Investment Management Methods

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Managing assets is no easy feat. Over the years countless strategies have been developed to try and generate better risk-adjusted returns with most falling under two broad categories: discretionary and systematic. Although the former is more common, powered by the computational advances of the past two decades, the latter is gaining in popularity. This short article will outline the similarities and differences between the two and introduce a new form of investment management.

Discretionary managers typically scrutinize a handful of assets using fundamental analysis and deep domain-specific knowledge to ultimately make the investment decision. The likes of Warren Buffet and Charlie Munger do this because it is hard to automate the ability to evaluate the robustness of a business model, analyze financial statements, and even critique management. Systematic managers, on the other hand, program computer algorithms, oftentimes using data-driven insights, to trade thousands of assets. Algorithms employ quantitative techniques by looking at price patterns, volume, and volatility in the market. Systematic investors typically do not know the specifics of what they are buying or selling – instead, models are “trained” on statistical properties of each asset. Hence, there is no emotion involved in systematic decision-making – only computers that consume market data, run code and generate trades.

Despite being fundamentally different, a systematic fund can actually implement similar screening conditions as the ones used by their discretionary counterparts. The result? A systematic *fundamental* approach to investing. Its construction requires a high-level of ingenuity, but the outcome is a unique edge. For example, if I want to go long companies with robust business models and short companies with flimsy business models, I would write an algorithm to look at the stability of the companies’ stock price over negative market periods while holding other variables constant. This would screen thousands of stocks that match this criterion, and automatically go long the low volatility ones (using stock price volatility as a proxy for business model robustness) and short the high volatility ones, with no human intervention. Add in a rebalancing of the portfolio every few weeks, and there you have it: a systematic fundamental strategy. Obviously, this is a simplified version of a strategy (that probably wouldn’t work), but the general idea becomes apparent: there are more variables than you might expect that can be systematically managed, even fundamental-based ones.

Now the dark horse of investment management is the “quantamental” approach. This newer method uses the best of both worlds: “intertwining quantitative and fundamental analysis to capture alpha” is how it would typically be described. It arose from critiques of the two initial ways

of management: systematic managers tend to neglect the market environment, and discretionary managers can be subjected to human biases. This method sounds awfully like the example of the systematic fundamental fund, but there is an important distinction: quantamental investments begin with a narrower scope of assets and the managers know what they are buying. An example of a quantamental strategy is as follows: say you are interested in discount retail stores (Costco, Dollar Tree, Five Below, etc.) and are trying to predict the outcome of their respective earnings reports. By utilizing satellite images to measure the number of vehicles parked outside a store over many months, you can predict how the business is doing. Compare those numbers with different companies and there you have it: a quantamental approach to discount retailers. Quantitative models (formulas from data of satellite images) were used to analyze a fundamental aspect of a company (earnings).

These three types of funds have dominated the fund management industry. The likelihood of more developing is high but knowing these differences as an investor is a crucial step towards finding the right fund for you. Each has their own strengths and shortcomings, and while managers might present their method with unrivaled confidence, having done your own research brings no harm.