**Computer-Driven, Automatic Trading Strategies Score Big**

So-Called Quant Traders Take Advantage of Volatility

By

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Recent market volatility caught many investors flat-footed. Among the few winners were traders who let a computer be their guide.

Hedge-fund managers who employ complicated, automatic-trading strategies made millions off the wild swings in currency and commodity markets in recent weeks, investors said.

Many of these so-called quants——including Leda Braga ’s BlueTrend fund, Cantab Capital Partners LLP and R.G. Niederhoffer Capital Management Inc.—performed well because they positioned themselves ahead of market moves that befuddled traditional investors. In many cases, they ramped up bets on the momentum against the euro and reaped a huge win when the [Swiss National Bank](http://quotes.wsj.com/CH/XSWX/SNBN)removed its currency peg, pushing the euro down deeper.

They also have capitalized on what was until recently a consistent plunge in oil prices without worrying about when they would hit a bottom.

The volatility is a rare treat for automated traders, who make their livings jumping on markets moving out of sync but have been stymied by the placid markets since the crisis and yearslong march higher for U.S. stocks and other related assets.

“These are the best conditions we’ve seen since 2008,” said Roy Niederhoffer, whose eponymous $700 million hedge-fund firm’s main fund shot up nearly 14% in January, an investor update showed. “Volatility has returned with a vengeance in every sector.”

The Newedge CTA Index, a broad measure of traders who use futures, options and other financial instruments to make rapid-fire bets on market moves, rose 4.4% last month, its second-best showing in six years. That is more than the average hedge fund made in all of 2014, according to research firm HFR Inc.

The Newedge index rose more than 15% in 2014, its highest annual tally since 2003.

“There are a lot of ways to make money all of a sudden,” said Jonathan Gane, chief executive of Common Sense Investment Management LLC, which invests in quantitative hedge funds.

Despite the popular conception of hedge funds as masters of global economic trends, these managers typically don’t have a strong view of where individual markets are headed. Instead, they frequently use significant leverage, or borrowed money, to invest based on momentum, using computer models to forecast which prices will continue rising or falling. That can pay off in a big way even when they don’t precisely predict the headlines.

For instance, Cantab Capital, the roughly $5 billion U.K. firm founded by former Goldman Sachs Group Inc. partner Ewan Kirk, scored a 13% gain in January, according to investor documents and a person familiar with the firm.

That was the second-best month in its eight-year history, which the firm credited in part to the Swiss National Bank’s decision to scrap its franc peg.

Bond bets, including buying up Canadian government debt ahead the Bank of Canada’s surprise interest-rate cut, also helped, the investor documents show. Meanwhile, the firm had bets against energy assets across the board.

The computer-driven BlueTrend fund, run by the Brazil-born Ms. Braga, one of the most prominent women in the hedge-fund industry, produced its largest monthly win since 2008.

BlueTrend, which oversees nearly $8 billion, climbed 9.5%, representing hundreds of millions of dollars of gains on paper, an investor update shows. Ms. Braga, a former lecturer in engineering at London’s Imperial College, credited wagers on bonds for the big payoff.

It remains to be seen if the recent gains can slow a stampede of investors from such funds. BlueTrend, for one, is only half the size it was in 2013, thanks to investor redemptions amid an 11.5% loss that year. Deep-pocketed individuals and institutions pulled about $33 billion from similar hedge funds in 2014, according to eVestment.

“The big problem was that because markets were so highly correlated, there were very few trends out there,” said Duncan Crawford, global head of prime brokerage at Newedge.

Some already are shifting again. Aref Karim, founder of $70 million Quality Capital Management Ltd. in the U.K., scored a more than 13% gain in January, more than he made in all of 2014. Buying up U.S. government bonds and the dollar were some of his best bets. But he is onto the next big trade and moving money into Europe, as yields stateside “look to be bottoming and turning.”

At least one high-profile manager appears to have missed the recent turn. Two Sigma Investments LLC, the $24 billion New York hedge-fund firm, plunged more than 12% in its main computer-driven fund in January, according to an investor update sent Thursday and viewed by The Wall Street Journal. That more than wipes out the fund’s gains from the final months of 2014. Two Sigma didn’t offer investors any specific reasons for the loss.

**WSJ: The Cheap Way to Hedge Against Stock-Market Volatility**

Sunday, 24 Aug 2014 08:30 PM

**By Dan Weil**

The stock market has endured several spates of volatility this year. So how should you guard against future bouts of it?

One option is low-volatility exchange-traded funds. Many investors are apparently opting for this strategy, sending $10 billion into the 10 biggest low-volatility ETFs since the beginning of 2010, according to Morningstar, [**The Wall Street Journal**](http://online.wsj.com/articles/strategies-for-a-smoother-ride-in-stocks-1408721429) reports.

The funds invest in stocks with relatively stable share prices. These are frequently blue-chip, large-cap, value stocks with substantial dividends.

But the simplest way to reduce your exposure to volatility may be to increase your weighting for bonds and/or cash, according to The Journal.

