THE JASPER CAPITAL NEWSLETTER

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The Case for an Integrated Alpha Model

Introduction

Since the start of the year, we have received growing interest in further understanding Jasper Capital's integrated alpha model. In this monthly, we attempt to explain the utility of our approach, which integrates fundamental, technical, and event-driven signals in a dynamic ratio.

We use the two MSCI inclusion dates of June 1, 2018 and September 3, 2018 as key markers given that each date was supposed to be book-ended by inflows. For context, as investors have seen in similar index inclusions, ahead of each inclusion date there would be active managers attempting to front-run the tens of billions of dollars in passive flows that would follow. One would expect an uptick in trading volumes around each date, and therefore a positive impulse into alpha in the A-share market given the high correlation between retail trading volumes and alpha generation.

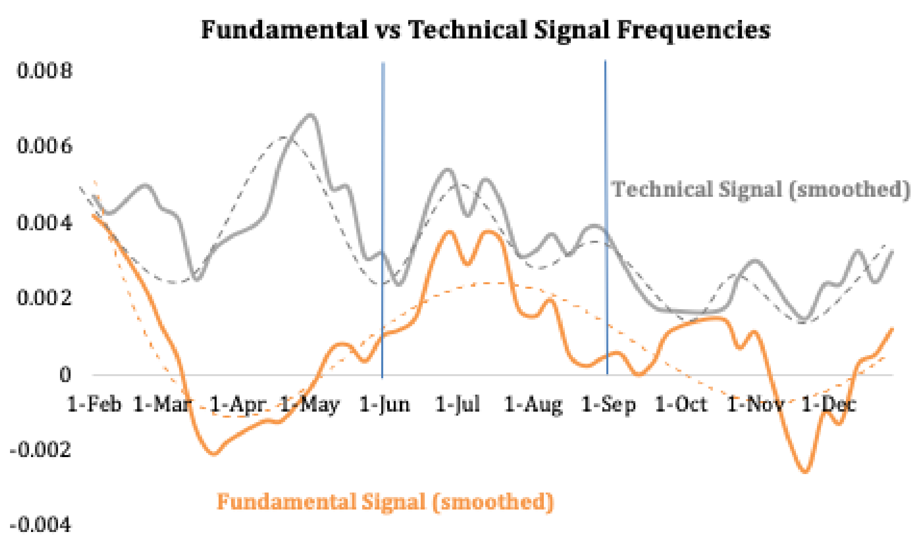
But these inclusions also happened in different market environments. The first happened in the throes of the trade war, when sentiment was rattled but still buoyant, and economic momentum remained robust, particularly following much better-than-expected growth data. Whereas the second inclusion occurred in the heart of the bear market when sentiment, price, and economic momentum were at their nadir. This offers the opportunity for us to understand what worked in different market environments given the same underlying assumption that flows should increase around the inclusion date.

The Concept

Our approach to building our quantitative framework has hallmarks of Daniel Kahneman and Amos Tversky's research on systems of thought and cognitive tendencies in decision-making. In his book, Thinking, Fast and Slow, Kahneman describes the dichotomy of two cognitive systems active in decision-making. One system is instinctive and emotional, and, therefore, faster. The other is more deliberate and logical, and, therefore, slower. This has its perfect equivalence in quantitative investing where technical signals capture the more emotional factors that change with high frequency, whereas fundamental signals capture the more logical factors that require some time to change.

The underlying logic of our framework lies in the contrast of Jasper Capital being a manager with a longer-term view than most, but also a manager that specializes in deploying quantitative methods to execute our views. For example, despite the economic slowdown and other externalities, China is still growing faster than most other rival economies. And despite the deteriorating macro backdrop and recent bear market, Chinese companies are still generating significant revenues and creating new market segments that have the possibility to be globally competitive (see TikTok).

