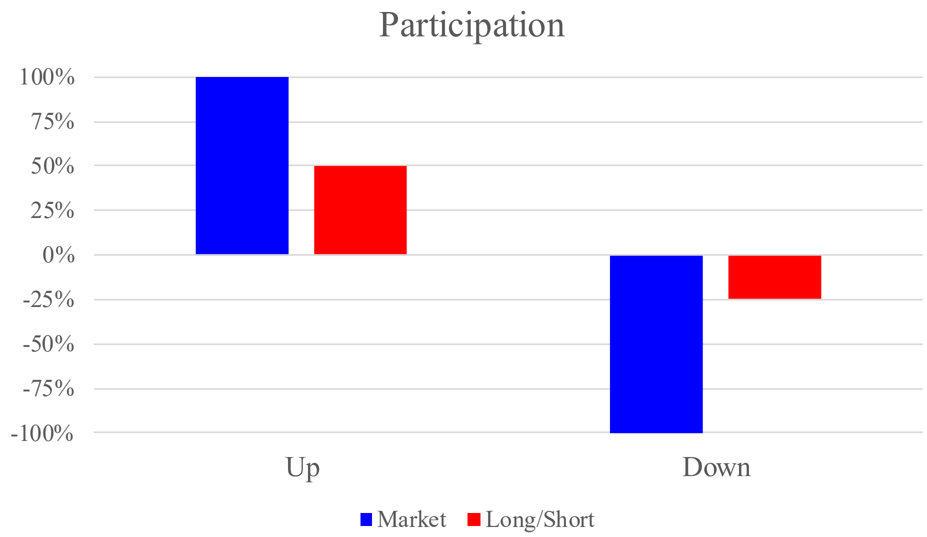
„Fusion Investing – combining fundamentals with psychology"

Exploiting the long/short spread in equities to achieve a positive asymmetric return profile

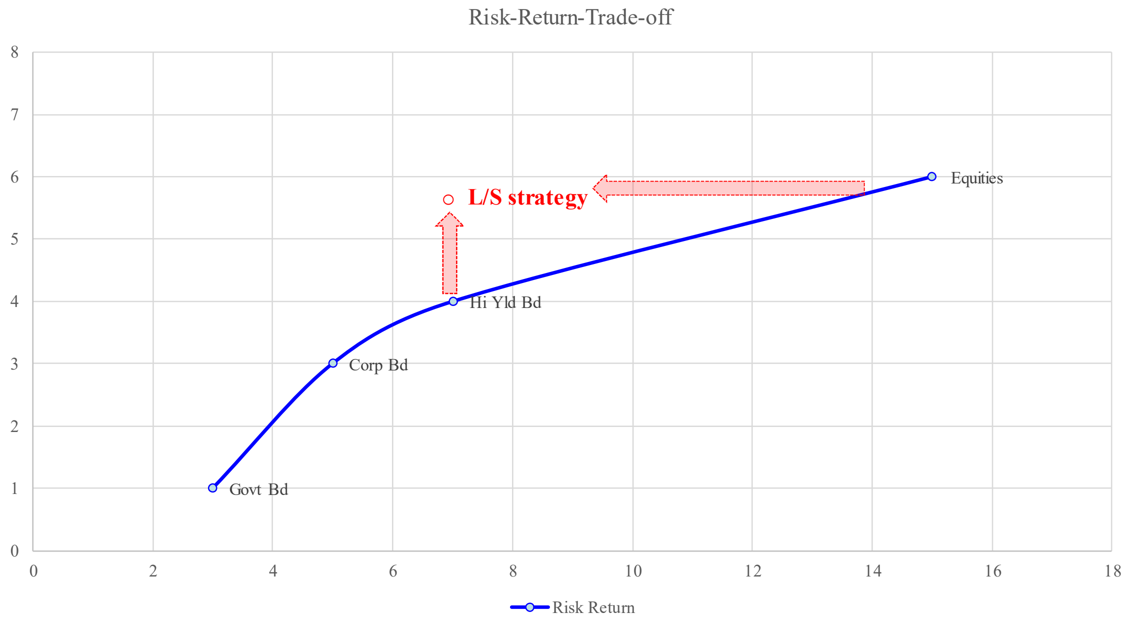
Gerd Kirsten, CFA, April 2021

Strategy Goal:

- Offer an alternative to traditional low-risk assets, as most of these harbour risks due to extremely low rates and tight spreads.
- Equities offer upside at the cost of high volatility, but this long/short strategy offers an asymmetric payoff with protection in down-markets:

