Fund Spy

Three Quant Funds Built to Last

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Quant funds are unquestionably down, but it would be a mistake to count them all out.

In Part 1 of our look at funds that let computers do the investing, we explored the reasons why they had generally struggled in both the October 2007-March 2009 bear market and the ensuing rally. We also detailed why they might mount a comeback--or why they might not. Some investing professionals believe quant investing has become too popular, causing both value and momentum signals (staples of many quant strategies) to lose their effectiveness. Others argue that these signals have simply been out of favor: Both value and momentum didn't work well in the recent bear market, and momentum has continued to struggle as stock prices--contrary to their history--haven't closely followed earnings. Buying modestly priced firms with rising earnings certainly ought to work over the long term, though. Those who are optimistic about quant funds also point out that the bear market has reduced competition among quants by shaking out many quant-driven hedge funds.

Quant funds will survive, and some will even thrive. Here's how to pick winning quant funds, as well as a few of our favorites.

What To Look For In A Quant Fund

One of the difficulties in assessing quant funds is that managers are reluctant to divulge the details of their strategies lest competitors copy it and arbitrage away any advantages or front-run their picks. This can make it tough to develop very strong conviction in a fund. Nevertheless, some managers seem to have struck a balance between disclosure to investors about their investment process and preserving their competitive edge over the long haul, even if their short-term performances sometimes look poor. Also, some of those who remain secretive make a good case for their funds through strong research-focused corporate cultures and commitment to approaches that have brought long-term success before their recent struggles.

Funds that go beyond very basic quantitative measures are more appealing, though they don't necessarily have to use a kitchen sink's full of factors to be effective. Also, as veteran Goldman Sachs quant fund manager Bob Jones noted in a recent paper on quant funds, managers who stay flexible by limiting fund size, keep transaction costs down, and focus on less-efficient corners of the market (where quant models stand a better chance of adding value) should have brighter prospects. Here are a few quant funds that have done those things.

Bogle Small Cap Growth (BOGLX)

John Bogle Jr. has been running quant funds for more than two decades, first at State Street Global Advisors and then Numeric Investors before starting his own firm in 1999. Although this fund was hammered in the recent bear market, it's performed well since the market's bottom thanks in part to its valuation model. (Its earningsdriven model hasn't really added value in the rally.) Bogle is committed to limiting the fund's size; it closed to new investors at $150 million in 2002 before reopening in 2009 at a lower asset level. And he likes to keep portfolio turnover from getting too high. He left Numeric (which used to offer mutual funds) in part because the strategies were too fast-moving for his taste. The fund resides in Morningstar's small-blend category, but typically leans towards the growth side of the style box. Thus, it's faced a headwind versus its peers over the past decade as value stocks have outperformed. When growth stocks finally lead the way again for a sustained period, expect to see the fund's relative performance perk up.

Bridgeway Aggressive Investors 2 (BRAIX)
One of the firm's most freewheeling funds, this one can invest in companies of almost any size. That said, it must defer to the closed Bridgeway Aggressive Investors 1 (BRAGX) when models select tiny companies. When those models are clicking, this volatile mid-growth fund can dramatically outperform--indeed, the firm believes it and Aggressive Investors 1 are capable of beating their benchmark (the S&P 500 Index) by bigger margins than any other Bridgeway offerings. Aggressive Investors 1, which was launched in 1994, has beaten all other mid-growth funds and crushed the S&P over the past 15 years. (Aggressive Investors 1 and Aggressive Investors 2 have looked pretty bad lately, though.) Lead manager and firm founder John Montgomery has made Bridgeway one of the most shareholder-friendly fund companies around, an impression that was only reinforced by a visit to the firm's offices last week. It closes funds at small sizes, keeps fees and transaction costs down, and adjusts the fees of many of its funds (including this one) for performance. This fund is volatile and can sorely test investors' patience, but it should benefit from Bridegway's practices over the long haul.

Vanguard Strategic Equity (VSEQX)
This mid-blend fund has historically been more valuation-sensitive and less volatile than Bogle Small Cap Growth and Bridgeway Aggressive Investors 2. (It also assesses companies' financial health and growth prospects.) But it, too, has struggled of late. It boasts rock-bottom fees, it's kept portfolio turnover under 100%, and its long-term record is solid. Finally, its broadly diversified portfolio and tilt toward financially sturdy firms provide some comfort. The fund has changed hands over the years, from Vanguard indexing guru Gus Sauter (now the firm's chief investment officer) to James Troyer. But the strategy, and the fund's appeal, are unchanged.

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