

Fund Management

The Quant Outlook: Il Paradiso?

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See Appendix A-1 for analyst certification,
important disclosures and the status of non-US
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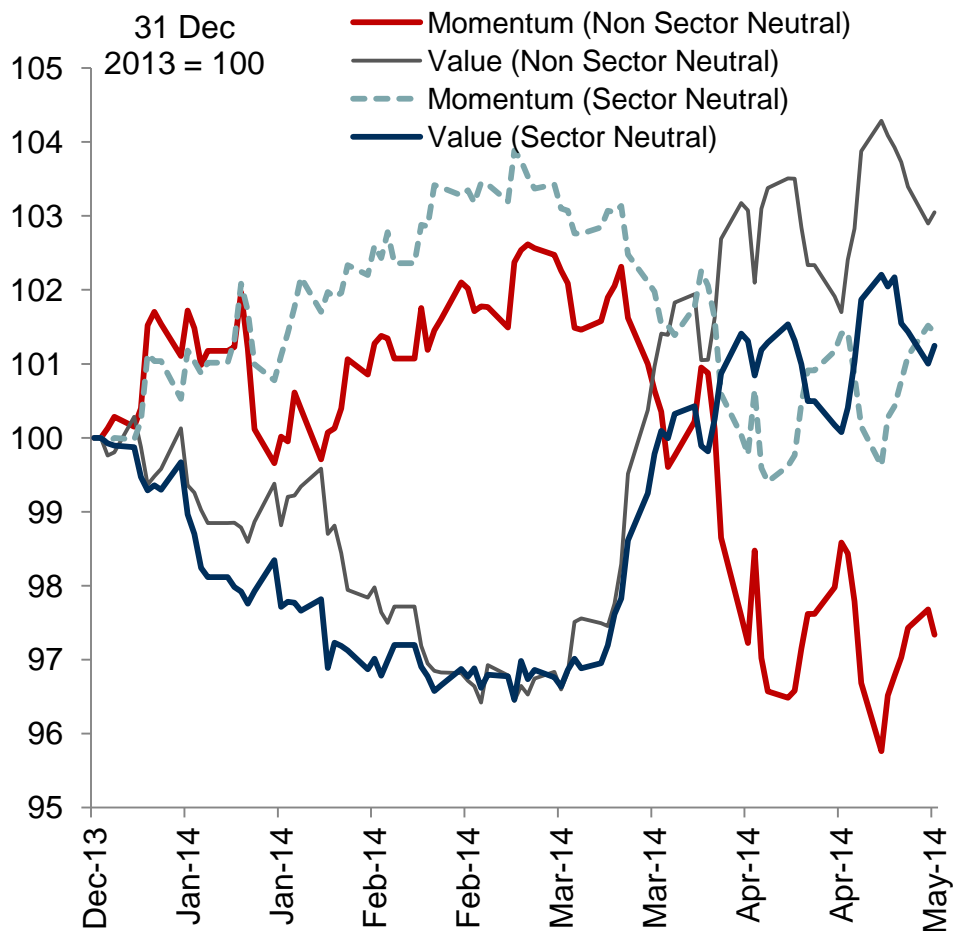
- Momentum's impact on recent fund performance
- No problem with low active share... as long as one is a quant
- The recovery of quant: *Il Paradiso?*

Momentum's impact on recent fund performance

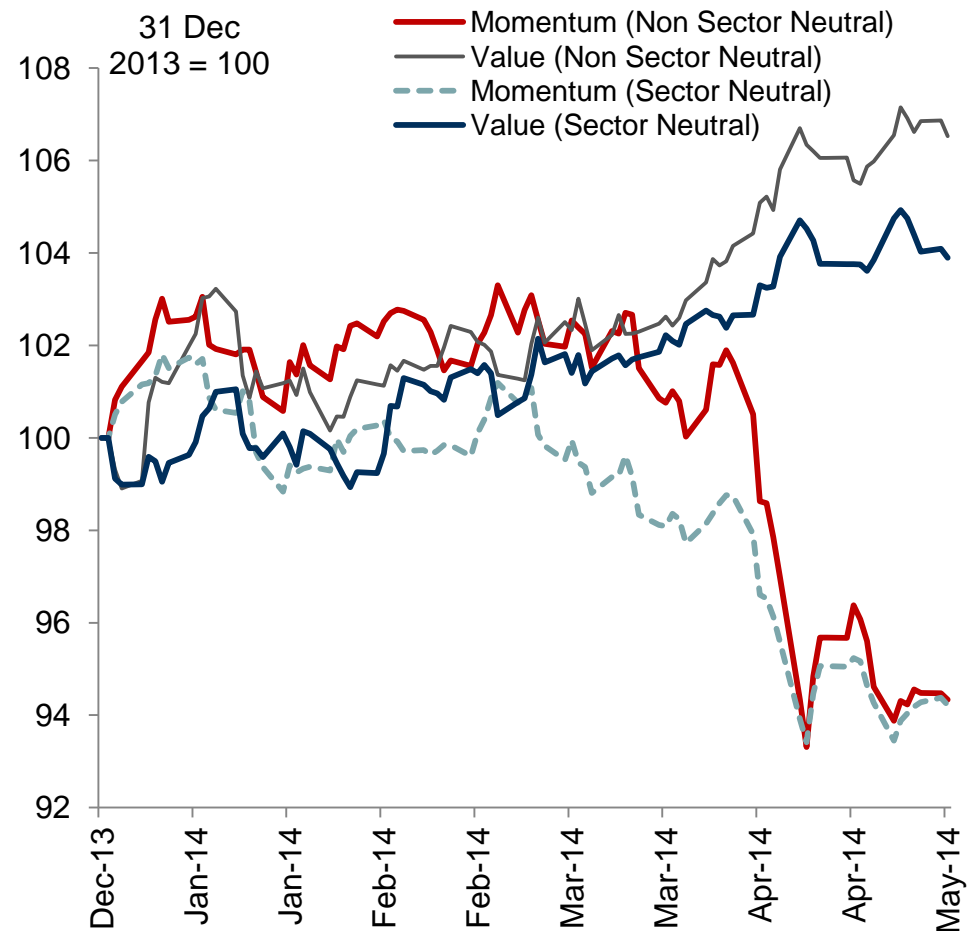
Daily performance of Composite Value & Composite Momentum

