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Active management's changing face

Ndina Rabali, chief investment officer of Lima Mbeu Investment Managers, discusses advantages of the 'quant-amental' approach.

As far back as 1974 Keith Ambachtsheer – currently a professor of finance at the University of Toronto – observed: "Active management is under serious attack because, as evidence knows, it has produced not overperformance but underperformance." This statement still rings true.

Active management finds itself under significant pressure from passive funds because most active managers have produced long-run underperformance of their benchmarks. Competition from passive funds is forcing active managers to justify not only their fees but also their existence. In this context, it's vital that active managers evolve and capitalise on advances in technology for delivery of better client outcomes.

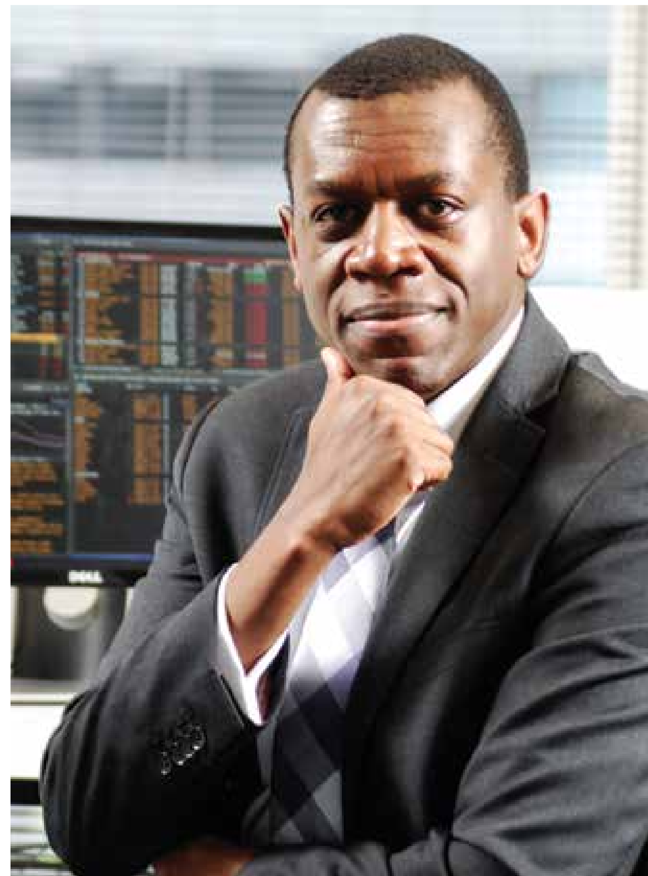
Active management is the process of building an investment portfolio where the weights of individual securities differ from the market. In the long run, investors expect a reward for taking on more market risk. Because of the higher risk that comes with investing in equities, they expect a higher return for investing in equities as opposed to cash.

Unfortunately, the same relationship does not necessarily hold when applied to active management. Investors will not always receive a higher return for building a portfolio that looks very different from the market.

Why have active managers performed so poorly?

Active management is about one thing – information. Active managers believe that they can access and process information better than others to build investment portfolios that add value.

However, critics believe the failure of most asset managers to outperform their benchmarks is evidence that active management is a futile exercise. This view has led to the increased popularity of passive funds.



Rabali . . . fresh views

Of course, traditional approaches to active management have weaknesses that may often lead to poor outcomes for clients. The two main approaches used in the selection of investments in actively managed portfolios are fundamental and quantitative.

Fundamental approach has flaws

For many years, analysts and portfolio managers have conducted fundamental research. They make buy or sell recommendations based on their knowledge of companies. This is a highly subjective approach that often leads to errors. For example, analysts are generally overconfident and believe their forecasts to be more accurate than what they actually are.

Eric Sorensen, chief executive of Boston-based PanAgora Asset Management (over $46bn assets under management) argues that fundamental active managers cannot analyse a vast number of opportunities. Their analytical framework is also susceptible to emotional errors such as falling in love with a stock. Unless fundamental portfolio managers find ways to reduce such errors, the trend of disappointing client outcomes may continue.

Quantitative investing also imperfect

Quantitative portfolio managers try to predict future prices of securities by looking at historically recurring patterns, based on analyses of various datasets. This approach is not susceptible to the emotional errors of the fundamental analyst. Unfortunately, it does not have the human insight required to adapt to changing trends.

For example, most quantitative funds were slow to react to the spike in volatility during the 2008 global financial crisis. The funds were still making decisions based on the data observed during prior years and were unable to realise that the environment had instantly changed. Quantitative investors must explore ways to incorporate human foresight into their strategy if they are to enhance their chances of delivering outperformance.

Quant-amental investing the solution?

It's possible for active managers to develop an approach that does not have the weaknesses of either the fundamental or quantitative methods. Globally, a new breed of active managers has emerged. They have taken advantage of the rapid advances in technology to develop an investment approach that harnesses the best elements from the two traditional methods.

Quant-amental investing is an approach that combines quantitative and fundamental techniques to make superior investment decisions. It leverages the power of data without abandoning the positive aspects of fundamental analysis.

For example, a quant-amental investor might use a statistical model to generate investment ideas but use fundamental analysis to decide which of these ideas to include in a portfolio. It reduces the level of bias that affects the generation of investment ideas while retaining the human foresight that is necessary to capture new trends.

Today, with the advances in technology, analysts can use sophisticated models to tap into multiple data sources. Access to unique data gives them an information advantage over those who remain rooted in traditional methods.

It is therefore possible to construct an approach that has numerous strengths relative to conventional approaches. This is the quant-amental approach that combines the best of both worlds.

Strengths/ Weaknesses	Quantitative	Quant-amental	Fundamental
Depth	✗	✓	✓
Human Insight	✗	✓	✓
Breadth	✓	✓	✗
Discipline	✓	✓	✗
Adapt to trends	✗	✓	✓

Source: Lima Mbeu Research

In conclusion

Active management faces numerous challenges due to the delivery of disappointing outcomes for clients. In response, investors are beginning to favour the use of passive funds.

But before sounding a death knell for the active-management industry, investors should consider improvements that can be made to traditional approaches. Quant-amental investing harnesses the benefits of traditional investment approaches without their baggage.

Active managers who use the same tools and techniques from the past will limit their ability to deliver investment outperformance. As Sorensen puts it: "New approaches with depth, breadth and focus will be the hallmark of tomorrow's successful active managers."