs in the investment process because the team is not sure how they are making inferences.

“It’s never great having to go to a client and saying ‘we underperformed and I don’t know why’,” observed Livermore.

In contrast, Lazard does use Small Language Models because the team is more confident that it can track how these models are making decisions. “We can see how it’s trained,” said Livermore.

Bond said that AI was good because it could take care of certain technical functions that staff were capable of, but now freed them up to do the more creative work.

“This makes us more productive,” he said.

“It’s never great having to go to a client and saying ‘we underperformed and I don’t know why’”

Participants

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Kurt Livermore

CFA, Director, Portfolio Manager/Analyst,
Lazard Asset Management LLC (Boston)

Kurt Livermore is a Portfolio Manager/Analyst on the Lazard Equity Advantage team. He began working in the investment field in 1997. Prior to joining Lazard in 2023, he was a senior quantitative equity Portfolio Manager with Acadian Asset Management. Previously, Kurt served as a Partner and Portfolio Manager for U.S. and global equity strategies at GlobeFlex Capital, and beforehand was a portfolio manager for U.S. equity market-neutral strategies at FrontPoint Partners/Matikos Capital. Kurt started his career at BGI/BlackRock. He has a B.S. in business administration from the University of Arizona. Kurt is a CFA® charterholder.

Capita

Jason Becker

Head of DC Investments, Capita Pension Solutions

Jason has extensive experience in DC Investment Consulting, having set up and led a large DC investment and consulting business in South Africa. Jason has a deep understanding of pensions and investments having successfully delivered a broad spectrum of services; including all aspects of investment strategy design, implementation, governance communication and distribution.

Pete Drewienkiewicz

Chief Investment Officer, Redington

Pete is Chief Investment Officer at Redington and is a voting member of Redington's Investment Strategy Committee. In this role he advises a range of institutional clients with combined assets of more than £200bn including pension schemes, non-profit institutions, LGPS, insurance companies and wealth managers.

Prior to taking up this role in March 2018, Pete led Redington's Manager Research team since 2011, where he oversaw a team of investment professionals responsible for the selection and monitoring of investment managers across both traditional and alternative asset classes. Before joining Redington, Pete spent 9 years working in fixed income and derivative markets at a number of large investment banks. Pete has a Bsc in Economics from the London School of Economics.

Noel Evans,

Senior Research Specialist, Phoenix Group

Noel Evans joined the Phoenix Group in 2011 within their Investment Office. Noel went on to join their Asset Management Business in 2020 where he has responsibility for a number of the key investment management relationships across the group. During this time he led on the manager selection for a c.£14bn UK equities quants mandate.

He was previously an Investment Specialist covering Hedge Funds at Columbia Threadneedle and has also worked as a Client Relationship Manager covering institutional clients.

Noel holds a BSc (Hons) in Economics and holds the Chartered Alternative Investment Analyst qualification.

Gregory Bond

Chief Executive Officer, Man Numeric

Gregory ('Greg') is CEO of Man Numeric, Head of the Americas for Man Group, and lead portfolio manager for Man Group's flagship multi-strategy fund. He also serves on the Man Group Executive Committee and the Man Numeric Investment Committee.

Previously, Greg was director of research at Man Numeric, responsible for research initiatives, including the day-to-day management of Man Numeric's strategic alpha research team. Before becoming director of research, he was a portfolio manager for various hedge fund strategies at Numeric as well as being co-head of its hedge fund group, having joined in 2003.

Greg holds a Bachelor of Arts degree in economics and in biology from Yale University and a Master of Business Administration degree from Harvard Business School.

Patrick Egan

CFA, Director, Senior Portfolio Manager, Russell Investments

Patrick is a member of Russell Investments' Global Equities team and manages Global, UK and European equity funds. Aside from selecting sub-advisors and managing portfolio exposures, Patrick conducts regular reviews of funded managers and participates in the research of broader manager universes and the firm's proprietary investment capabilities.

Prior to joining Russell Investments in 2006, Patrick worked for five years in the multi-manager team at Barclays Wealth where he covered Japanese, Asia Pacific and Emerging Markets Equity managers. Patrick joined Barclays as part of their Business Leadership Programme in 2000.

Patrick holds a Masters in Finance and a B.Sc. Management Engineering.

In attendance

Brendan Maton (Moderator)

Crayford Ash

Brendan Maton has been covering pensions and investments as a journalist for almost thirty years. He began his career at FT Business before going independent in 2003. Since then, he has chaired roundtables, moderated investor conferences and hosted the IPE channel of sponsored webcasts. He still writes on pensions and investments for IPE as well as freelancing for a host of organisations.

Tom Lever

CFA, Director, Consultant Relations Manager, Lazard Asset Management Limited (London)

Tom Lever is a member of the Consultant Relations Team at Lazard Asset Management Limited, London. Prior to joining Lazard in 2011, he worked for Mercer Investment Consulting for 5 years. He holds an MA in Economics from the University of Edinburgh and is a member of the CFA institute.

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Tim Peach

Head of Global Consultant Relations and Global Banks, Man Group

Tim is Head of Global Consultant Relations and Global Banks. Based in London, his responsibilities include leading the sales effort with key global consultants and other major financial institutions around the world.

Tim joined Man Group in 1997, initially covering European clients from both the London and Swiss offices. He transferred to Asia in 2006, where he was responsible for Man Group's Asian business until mid-2014.

He has over 25 years of industry experience across a broad spectrum of traditional and alternative investments, in both the institutional and wealth domains. Tim holds a BSc in Marine Geography from the University of Cardiff.

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Sean Thompson

Founder & Director, cio investment club

Sean has 38 years of experience working in London's financial services sector and the insurance market. After 10 years as Managing Director of CAMRADATA, Sean launched the cio investment club on 1st January 2024.

The cio investment club's mission is to become the voice of chief investment officers and investment professionals at institutional firms. To help achieve this the club hosts events throughout the year that educate and inform, whilst providing thought-provoking content to its members.

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