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US



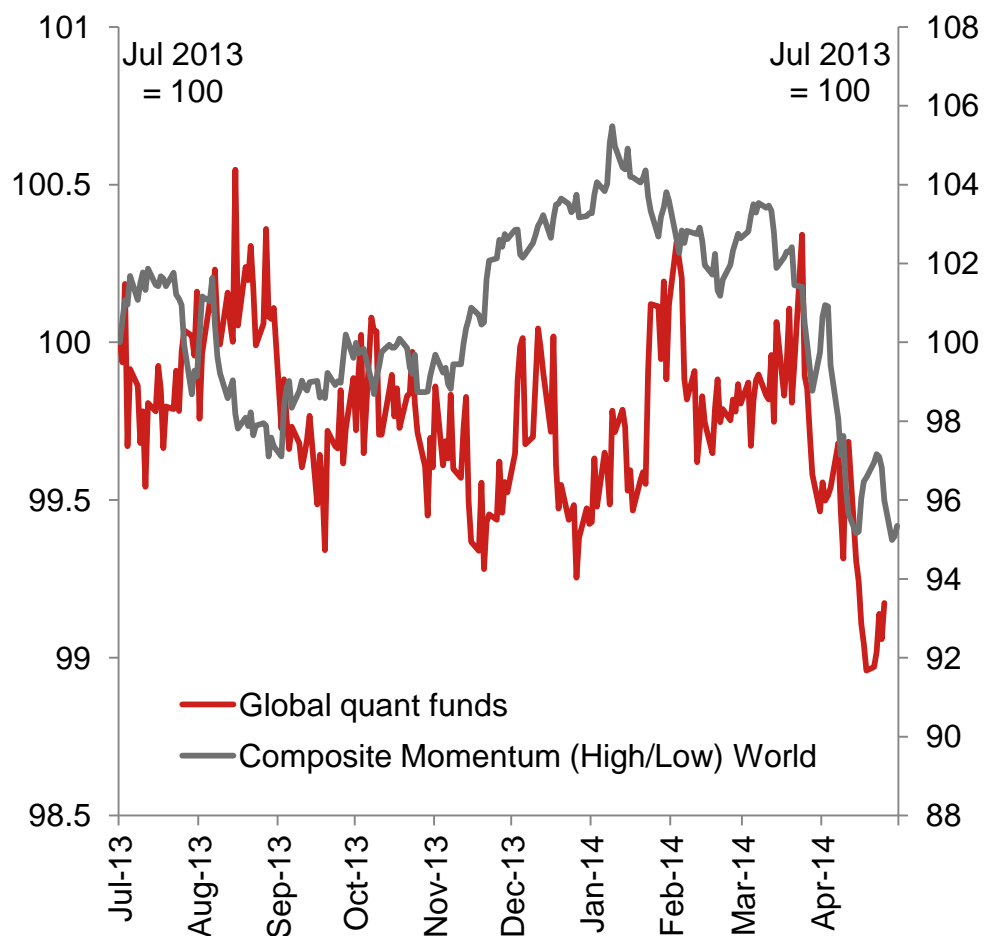
Europe



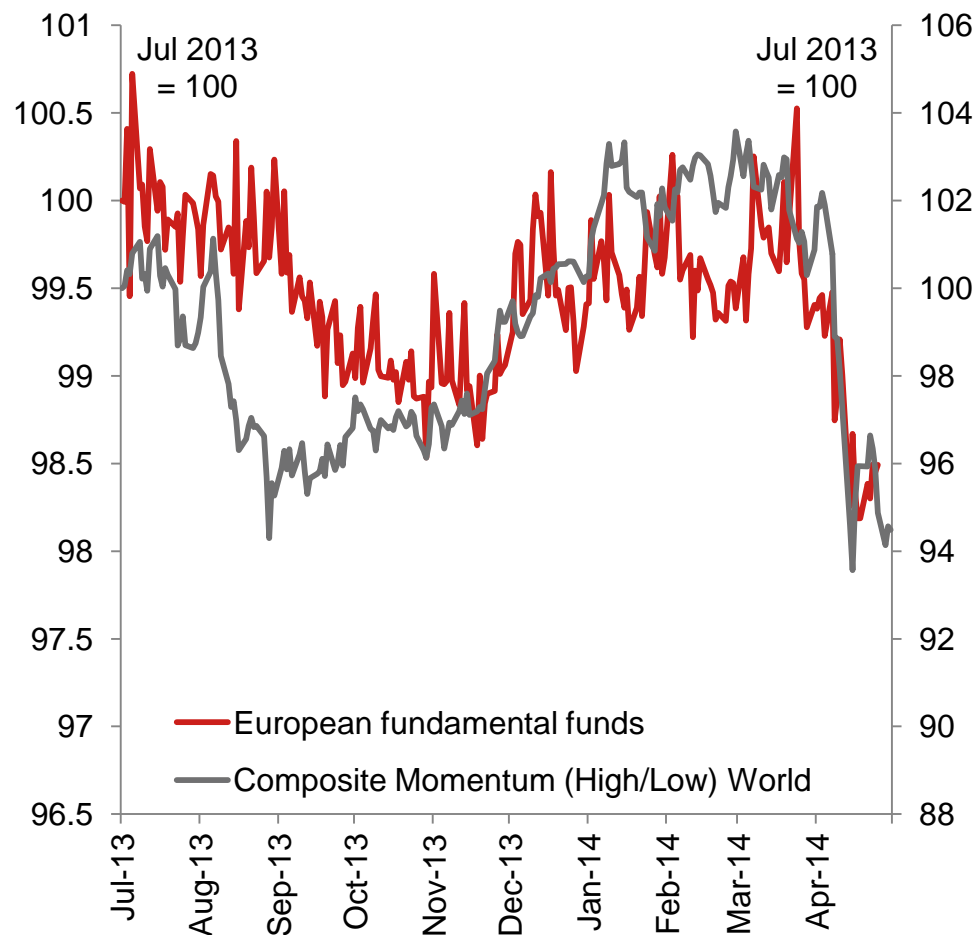
Both quants and fundamental managers had loaded up on momentum

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Global Quant Funds & Global Momentum

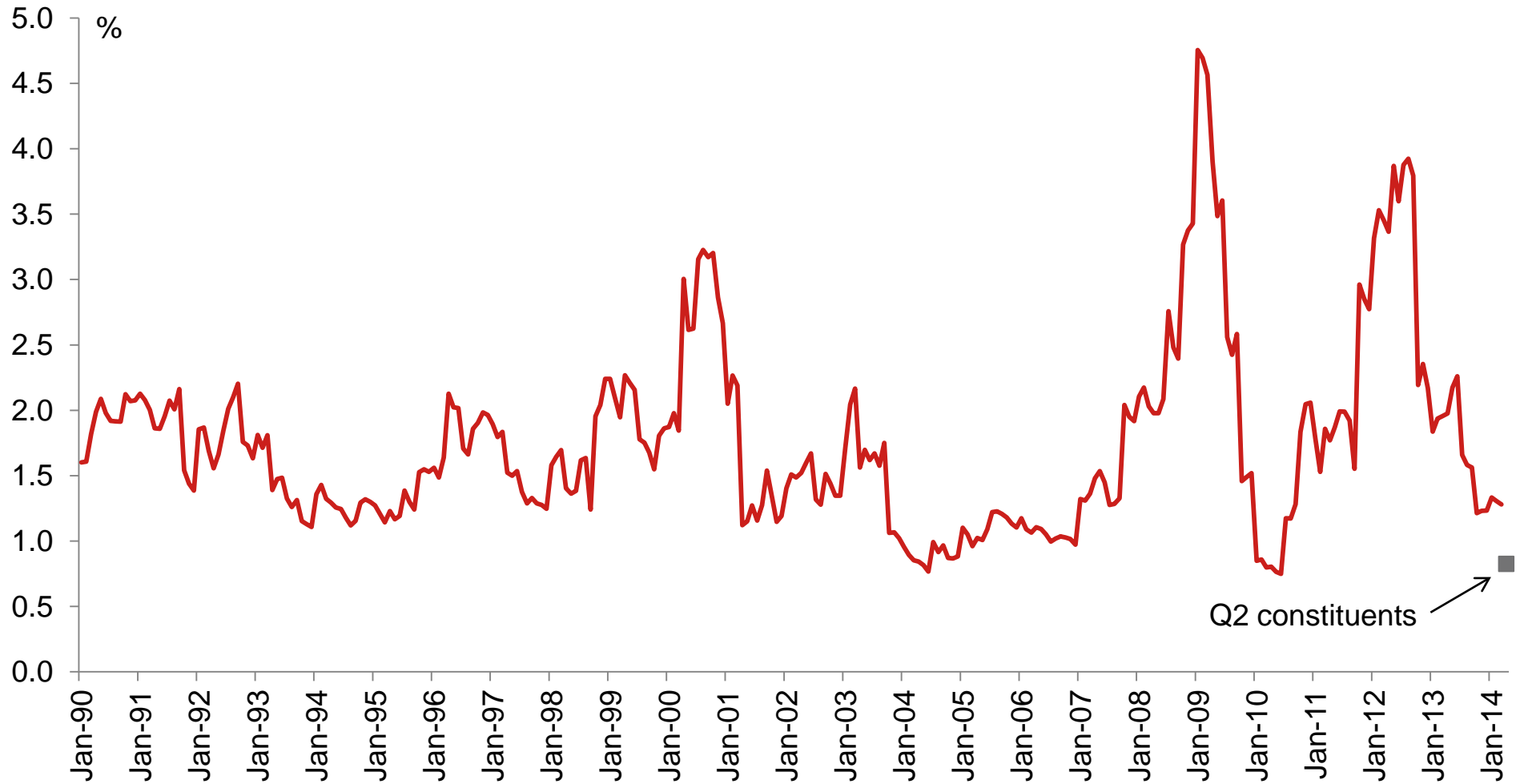


European Fundamental Funds & European Momentum



Momentum is cheap

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Momentum means different things in different regions

	Composite momentum			
	Global	Europe	US	GEM
Basic Industries	-5%	0%	-2%	-11%
Capital Goods	5%	-4%	7%	8%
Consumer Cyclicals	6%	14%	4%	3%
Consumer Staples	-15%	-23%	-7%	-3%
Energy	-10%	-16%	-6%	-7%
Financials	15%	24%	2%	-4%
Healthcare	7%	0%	8%	5%
Media	2%	3%	2%	3%
Technology	7%	3%	7%	14%
Telecoms	-3%	-3%	-2%	-8%
Utilities	-10%	1%	-11%	0%

**No problem with low active share...
... as long as one is a quant**

Active share increasingly used as an alternative to tracking error. Measures proportion of holdings that are different to benchmark, Cremers and Petajisto (2009)¹.

