# TWO PATHS TO THE SAME DESTINATION: SYSTEMATIC AND FUNDAMENTAL

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## ABOUT **THE AUTHORS**

Saliegh is the fund manager for the Shari'ah products (equity and multi-asset) as well as the managed volatility and managed alpha capabilities.

While Warren is responsible for constructing and managing portfolios, he is also in charge of the quantitative research and models that are paramount to the success of the boutique's strategies.

All active managers, whether fundamental or systematic proponents, have a singular objective – generating market-beating investment returns. Fundamental and systematic managers use similar historical and forward-looking data, albeit in different ways, to achieve this goal. Each approach has the potential to generate great outcomes; it should never be a case of either-or but rather about getting the best of both worlds.

## KEY TAKEOUTS

- SYSTEMATIC APPROACH RELIES HEAVILY ON FUNDAMENTAL DATA
- ADVANCED COMPUTER MODELLING REMOVES BEHAVIOURAL BIASES
- LOW PRODUCT CORRELATIONS REVEAL DIVERSIFICATION BENEFITS

Active investment management has two broad schools of thought: A fundamental approach and a systematic (quantitative) approach. Globally, there has been a growing interest in the latter, with approximately 25% of assets in the US currently being managed on this basis. However, despite its rising popularity, there are still a number of common misconceptions about the systematic investment approach.

To better understand the differences and also to appreciate the benefits of both strategies, the table below debunks some of these myths.

## THE SAME KIND OF DIFFERENT

Fundamental investors typically try to get an in-depth understanding of the underlying financial performance of a company and its business model by studying financial statement data over various historical time periods. They may also try to identify the quality of a company's assets (tangible and intangible), the resilience of the business model and how potential events/catalysts (stock specific or macroeconomic) can change a company's financial performance. In addition to incorporating an analysis of a company's future growth prospects, the quality of management and the environmental, social and governance (ESG) factors of a company may also be rated.

In general, using judgement-based models, this data is then used to estimate a company's valuation. Should the share be trading at a sufficient discount to this valuation, the fundamental-based manager may purchase shares in the company. Of course, every fundamental manager may place different emphasis on each of the various characteristics we cited and this may, in turn, impact their estimates of the valuation of a given company.

Systematic investors call the characteristics or attributes sought by fundamental investors "factors". They, too, may place

**SYSTEMATIC APPROACHES: MYTH VS REALITY**

| MYTH | REALITY |
|---|---|
| Computer models are difficult-to-understand "black boxes", with no regard for fundamental data. | Many systematic managers rely extensively on fundamental data (for instance, annual financial statements). Investment processes can range from being a transparent process (or "glass box") to less transparent "black boxes". |
| Machines rule humans, with no human judgement. | Significant use of human judgement is employed in the design, research and codification of investment strategies and models. |
| Systematic equals passive. | Systematic strategies can have a relatively high turnover compared to fundamental strategies, limited capacity, proprietary signals, high tracking error and active share, tactical timing and be risk optimised. Taking all that into account, the approach cannot be fairly described as being passive. |
| Analysis is backward looking and too dependent on history. | Models may include forecasts of macroeconomic indicators, earnings and risk-based measures. Both fundamental and systematic approaches use historic information. |
| All systematic managers are the same. | Systematic managers are no more similar or correlated to one another than fundamental managers are to one another. Different selections and definitions of factors combined with varying approaches to model design will lead to different return outcomes. |
| Its lack of concentration means the strategy has no conviction. | Firstly, concentration does not necessarily improve investment performance. Diversifying across a number of dimensions can help to improve risk-adjusted returns – it is the one free lunch in financial markets.<br>All things being equal, provided a manager has skill, it's always better to apply that skill across a larger opportunity set. |

different weights – determined subjectively or objectively – on these factors or characteristics within their investment strategy.

The lexicon listed in the table below highlights how fundamental and systematic investors simply use different terms for the same attributes/characteristics.

## SYSTEMATICALLY REMOVING INVESTOR BIASES

Factors sought out by systematic investors are used to design an investment strategy and process that uses a combination of robust research, economic intuition and human judgement in its design. Once the process has been designed, it is codified using various techniques that can range from a simple to a highly advanced artificial intelligence computer model. This ensures the elimination of behavioural biases and allows the investment strategy to be repeatable, scalable (can be applied across a large number of shares) and consistently applied. Other than in exceptional circumstances, there is no second-guessing or subjective over-ruling of model recommendations. This creates a dispassionate and an objective assessment of both buy and sell investment recommendations.

## HOW BOTH APPROACHES BENEFIT CLIENTS

Fundamental and systematic investors are both focused on generating market-beating returns, but they pursue this goal differently, which implies that return correlations between these investment approaches may be low. When we review the historic alpha (the difference in return between a portfolio and its benchmark) correlations of the oldest systematic equity fund in South Africa, the OMIG Managed Alpha Equity Portfolio, from January 2004 to February 2018 (the longest possible period) with the alpha of the Alexander Forbes (Median) SA Equity Portfolio (an institutional fund survey), we see a very low correlation of -0.01. Within the retail fund market, using data over the longest available period on Morningstar from August 2002 to March 2018, the Old Mutual Managed Alpha Equity Fund's alpha correlation with the SA - Equity - General peer group average Fund is 0.34. This means that both institutional and retail clients can get significant diversification benefits and potential improvement in risk-adjusted returns by incorporating a systematic investment approach that blends both fundamental and systematic strategies into their overall portfolio without compromising on performance. ■

| | FUNDAMENTAL CHARACTERISTIC | SYSTEMATIC EQUIVALENT FACTOR |
|---|---|---|
| | Attractive valuation/discount to intrinsic value | Value |
| | Improving sentiment | Momentum |
| | High and consistent profitability | Quality |
| | Resilient business model with a "wide moat" | Stability |
| | High cash conversion | Earnings and cash flow quality |
| | ESG performance | ESG factors |
| | Sound accounting policies and practices | Accounting and governance risk factors |