JASPER CAPITAL

THE JASPER CAPITAL NEWSLETTER

January 2019

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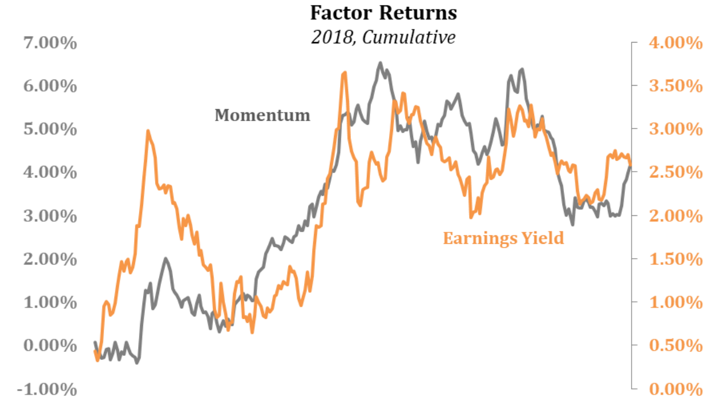
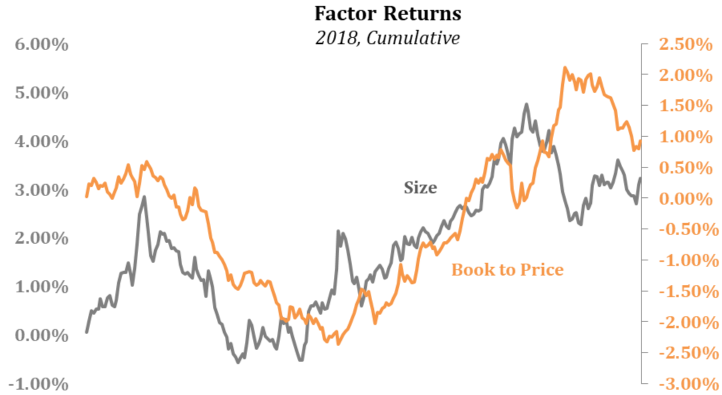
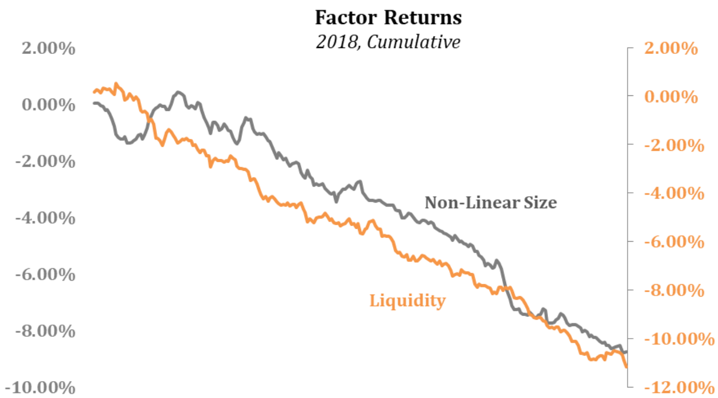
Factor Fracas

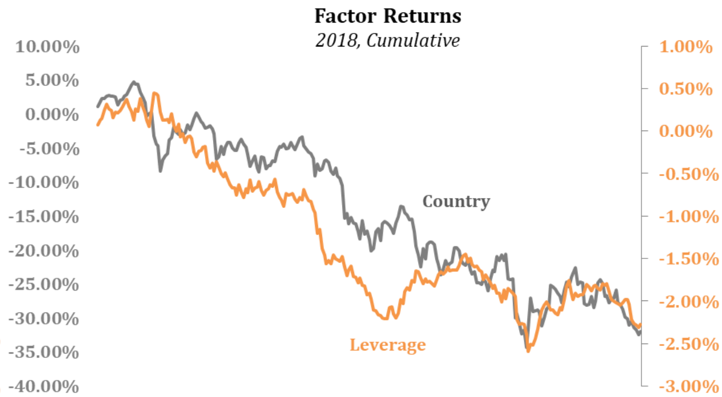
As we mentioned in our annual letter to investors, 2018 was a difficult year for active managers for a variety of reasons. Global macro and geopolitical factors aside, what matters most to us, as quantitative investors, is understanding what happened to our signals and how market factors performed, specifically in China where we operate. The sharp increase in cross-factor correlations surprised us given that the Chinese equity market maintains low correlations to foreign risk assets and remains relatively virgin territory for quantitative approaches.