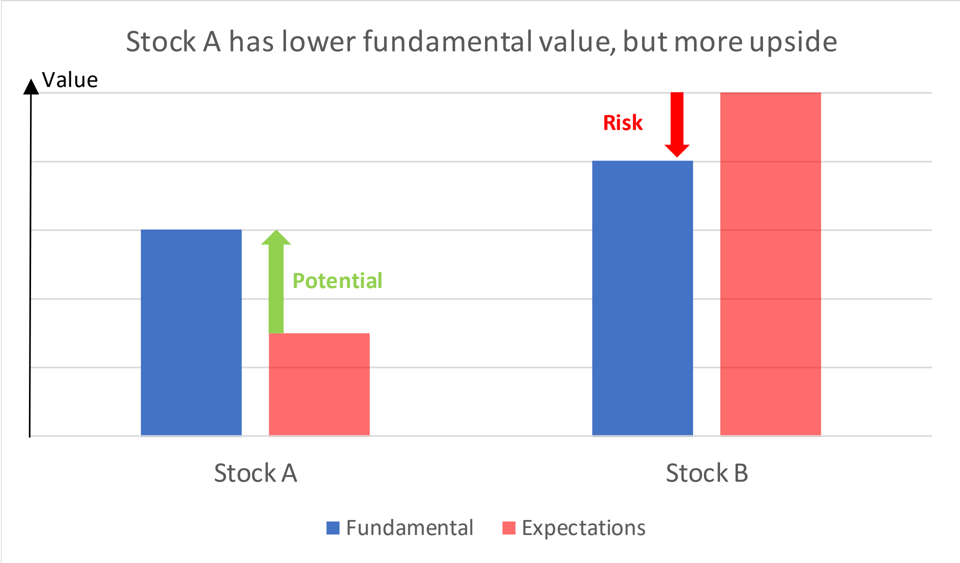


- Result: equity market return over the cycle with ½ the market volatility.

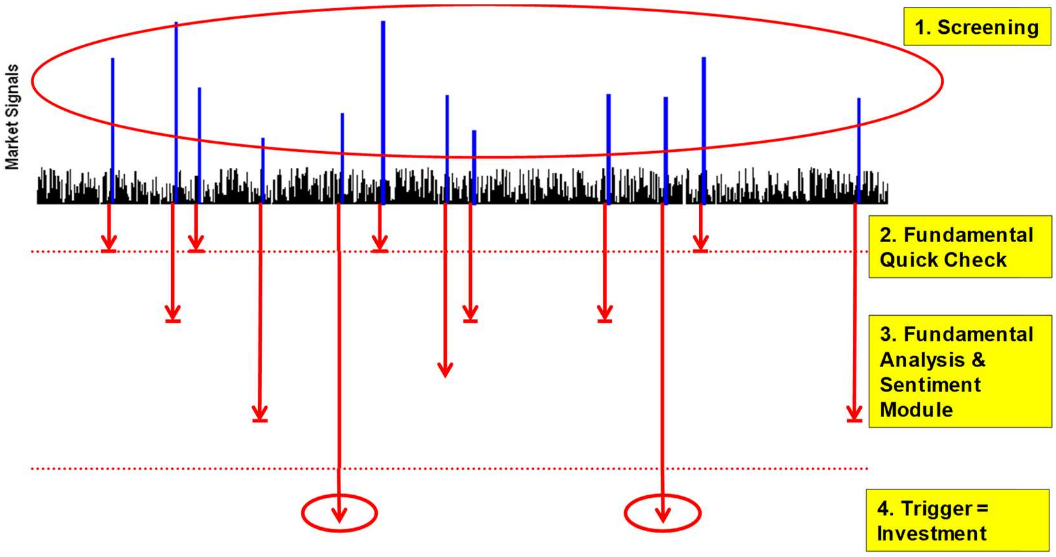


Where does such an alpha come from?

- Screening for the best stocks using fundamental factors (growth, value, quality) *wastes* much of the potential alpha. It is the spread between the best and worst stocks that can best be exploited using a long/short strategy.
- Fusion Investing is the **combination of fundamental with sentiment factors** which is ideal to identify exaggerations: good company = good stock?



- Two separate backtests over long time periods, both performed ex-ante, show a high and consistent alpha spread (see Appendix).
- Using as a disciplined screening tool and building on the results with a 3-tiered fundamental company analysis, the investment process unearths the most likely movers:



- A comprehensive database captures every process step.

How is the asymmetric pay-off achieved?