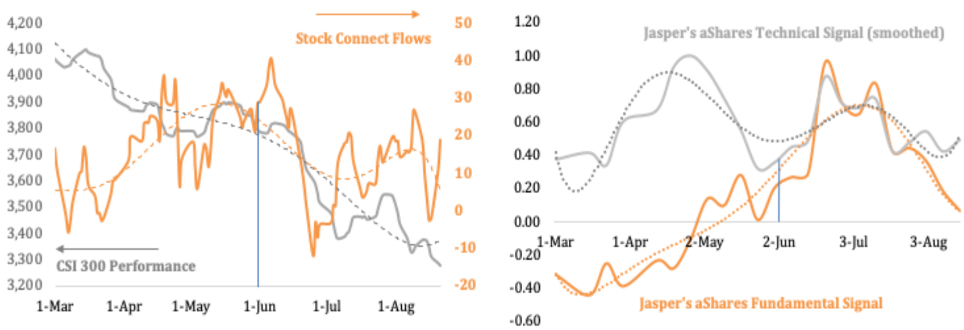
This, philosophically, begets the need to maintain exposure to fundamental factors as they are slower to reprice. On the other end of the spectrum, however, we know that retail investors dominate onshore volumes, and are highly emotional in their tendencies. When things are good, there is not enough leverage to go around. When things are bad, there is perennially the punter waiting for Beijing to make things good again. These ups and downs occur at a rapid pace, magnified by rumors, economic data, company announcements, and policy/political headlines. We believe that being solely focused on fundamentals or solely focused on technical needlessly sacrifices returns.



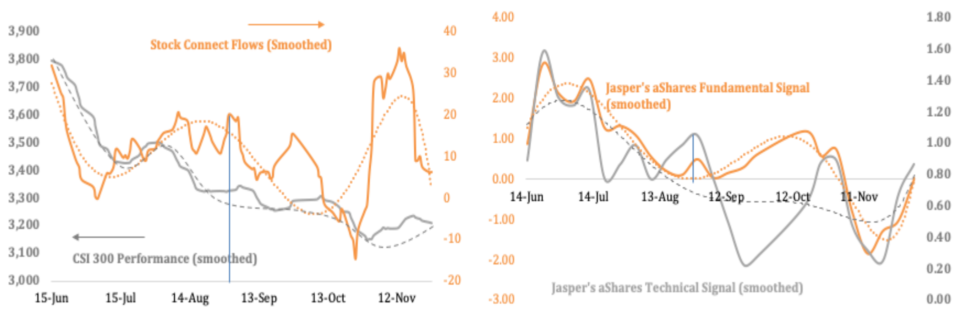
How It Works

In practice, company fundamentals are a lot slower to reprice, particularly in China where the best companies still have leverage but also have higher asset turnover. This suggests that leverage is actually being invested. These companies also tend to have significant stockpiles of cash and wide moats. This means economic momentum and market prices are slower to affect balance sheets for these companies, creating higher latency signals that continue to perform even as emotional, but faster, technical signals vacillate. This was clearly demonstrated immediately following each MSCI inclusion when volumes dropped quickly, affecting technical signals as the evolution of flows and volumes are the substrate from which technical signals are developed. However, fundamental signals were buoyed by still strong macro data, a robust consumer, and foreign inflows.

Flows and Signals Around the First MSCI Inclusion



Flows and Signals Around the Second MSCI Inclusion



The duality of fast and slow reacting signals serves as ballasts to portfolio volatility and returns, particularly when sentiment and flows quickly fade. We found that the inflection point for fundamental signal performance happens when these quantitative and qualitative (sentiment) aspects of a bear market converge, particularly following a sustained external shock, such as the escalation of the trade war in tandem with signs of a cooling economy.

However, our integrated approach provides more ways to maintain the consistency of alpha generation as we have found by using a combination of latencies across technical, fundamental, and event-driven signals. Our integrate approach sets us apart from our competitors, and firmly reflects the philosophy of Jasper Capital and the value we aim to deliver to our clients.

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