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Rise of 'Black Box' Quants Spurs Sharper Questions

By Lydia Tomkiw July 26, 2017

Debates over how to evaluate quantitative hedge funds are heating up amid an uptick of investor interest, as due diligence teams delve into complex algorithms to look into the inner workings of managers' "black boxes."

For consultants evaluating hedge funds, transparency over investment strategy remains a top concern, said **David Russell**, senior investment strategist and senior consultant at **Investment Performance Services**, during a recent panel at the **Investment Management Institute**'s alternative investment consultants summit in Stamford, Conn.

"There are still firms because of reputation and history and culture that don't provide full transparency. Fine, we won't deal with them… And there are some pretty big names out there – very, very well respected firms," he said during a panel. "I'm sure everything is fine behind the curtain, but if I can't see behind the curtain, I'm not willing to trust our client assets to folks that do not provide us with full transparency. It's simply a non-starter."

When it comes to the quant space, looking behind the curtain is important, especially should a marketplace anomaly take place, he added. "With quant funds, I'm not even sure 100% of the managers understand what's going on. I say that with all honesty. We don't use a lot of quant funds. We like folks who have a human overlay on it."

Investor interest in quantitative investing has been on the rise, with a recent **Credit Suisse** Capital Services survey showing 57% of investors plan to either significantly or moderately increase their allocations in the coming years, as **reported**.

Increased interest around quantitative funds has been noticeable over the last 18 months, but so have questions about whether certain areas are getting crowded and how much stock should be given to backtesting, says **Michal Dziegielewski**, director of investment research at **FQS Capital Partners**, a global fund of hedge funds with over $100 million in assets under management that invests with quantitative funds.

"It has always been one of the main questions on quant strategies: the transparency issue. It is a common problem – some firms are quite open, but it can be quite strategy dependent," he says.

For some strategies, there is a limit to what models are exploiting that may be explainable or easy for people to understand, Dziegielewski says. But there are legitimate concerns over the details, with examples of models breaking down especially following 2007-2008, he adds.

"One of the main risks today is there is so much computing power and so much new data. It's becoming easier to develop attractive back tests, but when you apply them to the real world you find they are not working," he says.

Evaluating quant funds should not be different than looking at fundamental ones, and the focus should remain on the people and the process, says **Viktor Ula**, managing principal at hedge fund advisory firm and consultant **PivotalPath**. But the general investing community is divided on how to evaluate and assess quant strategies, he says.

“The whole fallacy of the debate is you’re comfortable with a human who is very gray… with a tremendous amount of biases but less comfortable with a systematic model,” he says.

While interest in such models is up, with PivotalPath now examining over 30 quant managers, double the number last year, investors want to see track records and see models perform in real world scenarios.

“The biggest question is do they go with the established managers or do they look at emerging managers,” Ula says. “Unfortunately, many of the established managers are closed.”

The uptick in interest has also driven strong demand for institutional marketers that specialize in raising assets for quantitative strategies, says **Sasha Jensen**, CEO at **Context Jensen Partners**, an alts manager marketing and sales recruiting firm. Context Jensen Partners counted 79 quant marketer hire moves in 2016 and 41 so far in 2017.

“Marketers play an especially important role in helping investors feel comfortable with allocating to these strategies and seeing beyond the black box,” Jensen says in an email to *FundFire*. “Frequently, this requires an in-depth understanding of how the strategy would perform in different market cycles, and an ability to communicate how the machine learning algorithms are built and maintained.”

Many investors still have not yet made significant quant allocations, and are evaluating where funds fit in their portfolios as well as examining risk management, Ula says. And the market itself is still evolving, he says.

“I’m not sure the human brain… “gray box” is much better,” he says. “We’ll probably see the combination of humans and quant models where… we won’t have this debate about quant black boxes and fundamental. We’ll see the merging of new funds over time.”