$$\text{Active share} = \frac{1}{2} \sum_{i=1}^N [w_{fund,i} - w_{index,i}]$$

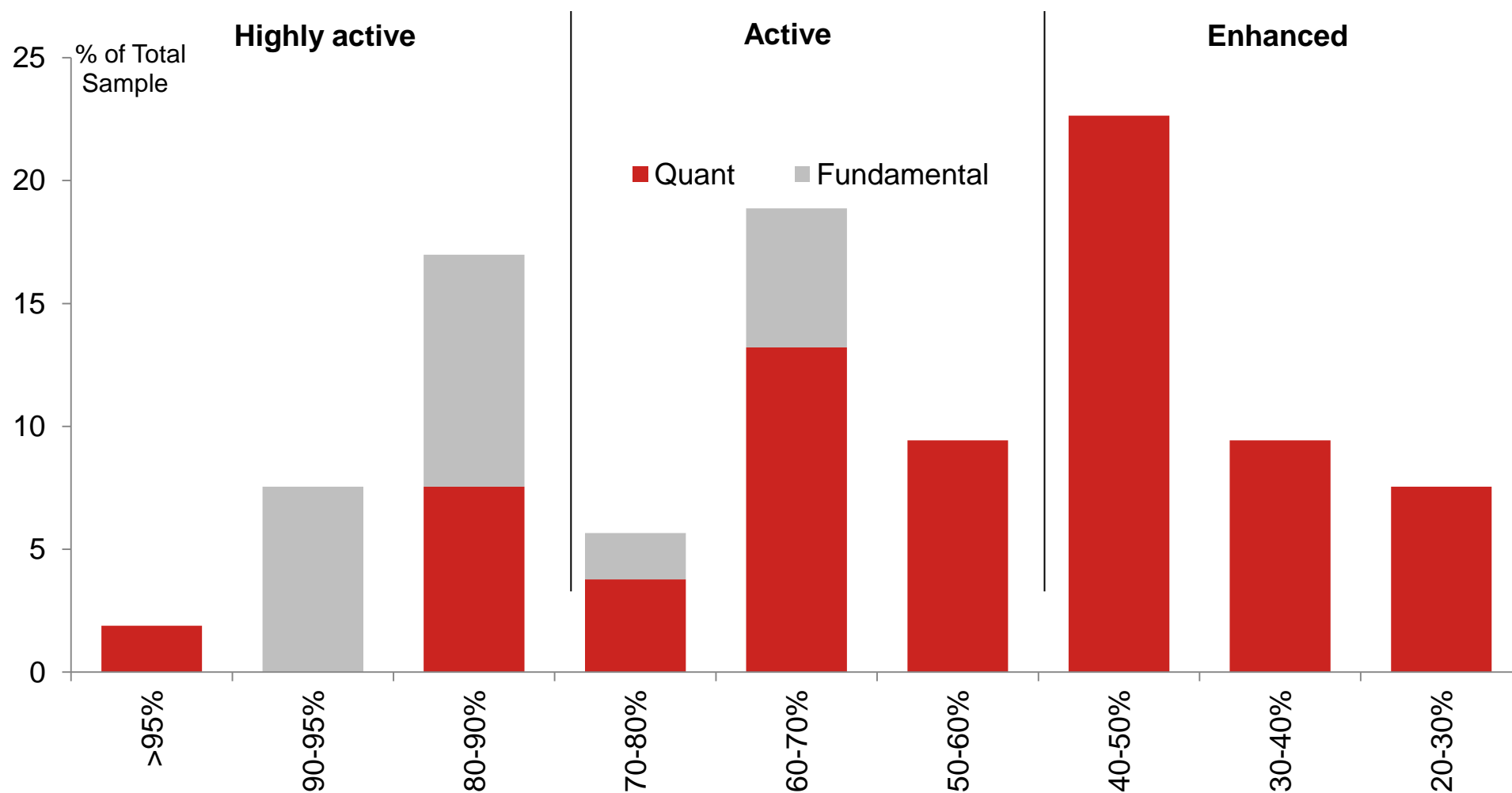
However, Petajisto (2013)² goes on to claim that low active share (<60%) is “just” closet indexing and does not add value. This has been picked up in the press and much discussed in meetings.

We do not dispute this for fund management at large. However, we think that for quants this is not the case. There is value in enhanced indexation.

1. Cremers, M and Petajisto, A (2009): How Active is your Fund Manager? A new measure that predicts performance, *Review of Financial Studies* 22, 3329-3365.

2. Petajisto, A (2013): Active Share and Mutual Fund Performance, available at SSRN

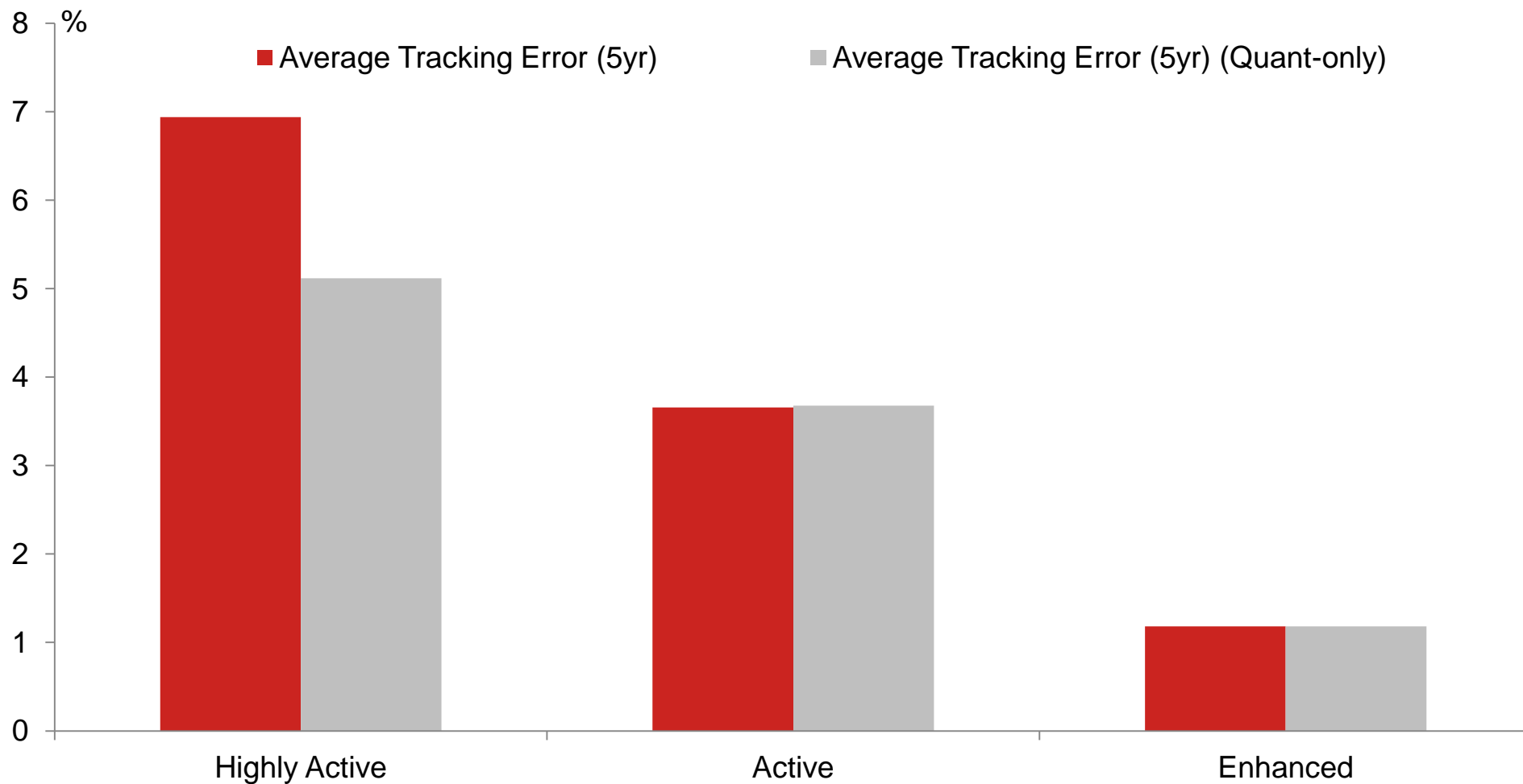
Distribution of active share



Based on a sample of 52 quant and management funds.

