Quant Funds' Strong Run Continues

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Funds that use quantitative stock-picking models are on a roll. A list of 50 U.S.-sold quant funds compiled by Morningstar beat more than 80% of their respective peers over the trailing three years through Dec. 2, and the group outperformed its respective peers in 2011, 2012, 2013, and has done so again thus far in 2014.

This hot streak represents a remarkable performance turnaround. The stretch of 2007-09 was rough for quant funds. The bear market that kicked off in late 2007 was marked by a sharp reversal of the prior five years of strong performance. Because many quant funds rely to a significant degree on models that track earnings and/or stock-price momentum, the funds were hit especially hard by the bear market, when sharp reversals tripped up those models. Quant mutual funds were also hurt in the bear market when their quant-oriented, hedge fund cousins started dumping commonly held stocks, driving down share prices. Making matters worse, some quant funds then rotated from economically sensitive firms into defensive fare, which held up relatively well in the downturn, only to get left behind again when a rebound began in earnest in March 2009.

As a result, our list of funds performed poorly for three consecutive years: They posted median category ranks of 66 in 2007, 55 in 2008's sharp decline, and 68 in 2009's big rebound. Even in 2010, by which time the market had somewhat calmed down, their median category rank was a perfectly average 50.

A Less Bumpy Path

So what has changed since then? For one thing, the stock market got less volatile. Since the second quarter of 2010, the S&P 500 has only posted three negative quarters of returns, and it declined more than 2.8% in only one of those periods (2011's third quarter, when the index lost 13.9%). True, the S&P lost more than 7% between mid-September and mid-October in 2014, but it quickly rebounded to new highs after that short decline. Thus, momentum-based models have had upward trends to latch onto. On a related note, correlations between individual stocks' returns (which typically spike in downturns) have declined.

There are other factors, too. Big outflows from quant mutual funds and hedge funds means the crowding effect that can reduce the effectiveness of quant models' signals has been lessened. Also, a few of the weaker performers from our list have been liquidated or merged away, while others have seen manager and strategy changes and now employ a fundamental approach, such as Deutsche Global Equity (DBIVX).

Some quant teams have also stepped up their game. Bridgeway, which runs seven actively managed quant funds, re-engineered its models to better handle periods when correlations are higher, and its lineup's performance has markedly improved since that process was completed at the end of 2011. (The flagship of that lineup is Bridgeway Aggressive Investors 1 (BRAGX), which has beaten 98% of its mid-growth peers over the past three years.) Goldman Sachs has 10 quant funds on our list, and their performance has improved since Ron Hua took over the quant team in late 2011 and introduced new factors. Indeed, over the trailing three years, the 10 funds' median category rank was 31. Of course, as we noted above, there haven't been any sharp downturns over this stretch.

Caution Is Still Warranted

It remains to be seen how quant funds will hold up when stocks go south for an extended period again. And given their elevated valuations following a 5.5-year rally, equities could turn volatile sooner rather than later. There are still few quant funds that inspire sufficient confidence in their long-term prospects to garner a medal from Morningstar's analysts. Bogle Small Cap Growth (BOGLX) earns a Morningstar Analyst Rating of Silver for its stable, veteran investment team, a disciplined investment process that helped it recover from the 2007-09 slump more quickly than most, and the firm's commitment to preserving the fund's flexibility. AQR Momentum (AMOMX), meanwhile, uses a straightforward process, and keeping fees and transaction costs low has contributed to a solid record. It earns an Analyst Rating of Bronze.

For a list of the open-end funds we cover, click here.
For a list of the closed-end funds we cover, click here.
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For information on the Morningstar Analyst Ratings, click here.

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Investment Considerations

Mutual Fund investing involves risk including the possible loss of principal. The Fund invests in small and micro capitalization companies which may be more volatile and less liquid due to limited resources or product lines and more sensitive to economic factors.

Past performance is no guarantee of future results.

Morningstar Analyst Rating for Funds

Unlike the backward-looking Morningstar Rating™ (often referred to as the "star rating"), which assigns 1 to 5 stars based on a fund's past risk- and load-adjusted returns versus category peers, the Analyst Rating is the summary expression of Morningstar's forward-looking analysis of a fund. Morningstar analysts assign the ratings on a five-tier scale with three positive ratings of Gold, Silver, and Bronze, a Neutral rating, and a Negative rating.

The Analyst Rating is based on the analyst's conviction in the fund's ability to outperform its peer group and/or relevant benchmark on a risk-adjusted basis over the long term. If a fund receives a positive rating of Gold, Silver, or Bronze, it means Morningstar analysts think highly of the fund and expect it to outperform over a full market cycle of at least five years. Analyst ratings do not predict or guarantee future fund performance and a high rating does not assure favorable results.

The Analyst Rating is not a market call, and it is not meant to replace investors' due-diligence process. It cannot assess whether a fund is the right fit for a particular portfolio and risk tolerance. It is intended to supplement investors' and advisors' own work on funds and, along with written analysis, provide forward-looking perspective into a fund's abilities. It picks up where commonly watched measures of the past leave off.

Research Methodology: The Five Pillars

Morningstar evaluates funds based on five key pillars--Process, Performance, People, Parent, and Price--which its analysts believe lead to funds that are more likely to outperform over the long term on a risk-adjusted basis. Analysts assign a rating of Positive, Neutral, or Negative to each pillar.

Process: What is the fund's strategy and does management have a competitive advantage enabling it to execute the process well and consistently over time?

Performance: Is the fund's performance pattern logical given its process? Has the fund earned its keep with strong risk-adjusted returns over relevant time periods?

People: What is Morningstar's assessment of the manager's talent, tenure, and resources?

Parent: What priorities prevail at the firm? Stewardship or salesmanship?

Price: Is the fund a good value proposition compared with similar funds sold through similar channels?

Analyst Rating Scale

Gold: Best-of-breed fund that distinguishes itself across the five pillars and has garnered the analysts' highest level of conviction.

Silver: Fund with advantages that outweigh the disadvantages across the five pillars and with sufficient level of analyst conviction to warrant a positive rating.

Bronze: Fund with notable advantages across several, but perhaps not all, of the five pillars—strengths that give the analysts a high level of conviction.

Neutral: Fund that isn't likely to deliver standout returns but also isn't likely to significantly underperform, according to the analysts.

Negative: Fund that has at least one flaw likely to significantly hamper future performance and that is considered by analysts an inferior offering to its peers.

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