# Interview with Ben Silluzio, CEO & CIO, at Qato Capital Market Neutral Long/Short Fund

*Qato Capital is an Australian-based alternative funds management group backed by single family office, Larkfield Funds Management. The Market Neutral Long/Short Fund is managed via an objective, consistent and replicable process utilising Qato Capital's proprietary 'Q-Score' methodology. The Q-Score process is fundamentally based, evaluating improving and deteriorating fundamentals within each business from a variety of financial metrics, such as valuation, growth, risk, quality, earnings & price.*

*The Fund seeks to preserve capital and maximise absolute returns through active and constant risk management, targeting monthly a net market exposure of 0% to hedge broader market risks through 30 S&P/ASX-100 positions (15 long & 15 short equally-weighted positions). Historically, the Fund has been uncorrelated to traditional asset classes with a negative beta to equity markets.*

*Qato Capital's process is entirely systematic – stock selection and risk management are all employed in a rules based approach. The Fund employs no financial leverage/gearing to purchase securities, no derivatives and no financial products to imitate leverage.*

**1. Qato Capital Market Neutral Long/Short Fund focuses on investing within the largest and most liquid Australian equities (S&P/ASX-100), targeting 0% net market exposure. Could you give us a short history on your fund and your main investment principles? What were your reasons behind launching an Australia mandated market neutral fund?**

Qato Capital is an alternative Australian-based funds management company backed by single family office Larkfield Funds Management. The long/short process was established on the August 1 2014 with Director's capital. Subscriptions were opened to sophisticated investors in December 2014.

The Market Neutral Long/Short Fund is managed via an objective, consistent and replicable process utilising Qato Capital's proprietary 'Q-Score' methodology. Our philosophy integrates our beliefs that:

a) share prices dynamically reflect changing financial fundamentals; and

b) changes in market participants' expectations, based on changing financial fundamental factors, drive demand & supply for each company's shares, such that:

   - improving financial fundamentals generally leads to outperformance; and
   - deteriorating financial fundamentals generally leads to underperformance.

Aside from being Australian-based and having expert knowledge within that marketplace, we are attracted to the diversity of industry in the Australian ASX-100 Index, as this diversity is a core driver for both our risk and return profile. Interestingly, we find the same diversification benefits in many mature international exchanges, such as the UK FTSE-100 Index, where we are currently in the test phase for replicating our Q-Score methodology overseas.

**2. Your fund has delivered outstanding performance since its inception eight months ago, returning 38.7%. How would you rate your performance compared to your market neutral peers in this period and why do you think you did as well as you did?**

Fortunately, we do not need to rank our performance as Eurekahedge kindly does it on the industry's behalf. According to the Eurekahedge fund rankings on April 13 2015, Qato is currently the number one ranked Fund out of 74 long/short market neutral Funds Mar 2015 year-to-date for:

- 2014 return (despite only being operational for 5 months of the calendar year);
- 2015 return;
- Annualised return since inception;
- Sharpe Ratio (5.9x); and
- VaR (90% & 95%).

We also differ from our peers because we have achieved these risk-adjusted returns with no financial leverage (i.e. we do not borrow to purchase additional securities). Our recent roadshow to Hong Kong has again emphasised that our proprietary Q-Score methodology has unique attributes and risk management processes that other participants in the marketplace are not using.

**3. Could you share with us the strengths of your proprietary Q-score methodology and its rules based approach to fundamental analysis? In your opinion, why is a systematic and objective process superior to evaluating other more qualitative factors?**

We believe a key strength of Qato's Q-Score methodology is that it is rules-based, focusing on fundamental factors in an objective manner throughout the cycle. We strongly believe that fundamentals will time and time again hold true. Qato's objective process eliminates decisions driven by emotion, indiscipline, passion, greed & fear. We never fall in love with any of our positions, long or short, as we have pre-determined holding periods and prescriptive risk management processes.

Although there are good subjective, discretionary traders who have great long-term track records, we believe that this type of investing is prone to additional risks such as style drift. We believe that a rules based approach that delivers consistent results with robust risk management is a preferable alternative.

**4. While your investment strategy is rigorously back-tested and simulated performance over the past few years has been compelling, the fund itself has a relatively short track record. Strategies which have worked well in the past can often turn unprofitable as markets evolve and change. What kind of assurance do your investors have that your fund will perform just as well out of sample in the future?**

Most people say that running money live yields very different results between out-sample & in-sample. I agree – the Qato team say 'tongue in cheek' that we produced returns of +28% p.a. annualised net of fees over the four and a half year in-sample period, whereas during our live (out-sample) period we have produced 38.7% (over 8 months) net of fees, or annualised returns of 63.3%.

The assurance that we can provide investors is that the Qato Q-Score process has a long history and has been refined and tweaked for more than 10 years. The process' foundations were originally formulated for long-only individually managed accounts, and this significantly outperformed the market's return over this 10 year period. Furthermore, the events that transpired in 2008 led to a significant tightening of our risk management processes which have reduced downside risks since this date and enhanced performance. For example, during the Greek Debt Crisis our model generated significant positive returns whilst global share markets collapsed.

**5. Conventional wisdom states that small hedge funds often generate higher returns in less publicised but capital constrained strategies exploiting market inefficiencies which their larger institutional counterparts overlook. Why does Qato Capital Market Neutral Long/Short Fund constrain itself only to the universe of S&P/ASX-100 stocks on a modest capital base of US$31 million?**

Fortunately, although we are currently classed as a 'small' hedge fund, on our analysis, the strategy becomes capital constrained at circa AUD$500 million – which is our target capacity for the Fund.