At the heart of these anomalies was a decline in retail trade volumes—a critical source of alpha in the A-share space—the natural consequence from the collapse in economic and consumer sentiment. This left us with the ever-increasing presence of institutional flows, which still tend to favor Fama-French style factor tilts. The result was a proliferation of misbehaviors in the factor landscape that were difficult to anticipate. What was particularly interesting was the rolling spikes in correlations between momentum and size with other factor families, making it difficult to balance exposures adequately and maintain size-neutrality.





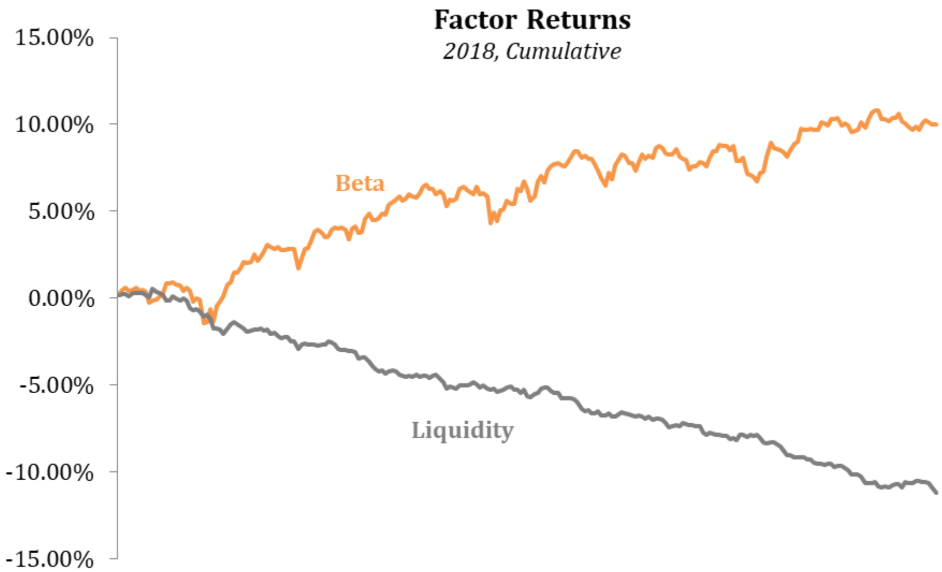




Historically, the size factor is fickle; both unreliable and inconsistent. Additionally, it typically exhibits 10% to 15% annualized volatility to a portfolio, which is intolerable for quant managers who live and die by our information ratios. Hence, we seek to maintain neutrality to the size factor, as we have mentioned in previous *Newsletters*. Still, when size becomes highly correlated to other fundamental factor families and momentum, our task becomes more difficult. Positively, however, machine learning-derived dynamic weighting helped us mitigate these difficulties to a certain extent.

In this situation, a quant manager is faced with the decision of maintaining size-neutrality and sacrificing risk premium, or tilting a model towards size and hoping that Beijing does not throw a curveball. We chose the former. But either way, information ratios will ultimately be hindered as either excess returns are sacrificed or volatility is introduced. One is also beset by the challenge of having a much smaller opportunity set of stocks given the growing percentage of stocks being absorbed by the correlation anomaly.

If unexpected correlations were at one end of the spectrum of difficulties, at the other end was the divergence in key factors. While volatility in factor styles is typically a successful recipe for alpha generation, particularly in the context of high retail trading volumes, when there are stark divergences in factors quant managers are left with the unenviable task of sacrificing one exposure for another. For instance, the divergence between beta and liquidity means that a manager sacrifices one family of factors and can no longer leverage the "sweet spot" between them, as was the case in the first weeks of 2018.



We endeavored to solve these problems as they arose. We successfully outperformed most of our peers and delivered sizeable alpha in our systematic long-only products, proving that our investments in machine learning experts, technology infrastructure, and data scientists were crucial for our successes and continued delivery of consistent excess returns for our investors throughout last year and into 2019.

Indeed, our methods continued to hold true in the first month of the year as clearly demonstrated by the performance of our αShares CSI-500 strategy, which earned 104 basis points in excess returns above the CSI-500's 0.2% gain for the month. Although, competition in the China's A-share market is increasing, it still presents more alpha opportunities than almost any other liquid equity market in the world.

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