Opalesque Exclusive: Rate of style drift in quant funds - author Rishi Narang offers help to understand black boxes

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From Kirsten Bischoff, Opalesque New York: California-based Telesis Capital manages the Ergos Fund, a fund of managed accounts that invests in short term quant managers. The Fund successfully increased its asset base during the financial crisis, and for portfolio manager Rishi Narang who met with many potential investors it became clear that there was no one source for them to use as in-depth, guide to quant strategies and how to approach evaluating them.

With the release of his reference book ”Inside the Black Box: The Simple Truth About Quantitative Trading” Narang hopes to provide investors with the information that will help them both evaluate managers for allocations and track those managers once invested.

“I find what quants do to be eminently understandable. They cover a wide variety of strategies and with “Inside the Black Box” I wanted to give investors a framework at how to look at and evaluate this space,” says Narang.

Domain knowledge
Ergos has always invested through separate accounts in order to maintain optimal levels of transparency into the managers through which it invests. Even prior to the current trend towards separate account structures, Narang says that Ergos never saw resistance to these structures from the quant managers the fund evaluated for investments. He attributes much of this to a long history of investing in quant funds and to having a deep understanding of the domain in which these managers work.

Asking questions that will gain the most interesting and insightful answers from a manager is a skill gained from having a level of understanding to how different quant strategies work. In Narang’s experience managers are much more forthcoming about their approach to trading when they are being asked questions that directly apply to their space.

The higher the jumping off point for delving into the conversation, the more time can be spent researching the specifics to that manager’s approach to trading. “There are so many events which happened that give us interesting things to discuss with managers. From the poor quant performance of August 2007 to the blow ups of 2008 to the huge rally in 2009,” says Narang.

These conversations into a manager’s approach to their strategy are also nuanced depending on what type of quant a manager is. If an investor is looking at a high frequency trading quant manager – then the emphasis for that manager would be on the execution and implementation of the strategy, whereas for a quant manager that invests over a longer term, the theory behind their strategy would be one of the most important focuses of due diligence.

New challenges in 2009: style drift
Once invested into a strategy, the focus on static due diligence shifts into the monitoring phase. “Monitoring requires you to look at the same things you looked at before you invested. However, now you are looking at trajectory so there is an added dimension, and you can focus on things such as style drift,” says Narang.

Because Ergos Fund has the ability to monitor every trade and position its underlying managers make, Narang has seen how the recent decline in market volatility has created new problems that the fund has to monitor.

Style drift has become a much bigger problem amongst quant managers than Narang has seen in the past. Watching managers who previously maintained strict stop loss policies allow positions to blow through those limits is one thing the Ergo Fund's constant monitoring of its separate accounts has proven is a real danger in choppy markets. Ironically, it has been the markets' rally that has caused some managers to change their behavior.

Says Narang, "Last year, our managers didn't have such a hard time with the markets. But it led some traders, including a couple of ours, to overweight whatever worked best last year. Now that the environment has changed, they are out of sync. It's funny, but sometimes too much success can be tougher to handle and build off of than a setback."