By selling some stocks and increasing cash reserves, investors can shield themselves from a market downturn and have dry powder ready to deploy when stock prices fall.

"History suggests that converting one-third of a stock portfolio into cash is an alternative to buying a low-volatility fund," Jack Ablin, chief investment officer at BMO Private Bank, told the Journal.

To be sure, volatility has been muted lately. The CBOE Volatility Index (VIX) closed at 11.47 Friday, a one-month low.

"Central bank accommodative policies tend to limit tail risks and therefore to prevent big market drawdowns and very high volatility spikes," Ramon Verastegui, head of strategy at Societe Generale in New York, told Bloomberg.

Even geopolitical unrest hasn't been boosted volatility for long. "We’ve had turmoil in the Ukraine, Syria, Iraq, and the West Bank," Arthur Lu, director of equity-trading strategy at Citigroup, told[**Bloomberg**](http://www.bloomberg.com/news/2014-08-21/fed-optimism-spurs-record-bets-against-stock-voalitlity.html).

"U.S. investors have taken hits and been mostly resilient to them."

# Have Investors Finally Cracked the Stock-Picking Code?

Believe it or not, there could be a new holy grail for investors. *CHRISTOPHE VORLET*

By **JASON ZWEIG**

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Believe it or not, there could be a new holy grail for investors.

"Great ideas come along maybe once every 20 years or so," [David Booth](http://topics.wsj.com/person/B/David-Booth/1156), chairman of Dimensional Fund Advisors in Austin, Texas, which manages more than $262 billion, told me this week.

Lately, he and other leading investors have gotten excited about a financial measure called "gross profitability" or "quality." The measure appears to identify companies that will earn even more money in the future. New funds are launching based partly on it. What should you know before you consider joining in?

Research to be published soon in the prestigious Journal of Financial Economics by Robert Novy-Marx, a finance professor at the University of Rochester, shows that bargain-priced "quality" stocks outperformed the overall market by more than four percentage points annually between 1963 and 2011. This stunning margin is even higher than that earned over the same period by traditionally measured cheap "value" stocks, but usually with less severe losses in market downturns. Quality also tends to do well when value does poorly—and vice versa.

"There's something there, and I don't think it can be ignored," says William Bernstein, a money manager and investment theorist at Efficient Frontier Advisors in Eastford, Conn. "We don't know exactly why it works, but it works."

Most investors zero in on the bottom line: a company's net earnings. But here, it is what is near the top line that matters: total revenues minus basic expenses. When a company's goods and services take in a lot more money than they cost to produce, that is a high gross profit margin—and a strong signal of quality.

"You get much more informative signals about the health of firms" this way, Mr. Novy-Marx says.

That partly is because many of the investments that companies make for their long-term future growth can result in short-term hits to reported net earnings. A firm that spends on research and development, for example, is seeking to bolster its future profits by ensuring that it won't run out of new products to sell. That spending rise will hurt this year's net earnings. But the quality measure doesn't penalize companies for spending on R&D—and thus might be more effective at identifying tomorrow's more profitable firms today.

Over the past four quarters, for instance, [Amazon.com](http://quotes.wsj.com/AMZN)generated $61.1 billion in revenues. Its cost of goods sold, or basic expenses, amounted to $44.3 billion, leaving gross profits of $16.8 billion on total assets of $32.6 billion. But, largely because the company spent nearly $14 billion on R&D and marketing, its reported net income was negative $39 million.

Focus only on net earnings and you might miss the massive investment Amazon is making in its future—which could well pay off in years to come. Remember that the quality measure is designed to capture this kind of raw profitability. (Amazon didn't respond to a request for comment.)

As Warren Buffett has long shown with his stock picks, if investors underappreciate how much a company is likely to grow in the future, it can turn out to be a bargain even if it looks somewhat pricey by conventional measures.

Cliff Asness, managing principal at AQR Capital Management, a firm in Greenwich, Conn., that runs more than $71 billion and is launching funds that use the factor, says taking account of quality is "a great way to make a more accurate value measure."

Fund companies have noticed. Last December, Dimensional Fund Advisors introduced four funds that combine quality with pricier "growth" stocks. Later this month, AQR is expected to start three funds that blend quality, cheap "value" and fast-moving "momentum" stocks. As for annual expenses, the DFA funds will charge 0.2% to 0.55%; AQR's haven't been disclosed yet.

Funds or ETFs investing purely on the basis of quality can't be far behind, say industry analysts, although none are available yet.

Picking stocks this way isn't something you could pull off on a weekend morning in your pajamas. For each potential investment, you would need to subtract the company's cost of goods sold from its revenue, then divide by its total assets.

In general, says Mr. Novy-Marx, you want that ratio to be 0.33 or higher. You then would look for a low price-to-book-value ratio, available on most financial websites—ideally 1.7 or below. You would have to stick to big companies and diversify across many industries and dozens of stocks.

There's no rush. Let the funds launch and get seasoned. See whether the managers can deliver. Then wait some more, sitting out the inevitable boom in popularity. Before long, investors will be complaining that quality is overrated and that other investing styles work better.

Mark my words: At that point you will be able to get quality in quantity