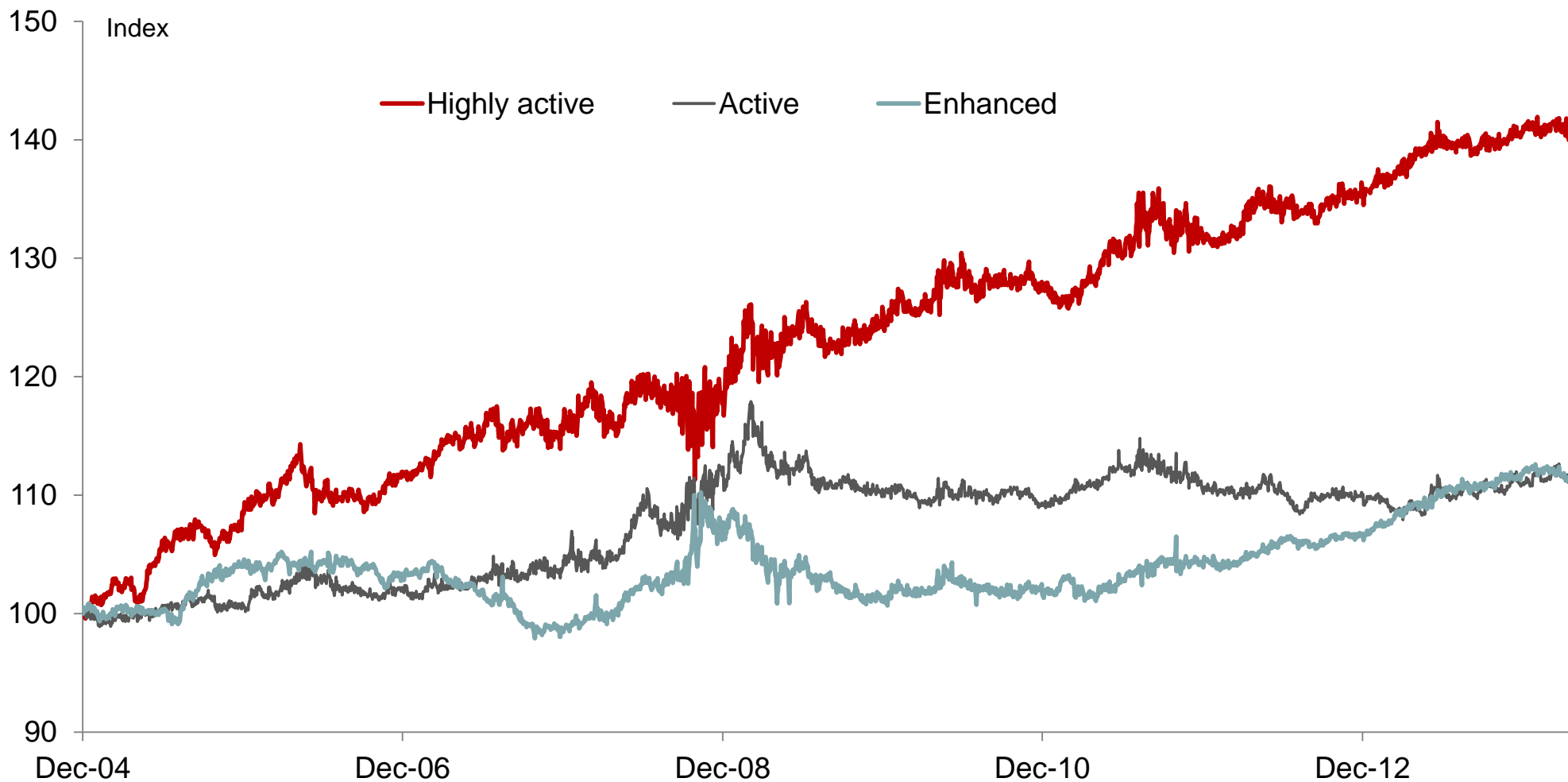
Source: Nomura Quantitative research

Relationship of active share and tracking error



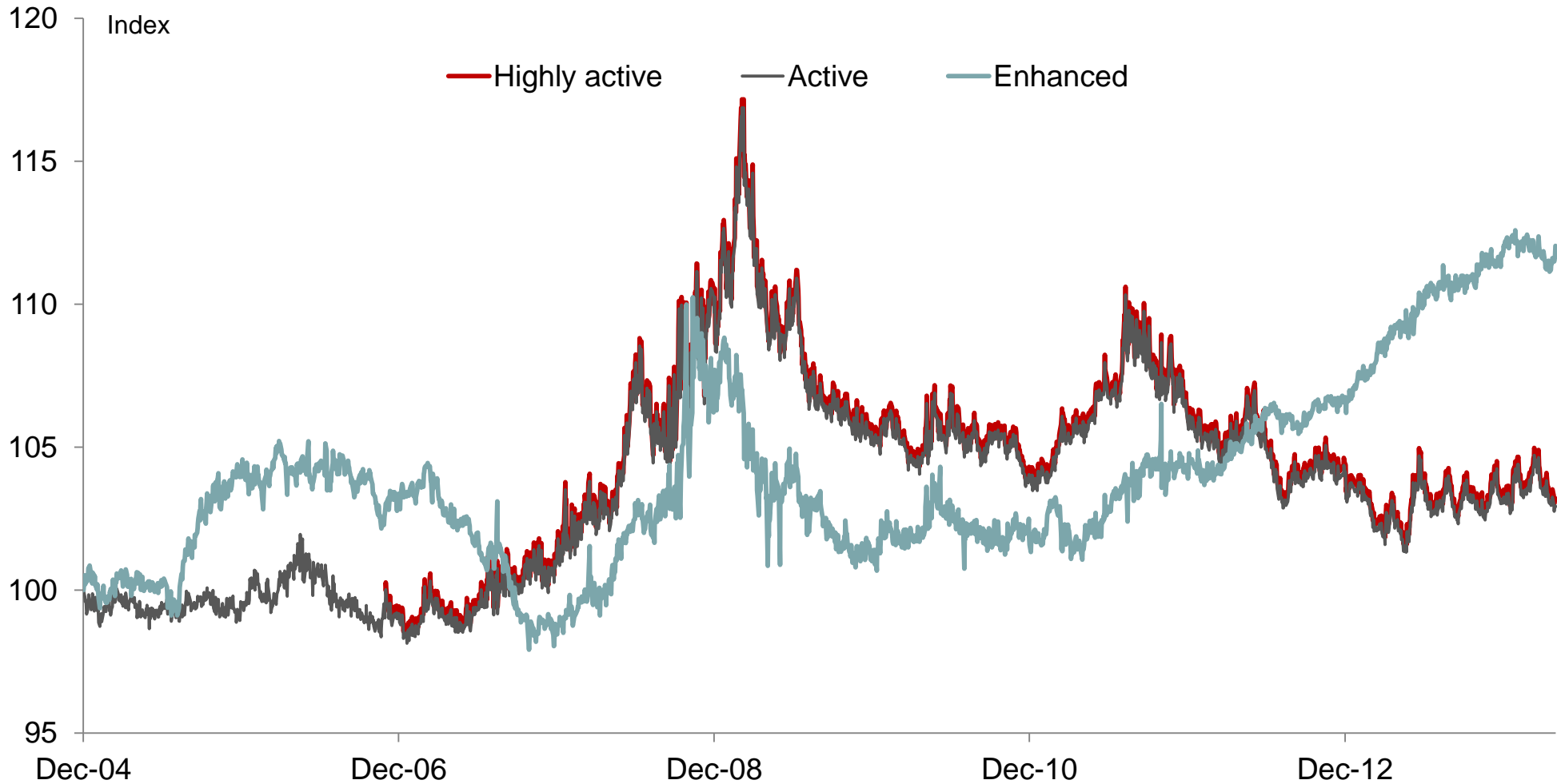
Relative performance of managers by active share group (quants and fundamental)

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Relative performance of managers by active share group (quant only)

