

Barriers to Entry in the Markets

I've spent the majority of my career performing due diligence on a wide variety of money managers, funds, and investment strategies. The due diligence process involves far more art than science but I've always found that it's more helpful to use the process of elimination by spotting red flags rather than seeking out the perfect investment.

One of the red flags for me was always when a manager would tout the fact that they're a pioneer in a given style of investing, form of data collection, or investment analysis. The reason this sets off some alarm bells is because (a) most of these "pioneers" were in name only and (b) competition is so fierce in the investment industry that any first-mover advantage can be gone very quickly as others swoop in to earn their share of the profits.

Being a pioneer in the business world can give you a huge edge over the competition. Being a pioneer in the investment world can give you an edge but the opportunity set can close very quickly these days. There's simply more competition than there's ever been and when you add the growth in computing power into the mix it makes it very difficult to continue earning easy profits.

There was a really well-written feature in the Wall Street Journal last weekend that discussed the rapid rise in quantitative funds and investors. The really mind-blowing stat to me is that quantitative hedge funds are now responsible for 27% of all U.S. stock trades up from just 14% in 2013. The way the quants are using their data continues to expand as well:

Humans have long searched relentlessly for ways to gain an information edge. Legend has it that financier Baron Rothschild built a network of field agents and carrier pigeons in 1815 to get a jump on the Battle of Waterloo outcome. Today's quants hope to digest—and act on—economic and corporate information faster than traditional investors.

Hedge funds with quant-focused strategies have been poring over private Chinese and Russian consumer surveys, illicit pharmaceutical sales on the dark web—a network of websites used by hackers and others to anonymously share information—and hotel bookings by U.S. travelers, according to Quandl Inc., a platform for such data.

In the late 1990s, an algorithm might have simply tried to ride the momentum of a stock's price rise, buying at a certain price level and selling at a predetermined moment. Today's algorithms can make continuous predictions based on analysis of past and present data while hundreds of real-time inputs bombard the computers with various signals.

One manager my old fund used to invest in started using satellite technology on midwestern farmland to try to predict the supply and demand for crops each year. Another had access to nearly every sell-side analyst and had them competing against one another for investment ideas. Then there was the fund that gave their analysts an unlimited travel budget to hop around the globe

looking for "boots on the ground" analysis. These firms are constantly looking for any edge they can to keep up with the competition.

As the WSJ story points out, this arms race is nothing new but it seems like technology has shrunk the window of time in which it takes competitors to come in and take market share or reduce profits for the incumbents.

For example, high-frequency trading firms (HFTs) went from making [\\$7.2 billion in 2009 to just \\$1.1 billion in 2016](#). Firms saw there was money to be made so they came in and the majority of the profits were competed away. This is how capitalism works but it seems to work much faster in the markets than elsewhere.

The reason for this is that there are very few barriers to entry in the markets. This doesn't mean there are no profit opportunities remaining but it's going to be harder to sustain a competitive advantage going forward than it was in the past, especially when using a fairly short-term time horizon.

Here are some barriers to entry that I believe still exist in the markets:

Relationships. Venture capital is a perfect example of the importance of relationships and expertise when looking for potential profit centers. Founders of start-up companies tend to want to work with certain firms or people. Most investors will never have the opportunity to invest with funds or companies in this space. This same applies for people like [David Swensen of Yale's endowment fund](#). Managers want Yale's money because it acts as a seal of approval.

Having a patient, faithful client base. My feeling is that not enough investment firms spend time thinking about or educating their client base. Most are simply willing to take any money that gets thrown their way. When you have a patient client base that is willing to see a strategy or plan through that's a huge advantage. Patient capital is hard to find but acts as a huge advantage when others are forced to sell or buy when they don't want to.

Simplifying your approach. These quant funds aren't spending millions of dollars looking for simple strategies. There's an opportunity for those investors willing to stick with a simple strategy as an offset to those who focus exclusively on complex strategies (many of which don't work).

Having a long time horizon. I'm convinced that having a long-term mindset and being more patient than other investors is one of the last true edges remaining in the markets. This is one of the few things that can never be arbitrated away by faster computing power or more intelligent hedge funds looking to make a quick buck.

Source:

[The Quants Run Wall Street Now \(WSJ\)](#)

A Wealth of Common Sense

Personal Finance, Investments & Markets

<http://awealthofcommonsense.com>

See also my favorite book on this subject:

[The Quants: How a New Breed of Math Whizzes Conquered Wall Street and Nearly Destroyed It](#)