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Today's Insights

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For: Lois Peltz

Disintermediation of the fundamental portfolio manager?

There is an explosion of alternative data sources. One needs to figure out which data sets to use and whether alpha signals can be generated from these, suggests Tim Harrington, co-founder and CEO of BattleFin Group, speaking at Peltz International's "Big Data, Artificial Intelligence/Machine Learning" seminar last week.

For example, one can often tell if there is an epidemic in the making by monitoring the frequency of key word searches via GoogleTrends such as "flu". As a real-time indicator GoogleTrends may even be more accurate and timely than the CDC estimates, comments Milind Sharma, founder of QuantZ Capital.

Tim Harrington

Milind Sharma

Or with satellite imagery, one can measure crude oil inventory levels through their floating tops, says Harrington. The amount of alternative data coming out of insurance companies and healthcare companies is high.

Machine learning/artificial intelligence is very real and changing finance. "You want to be ahead of that curve in finding differentiated alpha that is repeatable. If you can identify those with unique sources of alpha, those are the ones you want to be with. Look at pattern recognition and sources of data. If you're looking for an edge to generate alpha, AI is early. ML leading into AI is where you need to be aware," says Harrington.

"What happens if we have a trade war with China? What happens with Brexit? How do you write this stuff into an algo and try to use machine learning? Think like a human and make predictions. The next crisis will be something completely different and new. That is where AI will come in," adds Harrington.

Which factors or sets of ideas work well if interest rates are going to rise? If there is a trade war or a currency war there should be all sorts of knock-on effects including a spike in vol, suggests Sharma.

Three waves

"To paraphrase Marc Andreessen [co-author of Mosaic, first widely used Web browser; co-founder of Netscape; and co-founder and general partner of Andreessen Horowitz], we're getting closer to that point in finance where either you are the person telling computers what to do or (god forbid) the person being told by the computer what to do," says Sharma.

Sharma describes several waves of the progressive "quantification" of Wall Street. The first wave saw tremendous innovation in derivatives pricing alongside that in risk modeling. The second wave was driven by innovations in factor investing - this process is well underway now and has morphed into the smart beta indexation phenomenon. The third wave, which we are witnessing now, is about artificial intelligence and the leveraging of big data.

"The over-arching theme is the disintermediation of the fundamental portfolio manager. We've seen analogous disintermediation on the execution side with the onslaught of high frequency trading and algorithmic execution," adds Sharma.

"Many long-short hedge funds are still fundamental stock pickers. However, everyone now has easy access to the sorts of basic information that go into growth/value investing given that even an eighth grader can easily rank stocks by P/E in Yahoo Finance. Hence, there is no edge left. That game is over," says Sharma.

Hybrid approach

QuantZ Capital takes a hybrid approach. "We call ourselves a Quantamental. You need a tight feedback loop between the human who designed the machine and the machine. Our job is to keep the model out of trouble as we understand the design flaws and can best anticipate the pitfalls of our process. The plane may be on auto-pilot but the pilot still needs to be hands on particularly for take-off and landing. Markets are far too complex hence premature for the fully autonomous paradigm," says Sharma.

He adds: "We are not shy about tweaking model parameters when confronted with evidence to the contrary, but rest assured it is not in our best interest to interfere with the model arbitrarily either (given that the model represents our best ideas at that point in time)."

The investing world changed dramatically post-financial crisis. Sharma says despite the crash of 1987, most quants used to extrapolate from the readily available datasets going back to 1988 and thereby ended up data mining an inordinately bullish time frame up until 2007. Post-crisis global coordinated Central Bank intervention wreaked havoc with normal price discovery but wasn't factored into their back tests nor did most fundamental managers alter their thought process to account for it resulting in over 70% of active funds underperforming in recent years.

Most people don't understand how to leverage technology because they haven't coded these systems from the ground up. Sharma says you often have to nudge the system or make it explicitly aware of a regime change as it might not magically pick up on the regime shifts.

Challenges ahead

As automation and commoditization marches on, some of what used to be called "alpha" will become "beta" as is now the case with "smart beta" products, says Sharma. "For all its shortcomings, smart beta has more to offer than "dumb" [cap-weighted] indices. The next step is to figure out and manage the cyclicality inherent in these "smart beta" factors. That's where the better market neutral/ quant funds can add value by not only packaging a one-stop shop solution inclusive of factor rotation but also by augmenting the factor set."

At least one-quarter of QuantZ's factors are somewhat esoteric and hopefully not yet in the vernacular, says Sharma.

Managing and leveraging technology to handle the onslaught of the data deluge is the new challenge, says Sharma. "Before, the challenge for asset managers was managing the idiosyncrasies of star fundamental managers. Now, the challenge becomes one of managing quant processes and big data. In particular, you'd want to know if the quant process got lucky (small sample problem) or if your manager was right for the right reasons if you want persistence in alpha."

Harrington is sensitive to the compliance aspect relative to alternative data and believes it will become more important going forward. "Buyers will need to look for alternative data sets that are not exclusive as they could run into issues that relate to publicly available information. We believe data platforms that try to dictate which clients get access to which data sets will run into trouble. Data will need to be anonymous and rules around Personally Identifiable Information will need to be put in place and followed."