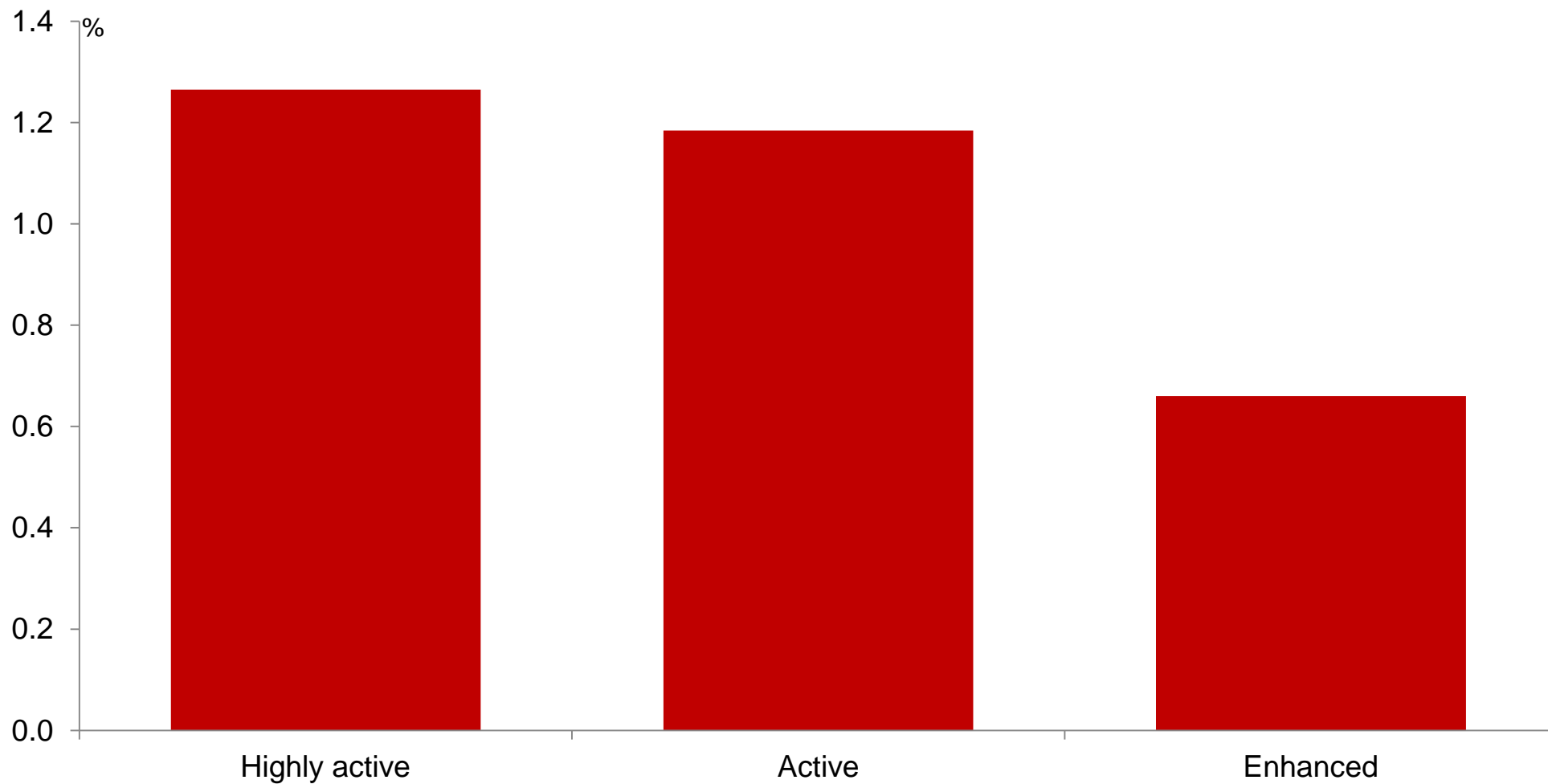
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Return and Risk for fund types by activity level

	Highly active	Active	Enhanced
	3 yr		
Return	3.01	0.10	3.34
Risk	7.51	5.18	4.15
R/R	0.40	0.02	0.80
	5yr		
Return	2.64	-0.21	1.58
Risk	7.89	5.29	5.11
R/R	0.33	-0.04	0.31

Expense ratio by active share category



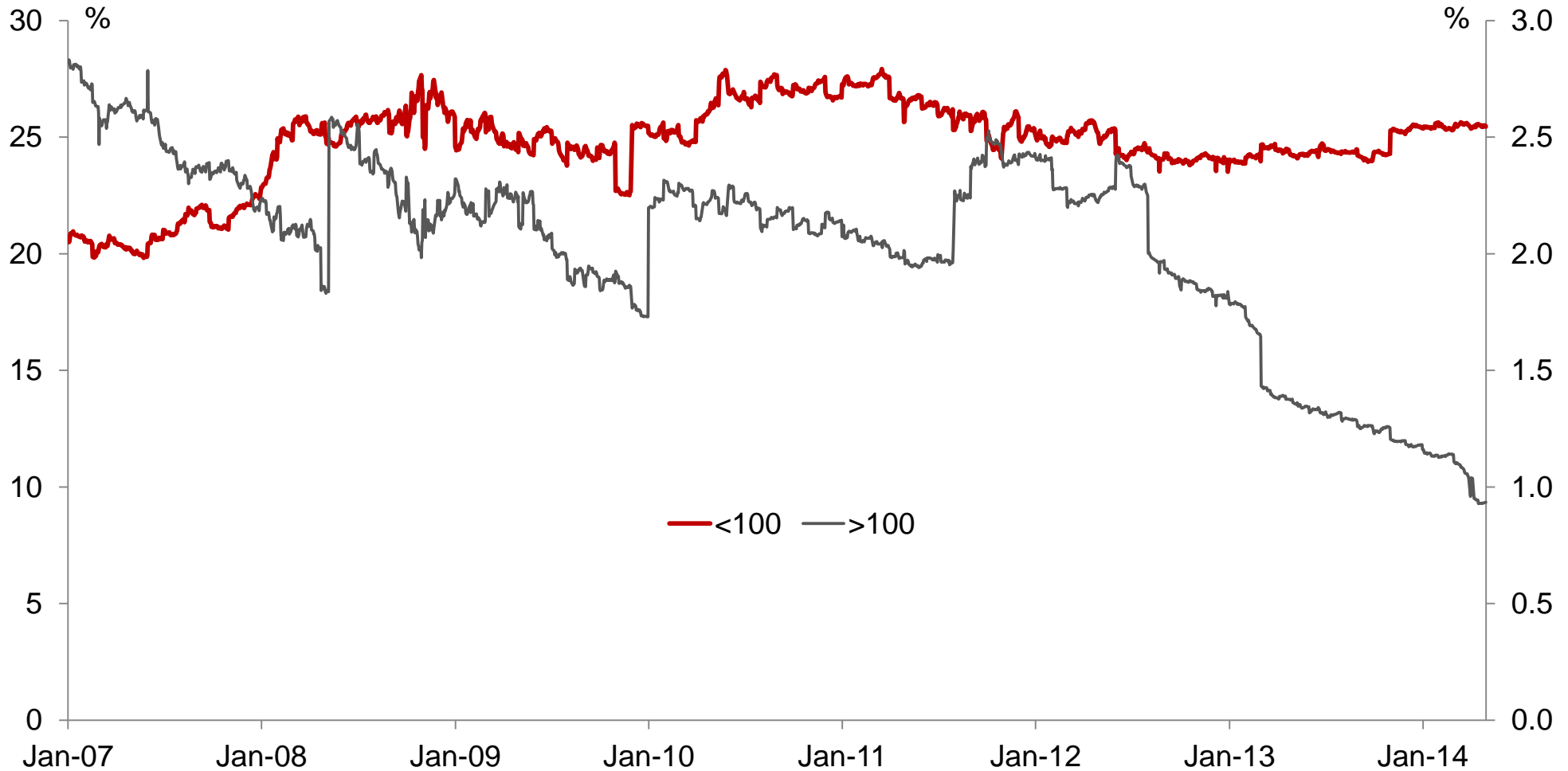
Active share and fee structure

	Highly active	Active	Enhanced index
Management fee	1.13	0.98	0.46
Expense ratio	1.27	1.18	0.66
Front load	1.41	2.84	2.18
Back load	0.10	0.20	0.34
Performance fee	7.83	7.86	0.00

We define highly active as funds with an active share >80%, active as between 50 and 80% and enhanced index as active shares <50%.

