FIRST QUADRANT

MARKET INSIGHT

Different Perspective, Different Results

August 2020

Executive Summary

- Different Perspective, Different Results
- Fundamental characteristics matter only when they matter to investors
- Market influencers have different objectives that are not all motivated by profit
- Market influencers' behavior is influenced by catalysts in the environment
- Understanding market influencers' objectives and motivations provides a rich opportunity to add value

The financial market is a rich and complex space, and academics and practitioners alike have dedicated enormous effort into understanding its forces. It is perhaps surprising, then, that so few have focused on the forces driven by the diverse groups of individuals and entities that trade and influence financial assets. Many treat these market influencers as a homogenous group, all motivated by a singular desire to maximize profit. But of course, different market influencers have other objectives which are not purely motivated by profit and can vary significantly – sometimes even during the same trading session! This incredible diversity among these groups of market influencers, and their varying objectives, provides fascinating insight into how asset prices are formed.

At First Quadrant, we approach investing through this lens. We study the different groups of market influencers, take what we understand about their objectives and constraints, and seek to understand how these different groups of investors' needs and preferences change with evolutions in the market and economic environment. Through this lens, we can gauge where the demand for various financial assets will wax, and where it will wane.

How Is This Different?

Asset prices result from the interaction of supply with demand, of course, but many active managers tend to focus on supply. What is supplied is assessed both in terms of quantity and quality. Quantity is determined by those who "produce" financial assets. For example, public companies supply stock and corporate debt, while treasury departments supply sovereign debt, and central banks supply money. Active managers concern themselves with the quantity supplied, recognizing that the more shares issued, the more money printed, and the more debt sold, the less any individual asset will be worth. Fundamental analysis is then concerned with the assessment of quality - both current and future - of these assets. Together, the quantity and quality of financial assets supplied are the focus of most active investors.

We believe what gets much less attention are the forces that drive the demand for financial assets. There are several potential reasons for this. First, our industry may have unintentionally absorbed simplifying assumptions - necessary for academic theorizing - as familiar truths. Specifically, academic models have tended to make the simplifying assumption that market participants are a singular, homogeneous group with only one objective, that being to earn a profit. Convenient and understandable as this may be when building theoretical models, we know this simply isn't true. Second, those that participate in the market rightfully seek to do so as quietly and unobserved as possible, so as to not be exploited by other players in the market. The result is that there is generally very little data available about these market influencers to be able to study them quantitatively, which naturally leads to fewer opportunities for research.

However, even for a systematic manager, data does not have to be the primary source of knowledge and information. What we do at First Quadrant is to place greater weight on our experience and understanding about broad groups of market influencers. More precisely, we study not only the objectives of these groups, but also the market or economic catalysts that influence their behavior. It is ultimately our observation of the catalysts that tells us when to expect pressure on asset prices. For example, we know that central banks will react to market and economic conditions to pursue inflation and growth objectives. We know that producers in the real economy will prefer to, and sometimes need to, engage in hedging activity when certain conditions exist in the commodities markets. We know that equity investors operate with limited tolerance for downside risk, and they will act to address those limitations when market fragility increases. These are only a few examples of market influencers and their behavior. There are many other different insights about the differences in these cohorts' motivations and objectives, as well as the market or economic conditions that trigger action on their part. So in essence, data is not used as a source of ideas but rather as supporting evidence, since many of our insights would not be discovered through data analysis alone. We also use empirical data to assess the historical effectiveness of our ideas and to assess their risk characteristics.

While our focus on the demand for financial assets sets us apart, it does not make us truly unique. Discretionary macro managers put similar knowledge to work; though they tend to focus on discrete, one-off situations, while we focus on more continuous, recurring opportunities.

Our focus on demand is also not all that we do. We complement this work with insights about fundamentals. For instance, we pay attention to relative value (we don't want to buy at extreme highs or short at extreme lows), and we pay attention to the way that short-term variation and long-term evolution in risk affect the risk-adjusted fundamentals of assets. Our strong focus on risk, we believe, is where we find some degree of fundamental edge. We also think that it is essential to have a balanced blend of short-term, intermediate-term and long-term models, as it takes a combination of long-run valuation models and faster reacting models to navigate steadily through evolving market environments.

Finally, it is worth mentioning what we don't do. As we spoke to above, prices and returns are the result of the interaction between supply and demand. This has received significant attention from other systematic investors. The trend-followers, momentum players and CTAs pay attention to patterns in price changes, while other systematic macro managers search for long-term tendencies in returns that can be viewed as risk premia or common factor returns. We take a different approach, however. We generally avoid exposure to trend and explicitly seek to avoid long-term exposure to risk premia, common factors,and any well-known systematic macro managers or strategies employed (other than value). On that last point, carry would be the most important example of a systematic strategy that we avoid.

What it takes

To gain an edge, of course, requires more than simply recognizing the opportunity in an overlooked area of market drivers.

First, it is critical to have a deep, intimate, practitioner's knowledge of the markets and the diverse groups of market influencers. This work requires deep, rigorous analysis. Where clean, elegant theoretical models end, the complexity of reality begins. We believe that our differentiated perspective has provided us an investment edge, and an opportunity to explore additional avenues for future alpha.

We hope this sheds some valuable light on why our long-term results have tended to be so different from both markets and competitors, and we hope this inspires you to learn more about our process. We believe our insights can add value to your portfolio, and we would welcome the opportunity to demonstrate how.

FIRST QUADRANT, L.P. | 800 E. COLORADO BLVD. SUITE 900, PASADENA, CALIFORNIA 91101
MARKETING SERVICES INFO@FIRSTQUADRANT.COM | OFFICE 626 683 4223 | WEB FIRSTQUADRANT.COM