

WHY FACTORS AND QUANTS DISAPPOINT AGAIN

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Investment Perspectives

Etalon Capital

Why Factors and Quants Disappoint Again

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Recent Bloomberg [article](#) reviews performance of different quantitative factors and strategies in 2023.

10 out of 12 long-short factors tracked by Bloomberg lost money in equities.

Quality, value, momentum, dividends, short interest, share buybacks, ESG, volatility, you name it.

Everything underperformed.

In addition to this Goldman Sachs Group Inc data show the four main market-neutral strategies in credit delivered lower returns than cash.

After interest rate hikes cash provides investors with viable alternative. In such market environment hedge fund managers will certainly have to work harder to justify their existence.

But I believe higher returns on cash are not the reason for quant factors and strategies underperformance.

The reason for quant factors underperformance is the same reason why many quant funds had [disastrous returns](#) in 2020.

During covid crisis in 2020 we saw the inability of models and their operators to adjust to unfolding reality.

What was required was the exercise of plain common sense, nothing more.

The same is true of 2023 as well. Current market environment with its issues of volatility, interest rates, macroeconomy, geopolitical uncertainty, even without speaking about mega-cap tech and AI, presents investors with an environment where extra flexibility is required.

Instead of focusing on actual reality and events, quants [continue](#) to stubbornly flog a dead horse in the form of a fixed, reduced models.

And here it is important to understand the difference between science and art.

Scientists reduce complex processes and problems to smaller, simpler components. They do it because it makes it much easier to do the research.

Modern artists implement the same principles but approach the problem from an opposite direction. They start with simple and reduced elements of visual representation and force us to move towards more complex ideas.

[Picasso](#) destroyed the form. [Rothko](#) reduced everything to color. [Pollock](#) integrated chance and accident into painting.

Because of these "techniques" and the biological mechanisms underlying our visual perception, abstract modern art enacts a powerful influence on us: we become more creative, and our imagination starts to function better.

It is not hard to draw parallels with the world of investing. Quantitative models, algorithmic trading, and factor-based strategies all aim to achieve the same.

They reduce complex processes, in this case, the economy and the stock market, to a simple, or relatively simple formula. Factors can describe the portfolio, for example, and it is a great tool that allows to understand performance and manage risks.

The problem thought is with the conclusion regarding factors ability to generate performance.

The implicit idea here is that if we reverse engineer the market or the approach of a successful value investor such as Buffett for example, and find these factors we can, without much effort, replicate them and achieve similar results.

But the truth is that successful investors, as well as artists, do not start from a reduced model. The artists force us to start the perception of art with the help of a reduced model, and their genius lies partially in the ability to create and develop one, but techniques and models are the means, not the ultimate objective.

Artists do not start from the model. And they do not finish with it. Otherwise, their paintings would not be worth tens of millions of dollars.

They start from a different place: from a complex and unique vision of the world. From the depth and strength of feelings they want to share with use. From philosophical, religious, or cultural concepts they want us to understand.

Modern artists just feel that it is very hard, if not impossible, to relay their vision without a reduced and simplified form. But it remains our task to use it as a starting point and move towards a deeper understanding.

[David Bohm](#), an American scientist who has been described as one of the most significant theoretical physicists of the 20th century, once explained this idea well:

"A good picture is not only an integral whole, but even more, it achieves this wholeness by expressing something having universal significance. In other words, while it is something specific, particular, limited in its existence, etc., its relationships to its parts are rich enough and of the right character to suggest the universe and its relationships to its parts. Thus, it is "universal" in the sense that somehow its structure reflects that of the universe. In other words, it makes a kind of "world in itself".

All reductionist models contain certain aspects of truth.

But they do not capture complex reality entirely.

Markets and economy are dynamic social processes. Objective reality constantly changes and evolves.

So, when one adopts a religious attitude to following these "fixed" models, achievement of satisfactory results becomes impossible.

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