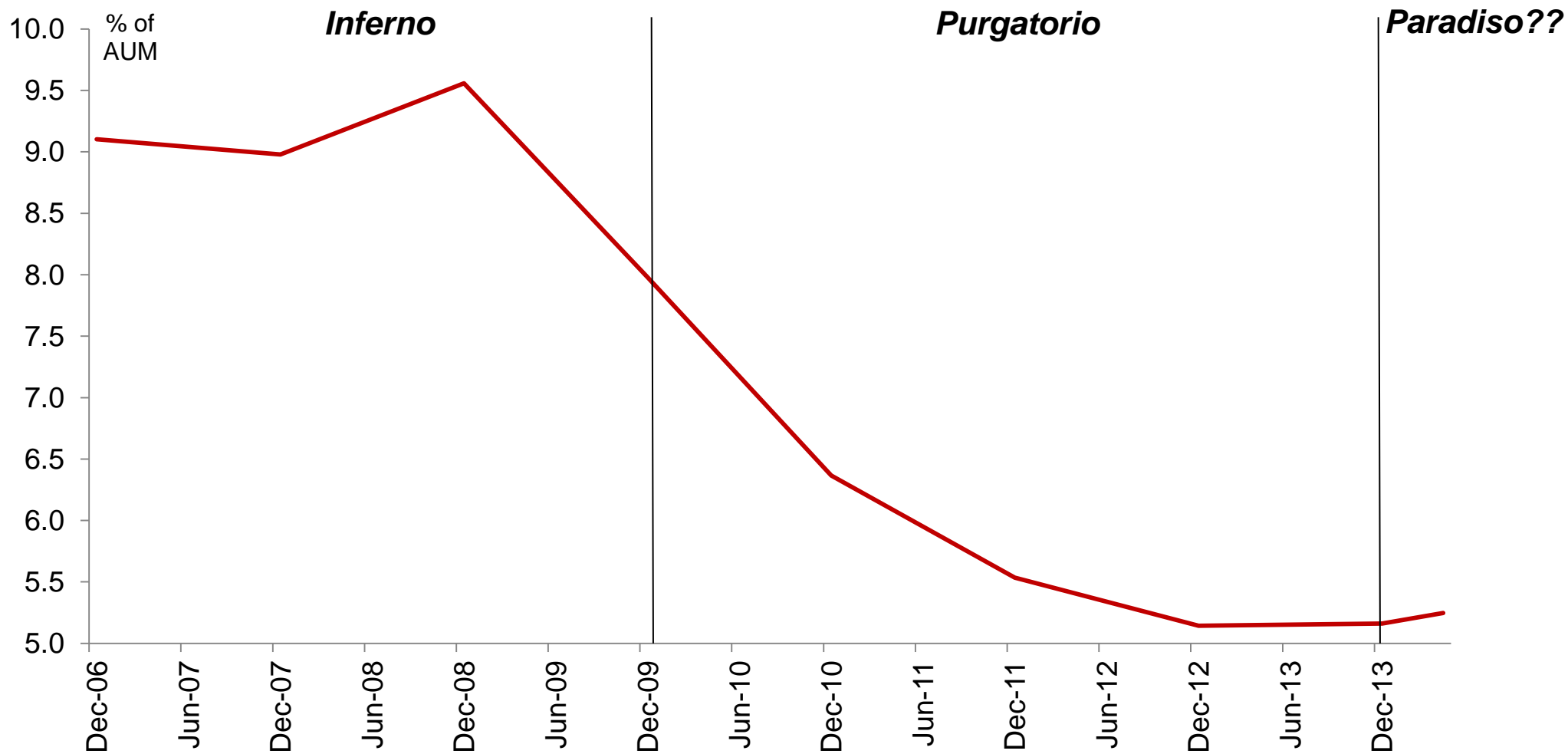
Source: Nomura Quantitative research

The demise of diversified fundamental managers?