However, given the substantial relative liquidity that exists in the UK FTSE-100 Index we believe that capacity could be over US$2 billion for this product when launched.

**6. Your fund allocates the same dollar weighting to all its 30 long and short holdings in order to diversify portfolio returns. However, does this mean that the portfolio could have a net market beta exposure depending on the sum of its components' total sensitivity to the market? Also, why do you allocate the same dollar weighting to your stock picks regardless of how well or badly they scored in your Q-score methodology?**

It is unlikely that our portfolio will ever have a net beta exposure, as our process targets negative beta .

Qato equally weights positions even though the Q-Scores between positions vary – we are big believers in smart beta, emphasising weightings based on fundamentals rather than standard index weightings. Our risk management processes and procedures are all linked to smart beta. For example, BHP in recent years was over 12% of the ASX-100 Index. Why would we simply own BHP if our methodology says its fundamentals are deteriorating? Today BHP is 6% of the same Index.

 

We have no business in buying companies with deteriorating fundamentals – we invest objectively.

**7. Usually, the fund rebalances its position based on the next monthly or quarterly review. How do you manage your risks if an unexpected event arises which cause the fundamentals to deteriorate/improve quickly? If the fund is unfortunately stopped out of a position, how does it handle the resulting net market exposure?**

We have prescriptive intra-month risk management procedures, including ratcheting stop losses, based on individual share price movements, company specific announcements as well as net & gross exposure limits at the book level to manage risk. Our 'all-weather' investment approach allows us to manage the Fund's risk on a consistent basis throughout the cycle - short-term events will not change our risk management framework.

If a stop-loss is triggered intra-month and we are within our net exposure limits the position will be retained in cash until the next rebalance period. If however our net exposure is positive and above our limit, we ensure the net exposure is reduced within the acceptable parameters by either closing out long positions or executing additional shorts. If our net exposure is negative and below our limit, we ensure the net exposure is increased by either executing additional long positions or closing out short exposure.

**8. Historically, your fund has reported a negative beta, being inversely correlated to the equity markets. However, do you still think this is an attractive feature for investors given that the S&P/ASX-100 has gained 48.5% since the start of 2012 to March 31 2015? Going forward, would you make any adjustments to the fund's beta?**

A negative beta indicates that an investment tends to go up when the market falls. A negative beta is often defined as a measure of a portfolio's volatility in relation to the rest of the market. In Qato's case, our Fund is more likely to produce positive alpha when the broader market falls. Thankfully, markets produce a significant number of down days and months in which we generally deliver alpha.

To be clear, a negative beta does not imply that if markets rise that Qato will fall in value. Evident to this, despite the ASX-100 rising over this period, our testing indicates that our process would have returned +144.5% over the same period, net of all fees. Hence we see no reason to make any adjustment to the Fund's beta.

Our historical attribution also confirms this. Over the past 5 years when the ASX-100 has experienced a negative month, Qato Capital's Market Neutral Long/Short process has produced positive monthly returns 87% of the time. The average performance of ASX-100 in falling months is -2.7% while Qato's average net performance in these same months is +3.8%.

Most importantly this has continued during live trading from August 31 2014 to March 31 2015. Over this period the Fund has delivered positive returns 100% of the time when the ASX-100 has fallen on a monthly basis (the ASX-100 has fallen in four of the eight months) where Qato's average net performance is +4.9% while the ASX-100's average is -2.6%.

**9. How well do you think Australia would deal with falling commodity prices and demand, especially in light of the recent economic slowdown and signs of slowdown in the Chinese economy? Also, how much of an impact has falling crude oil prices had on equities and how do you plan to position your portfolio to avoid any adverse impacts from this development?**

Firstly I must emphasise we are not a macro group, however we believe Australia's ability to deal with falling commodity prices and a slowing Chinese economy is relatively limited. Clearly the cycle is currently not moving in Australia's favour, which is leading to a reduction in interest rates, to record lows, and therefore artificially expanding valuations of traditional asset classes. Falling commodity prices throughout history have always weighed heavily on the companies exposed to these markets. It is no different in the case of crude oil. Generally, falling commodities prices lead to a deterioration in companies' fundamentals in these exposed sectors. Conversely, falling oil prices also generally benefit companies in the transport sector. It is safe to say that our objective process, in its simplest form, identifies companies with improving/ deteriorating fundamentals in advance and as a result we have held select short positions in the oil and gas and resource sectors whilst we have been long select companies in the transport sectors since last year.

**10. On a final note, a number of managers have been predicting a major correction or even a crash in 2015. What are your personal expectations of the market for 2015?**

We just are not in the business of predicting markets. That said, if we do have a major correction, or even a crash, I know where I would want my money tied up – in a long/short market neutral process (not in a long only beta fund which would most likely fall in step with broader market movements).

The risk of a correction or crash is always up for debate, particularly after a rally from the 2009 market bottom that has lasted for over half a decade. Given the economic headwinds, I believe that domestic equity returns will be somewhat muted, especially given the reliance on stimulus and interest rate cuts to drive markets higher.

Markets throughout history have delivered many swift corrections that in hindsight turn out to be a bump in the road. I would not be surprised at all to see a correction; in fact I would almost welcome one given our Fund's tendency to provide positive returns in falling markets.

My team monitors quarterly earnings in the US, which have historically been a great forward indicator. Since 1989 US quarterly earnings have fallen on six occasions. The first five of these have seen US equity markets fall from top to bottom -20%, -22%, -51%, -58%, -9%. The sixth and most recent fall in quarterly earnings was last quarter so it will be interesting to see where this leads us, given the effect the US market has on global markets.

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