THE SCANNER

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Quant + Fundamental: A potent mix

If you are looking to meet the twin objectives of wealth creation and preservation then it is imperative that you adopt a long-term perspective to portfolio building. Essential to creating such a long-term portfolio is adopting a layered approach to portfolio construction. What this essentially means is applying methodologies and strategies that go beyond traditional fundamental and technical investing. An approach that we at Multi-Act have found to be particularly value accretive is quantamental investing.

As a strategy, quantamental investing combines the strengths of both quantitative analysis and fundamental analysis. It seeks to leverage the strengths of both approaches to gain a comprehensive and informed understanding of potential investment opportunities. It allows investors to incorporate both quantitative data (to identify patterns, trends, and relationships within a data series) and qualitative insights (evaluate the intrinsic value and quality of an asset by examining relevant financial, economic, and qualitative factors) into their decision-making process. The quantamental investing process typically involves the following steps:

The Highs & the Lows (benefits & risks)

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There are several benefits that can accrue from adopting the quantamental approach to investing. Some of these include:

Data-driven Decision Making

The data-driven approach enables investors to test investment hypotheses and evaluate the merit of the investment idea by identifying patterns, trends, and anomalies that may not be immediately apparent through traditional fundamental analysis alone.

Efficiency and Automation

Since quantamental investing enables a certain degree of automation, it inevitably allows for more efficient analysis and decision-making. This can be particularly useful when dealing with large datasets or when processing information at a speed that may be challenging for human analysts.

Enhanced Risk Management

By incorporating quantitative risk models, quantamental strategies can provide a more systematic and objective assessment of investment risks. This can help investors better understand potential downside scenarios and implement risk mitigation strategies.

Scalability & Diversification

The use of quantitative models allows for scalability in investment analysis and portfolio management. Owing to faster processing power and capabilities, quantamental strategies may identify investment opportunities across a broad range of securities across different sectors and geographies.

Adaptability

Quantamental models are usually designed to adapt to changing market conditions. The ability to incorporate new findings and adjust strategies based on evolving market dynamics can be an advantage in navigating through different economic environments.

Limiting Behavioural Biases

Quantamental models provide a systematic and objective framework for evaluating investment opportunities, thereby helping mitigate biases that may arise from subjective judgments in traditional fundamental analysis.

It is crucial to acknowledge that, despite the various potential advantages offered by quantamental investing, it presents its own array of difficulties. These challenges encompass issues related to the quality and reliability of data, as well as the complexity trap. Poor data quality may result in less-than-optimal analyses, while the complexity trap can make the analytical process formidable. Additionally, challenges such as overfitting, snooping, and execution risks may arise. Therefore, it is imperative to exert significant efforts to ensure the integrity of the data.

To circumvent these complexities, investors can opt for simplicity and flexibility in their models, grounded in logical understanding. Employing systematic processes to assess the models' outputs through logical reasoning can effectively reduce the risk of overfitting. It is advisable to comprehend the models' limitations and establish a tolerance limit within which the model can operate.

Having said that, if the quantamental approach is systematically and consistently applied, the benefits are likely to far outweigh the risks.

The MARQE score

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Multi-Act has created an evaluative metric known as the MARQE (Multi-Act Research Quality of Earnings) score. The score is specifically crafted to proactively detect potential pitfalls or areas of concern related to the Quality of Earnings (QoE). This score is formulated by analysing key quantifiable indicators crucial for ascertaining a company's overall QoE. The outcomes derived from such a composite scoring system significantly aid in sieving out companies of inferior quality, typically prone to encountering considerably higher drawdowns.

Exhibit 1

Relative assessment of Best-quality companies (Q1) with Worst-quality companies (Q4) demonstrates that Best-quality companies (Q1) perform better than benchmark (NSE500), whereas Worst-quality companies (Q4) exhibit underperformance compared to NSE500 over the long term.

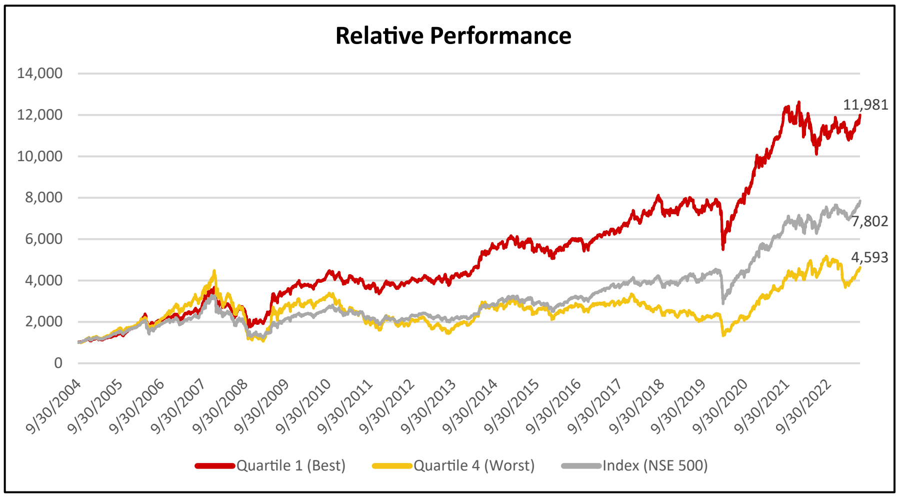


Exhibit 2

Drawdowns indicate the maximum drawdown for Q1, Q4, and NSE500.
It is observed that the drawdown for Worst-quality companies (Q4) is notably higher in comparison to Best-quality companies (Q1). This discrepancy underscores the resilience of high-quality investments during adverse market conditions.