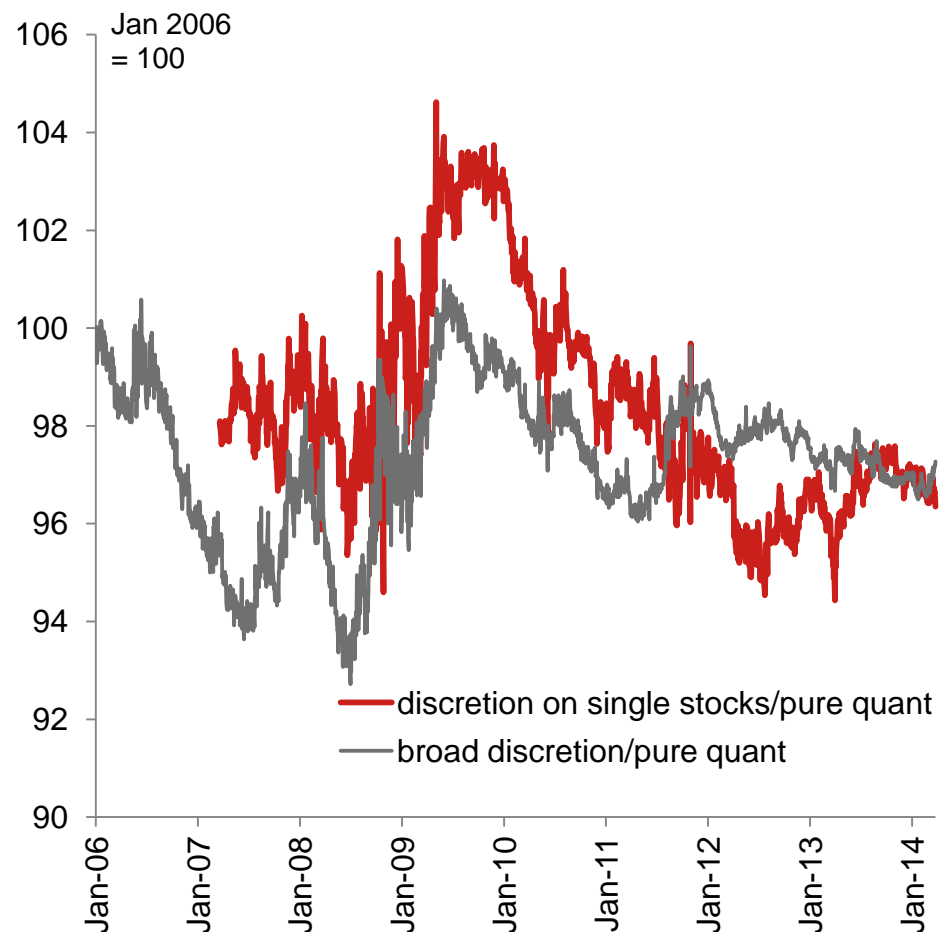
The recovery of quant: *Il Paradiso?*

Quant market share

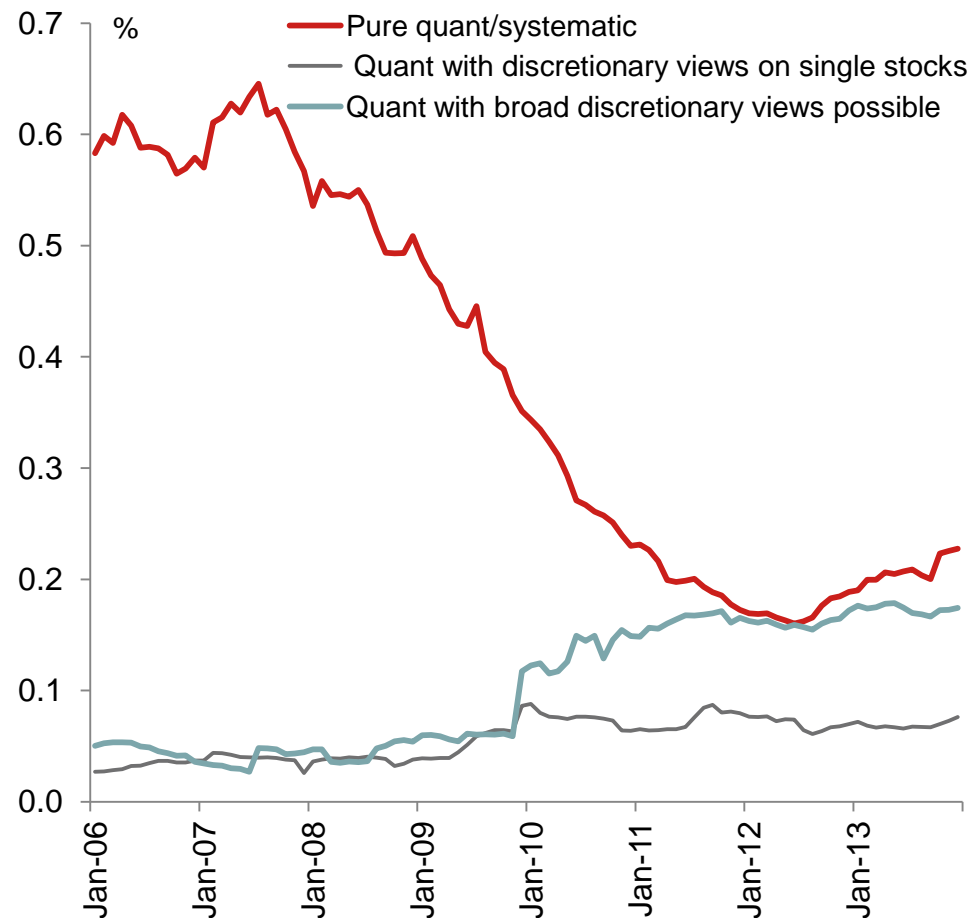


Pure Systemic Funds gaining back share

Relative performance of pure quant and quant + discretionary funds



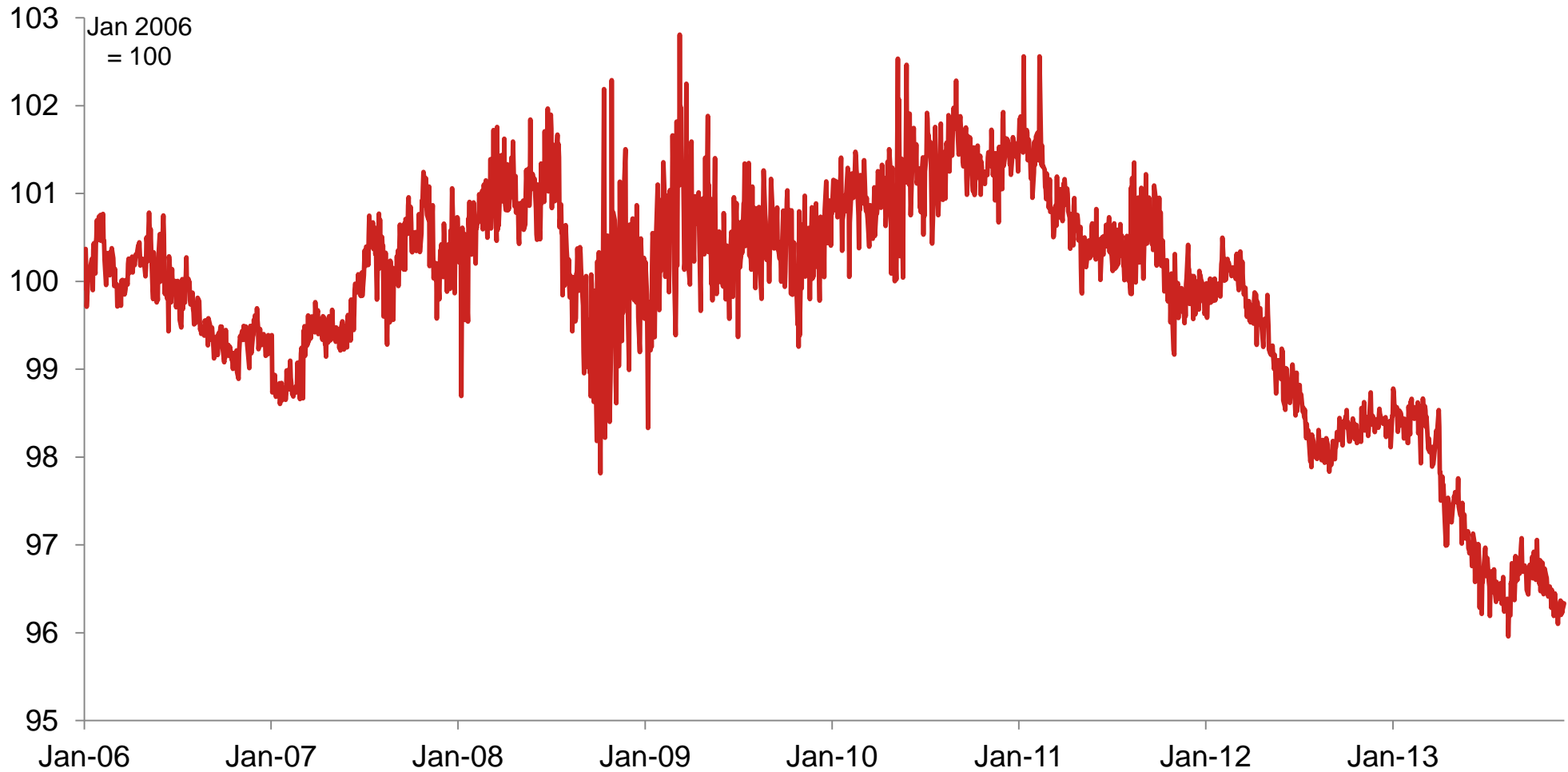
Relative asset share of pure quant and quant + discretionary funds



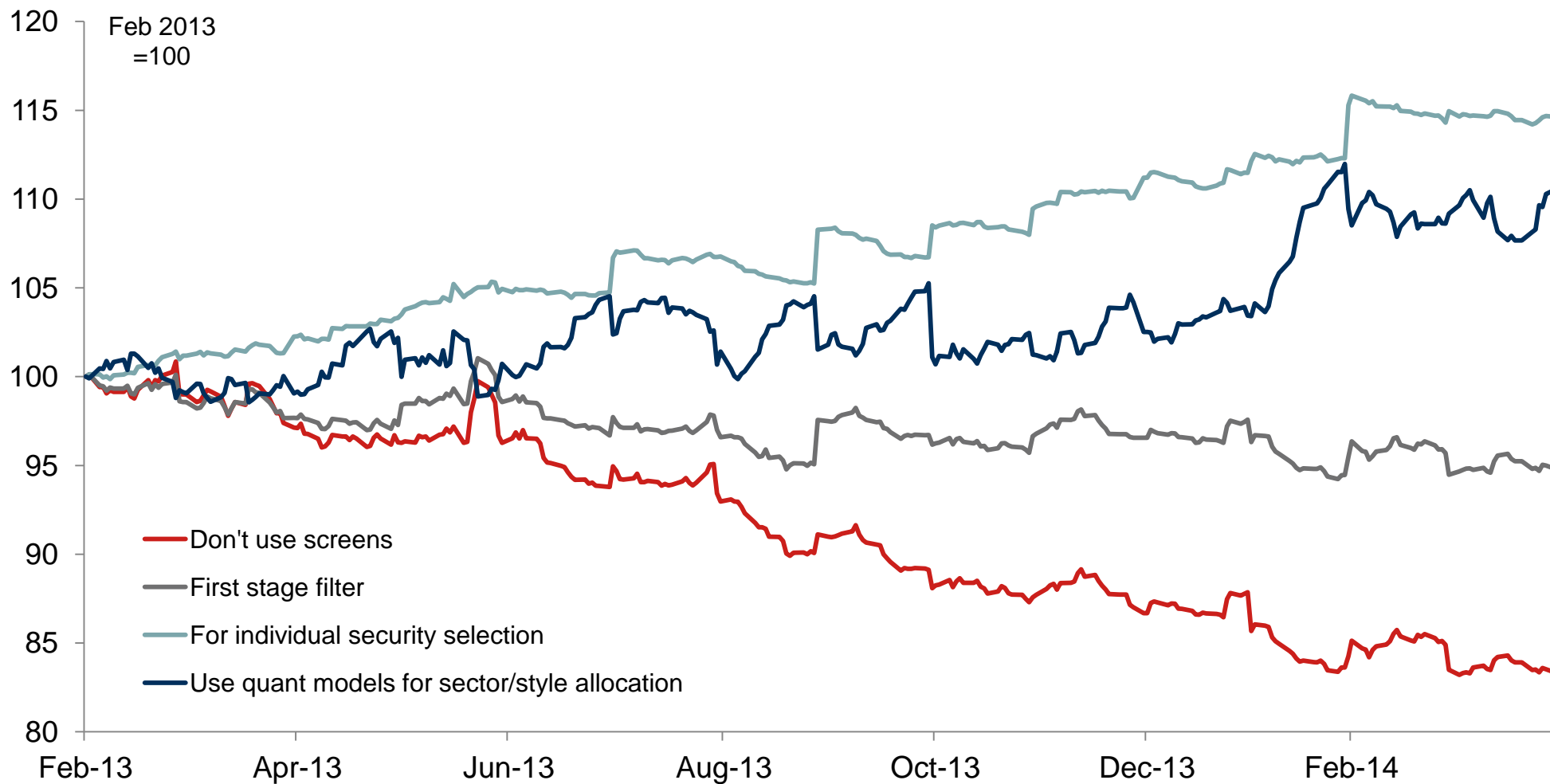
Performance of funds that employ different levels of discretion relative to pure quant funds with no discretion.
Source: Nomura Quantitative research

Percentage AUM as a share of active equity funds.
Source: Nomura Quantitative research