- Portfolio construction is performed by determining a risk category for each position and then balancing these categories. Given the return target for each category, this results in an asymmetric pay-off for the portfolio:

		BULL mkt: +20%		BEAR mkt: -20%	
Weight	**Stock characteristics**	**Avg.Return**	**PF Return**	**Avg.Return**	**PF Return**
30%	"Solid Growth"	15%	5%	-15%	-5%
40%	"Turnaround"	25%	10%	-20%	-8%
20%	"High Flyer"	50%	10%	-35%	-7%
90%	**LONG sum**		**25%**		**-20%**
-20%	"Low Diver"	33%	-7%	-40%	8%
-40%	"Failing Growth"	20%	-8%	-25%	10%
-60%	**SHORT sum**		**-15%**		**18%**
30%	**PORTFOLIO**		**10%**		**-2%**

Return data in this paper are for illustrative purposes only.

Competitive Advantage

- **Sources of excess return:**
- Exploiting inefficiencies
- Flexibility in portfolio management
- Flexibility in investment opportunities
- Talent

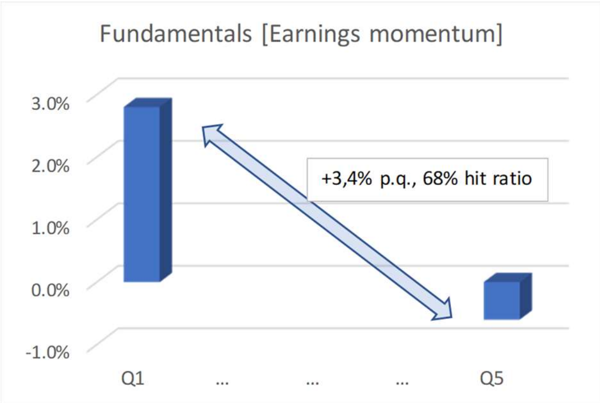
- **Investing principles:**
- Do your homework !
- Don’t analyse to death !
- A good company is not necessarily a good investment.
- Don’t fight the market !
- When in doubt get out !

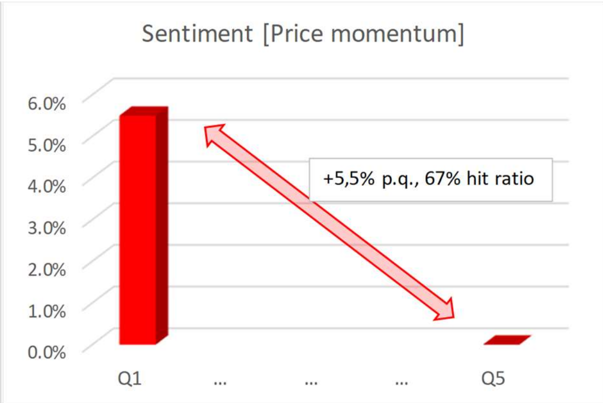
Ex-Ante Backtests: „Fusion Investing“ works

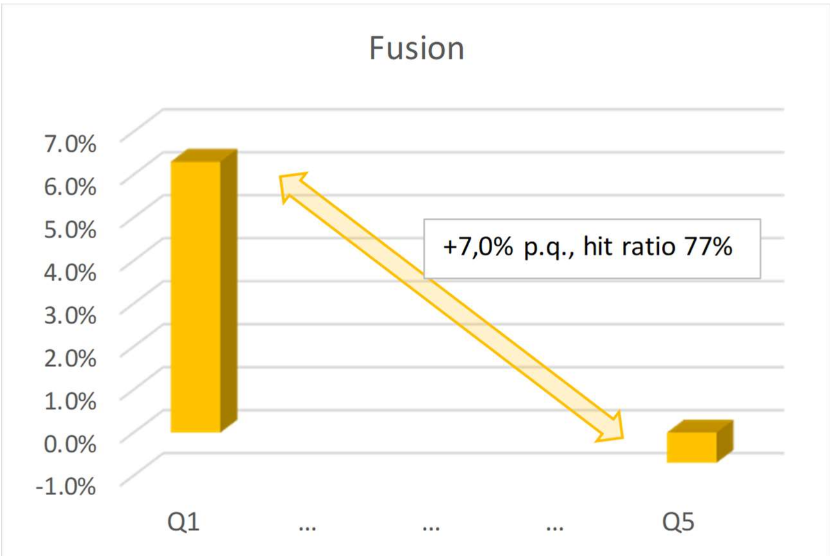
Before launching my long/short funds, I had quantitative analysts perform backtests on the base screening criteria.

(1) 1998-2005 German equity universe: change in earnings revisions and relative strength

- Outperformance in both bull- and bear-market phases







(2) 1994-2011 European equity universe:

- Outperformance in both bull- and bear-market phases