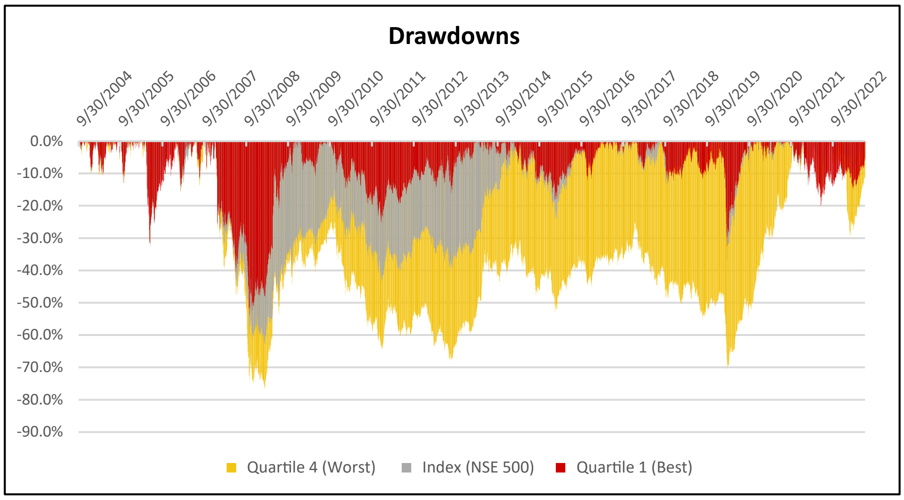
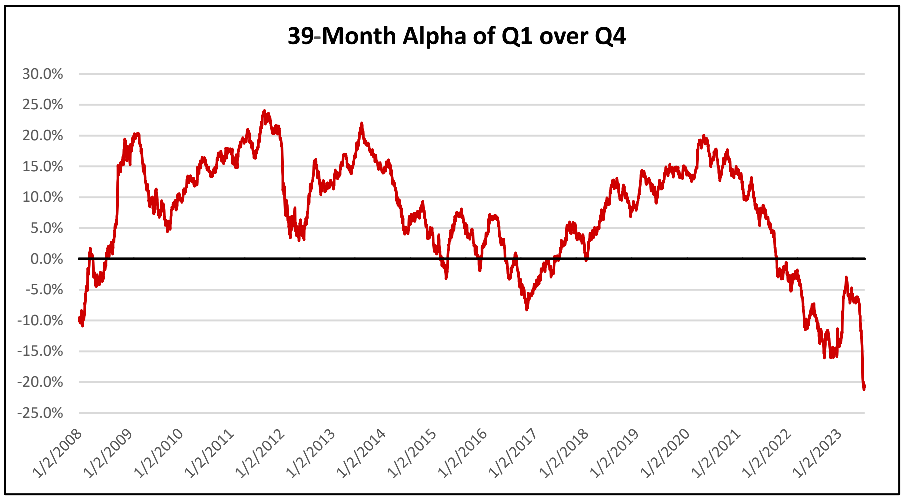


Exhibit 3

39-month Alpha of Q1 over Q4 indicates the outperformance of Best-quality companies over Worst-quality companies throughout the period. Notably, the alpha is negative for approximately 10% of the reviewed timeframe.



Q&A

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How is quantamental investing different from the commonly used technofunda approach?

Quantamental investing and technofunda investing represent distinct strategies aimed at wealth creation. Technofunda relies primarily on predicting price charts and utilising technical indicators to determine entry/exit points for stocks that may appear to be fundamentally strong/weak. This approach follows a bottom-up investing style and aids in position sizing. In contrast, quantamental investing involves identifying a group of stocks based on a broad investment thesis. This approach is not confined to position sizing and assists in recognising trends and factors that are likely to dominate in a given market environment. It incorporates the use of statistical and quantitative tools/frameworks to analyse market behaviour, technical strength/weakness, and fundamental strength/weakness. It serves as an approach for stock screening, selection, portfolio construction, as well as portfolio optimisation.

Does the quantamental approach to investing enhance the probability of wealth creation?

Drawing the conclusion that quantamental investing increases the likelihood of wealth creation may be inappropriate, as other investment approaches might offer higher returns at any given time. Nevertheless, quantamental investing plays a crucial role in identifying overlooked pitfalls within traditional fundamental investing. Through the screening of extensive datasets, quantamental investing can evaluate broad investment ideas and predict the anticipated success rate or conditions under which an investment idea is likely to falter. For instance, while it's commonly accepted that high-quality companies typically outperform low-quality ones, a long-term assessment of returns across different quality categories can help discern periods or conditions when low-quality companies might outperform high-quality ones, especially after a significant market correction.

How does quantamental investing help in mitigating downside risk?

At Multi-Act, we employ a rule-based investment approach that helps mitigate behavioural biases, a characteristic often observed in conventional fundamental investing. Additionally, we conduct a comprehensive examination of back-tested outcomes, and factor assessment aids in recognising situations where the portfolio might exhibit suboptimal performance, whether on a relative or absolute basis. The probabilistic approach inherent in this methodology also facilitates the identification of value at risk and the expected probability of underperformance. We leverage strategy optimisation models to allow for the amalgamation of several independent and low-correlated strategies into a unified portfolio, promoting factor diversification and consequent risk reduction.

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