Inductive models underperforming deductive strategies

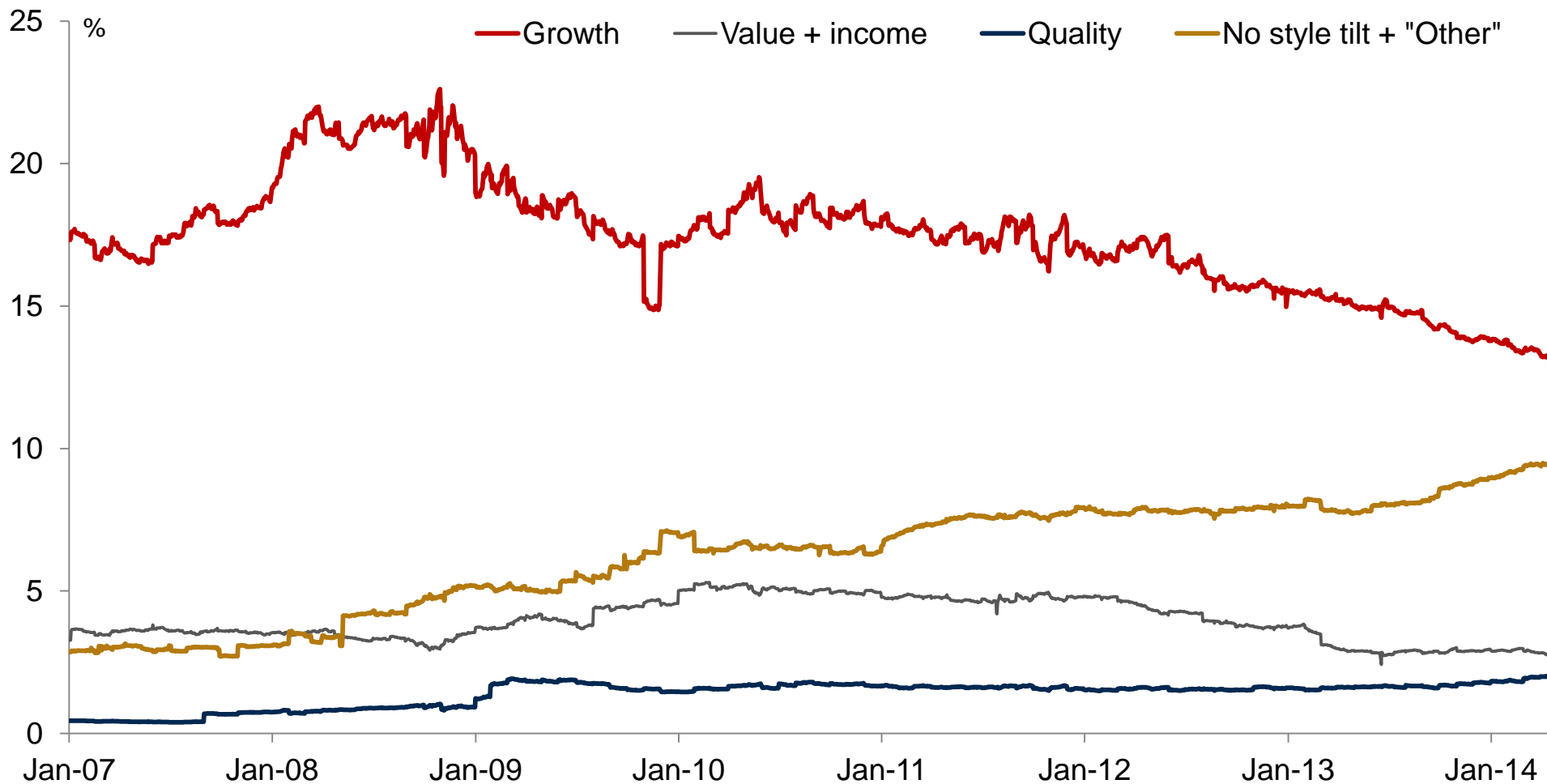


Non-quants who do not use quant are in decline



Where have the growth managers gone?: Asset share of fundamental managers by style tilt

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The Nomura Global Equity Quant Recommended Portfolio

	Trade	Bloomberg	1 month	YTD	1 year	2 year	3 year	1 year R/R
Strategic trades	Global Multifactor Model	na	+0.7%	+3.3%	+13.3%	+7.6%	+5.3%	2.7
	Equity Alternative Beta	na	+0.6%	+0.5%	+4.7%	+4.3%	+3.8%	2.3
	Volatility Risk Premium	NMEDSVP1 & NMEDSVP2	+0.8%	+1.2%	+4.8%	+7.0%	+4.9%	2.0
	Natural Index	na	+0.4%	+2.0%	+22.1%	+18.0%	+12.8%	2.0
	Stable Dividends	NMRASDVD	+1.3%	+2.5%	+20.5%	+19.1%	+15.3%	1.9
Tactical trades	Long Composite Risk	NMGLRISK	-3.0%	-0.5%	+7.7%	-2.3%	-8.3%	1.2
	Short Composite Quality	NMGQUAL	-0.9%	+0.5%	+0.2%	-0.6%	-4.4%	0.1
	Long European cheap domestic	NMRDOMS	+1.6%	+11.3%	+30.4%	+15.7%	-3.2%	2.8
	Long European Expected Growth	NMRAEGRW	-1.3%	+2.1%	-2.3%	+2.8%	-1.5%	0.5
	Short European Dividend Yield	NMRADVDL/NMRADVDS	-2.2%	-1.6%	-8.4%	+0.2%	+1.3%	1.2
	Short European internal Growth	NMRAINTR	+0.7%	+0.4%	+10.5%	+4.8%	-2.4%	1.8
	Long Composite Momentum		-2.8%	-3.1%	+20.6%	+14.6%	+6.3%	1.1
	Long EM quant country selector Model		-0.8%	-0.7%	+0.6%	-0.2%	-0.3%	0.6
			1 month	YTD				
Recommended Quant Portfolio			-0.3%	+1.4%				
HFR Market Neutral Index			+0.6%	+2.1%				

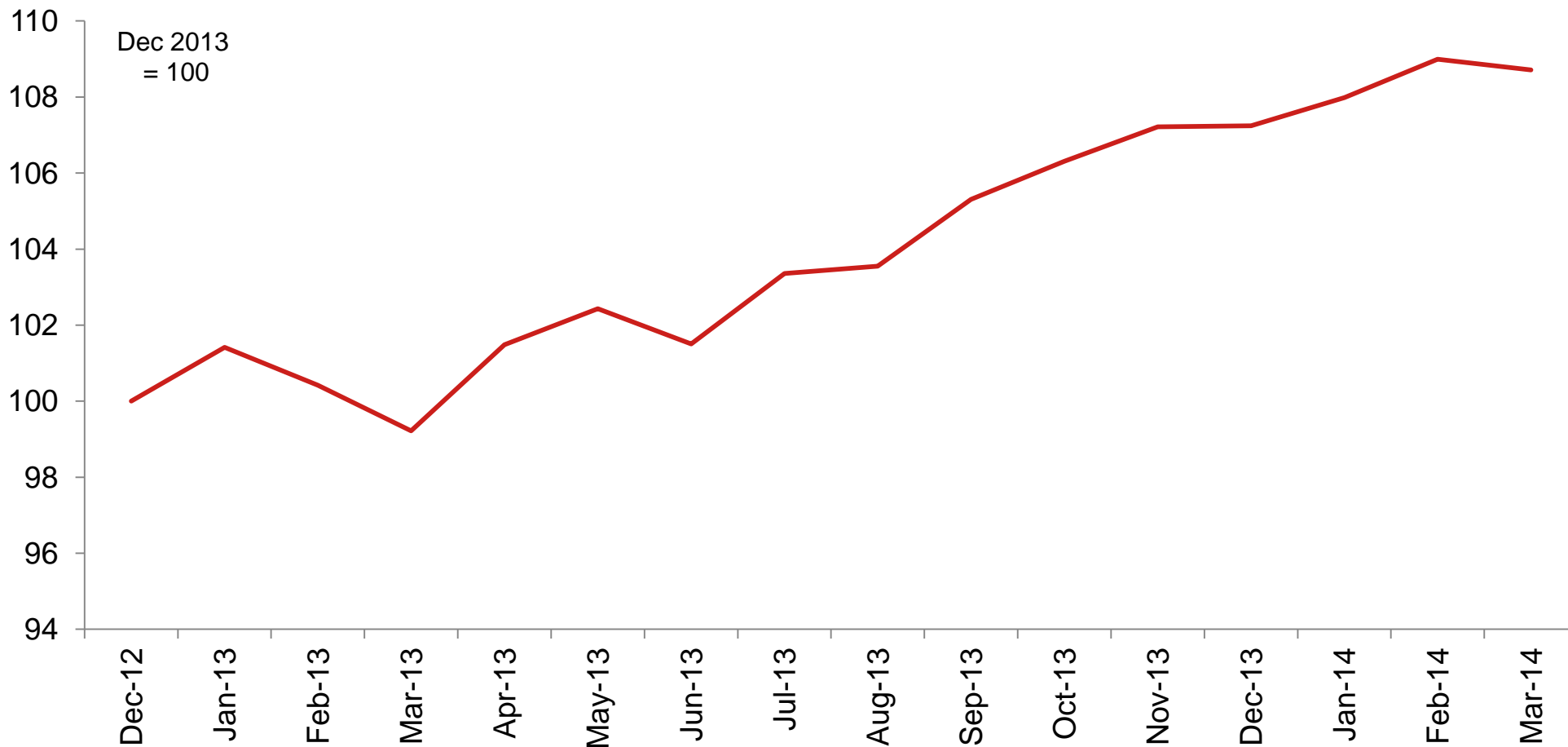
Note: As of end March 2014

We established our Recommended Global Quant portfolio in August 2013 (see A portfolio of Quant Ideas August 27 2013). It uses a combination of strategic strategies that are long-term core quant holdings and tactical ones that are a function of the cycle. The strategic and tactical components receive equal weighting and among the strategic quant trades we use equal risk contribution weighting. This is an absolute return strategy, so the benchmark is cash or market neutral hedge fund strategies

Source: Bloomberg, Nomura Quantitative strategy

Performance of The Nomura Global Equity Quant Recommended Portfolio

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Note: As of March 2014

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Conclusions

- Active share is a useful counterpart to tracking error.
- Low active share can be value-added if one's process works on average rather than through high conviction, ie, if one is a quant.
- There is evidence that non-quants are leaving this space.
- Quant asset share rising (stabilisation of traditional quant + growth in alt beta).
- Alt beta is not a panacea for investors as single factor unlikely to perform, so need something else. Nor a panacea for managers as fees falling to 10-12bp range.
- But can be highly disruptive to non-quants. No point in paying for closet factor-hugging.
- Is this the revenge of the quants?

Appendix A-1

Any Authors named on this report are Research Analysts unless otherwise indicated

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