

## DUNSTAN

## Unique system gives head start

Fund manager BCS Capital uses a complex quant modelling process to pick up signals quicker than the overall sharemarket, writes **Barrie Dunstan**.

**W**hen the first federal government cash drop hit households in 2008, it quickly became apparent that people were using their windfall to buy plasma and large screen television sets. For one small, obscure fund manager, the link was quickly obvious and immediately it was a buyer of JB Hi-Fi shares.

The fund, BCS Capital, was using its own system to select shares based on company, industry and macro-economic factors which drive individual share prices — and which it claims picks up the signals quicker than the overall share market.

The clues to consumer behaviour for retailers like JB Hi-Fi lay in the secondary incomes in households — essentially government transfer payments. These trends were unremarkable until the two household handouts, when the graph showed big rises in the income and in the JB share price.

The correlation between the two was uncanny — and their confidence in the model enabled BCS to act quickly.

The new manager has been assembled by several experienced names in funds management and corporate consulting: John Bowers, former head of the Frank Russell group and then Barclays Global Investors; David Clarke, former Lend Lease, MLC and BT funds chief executive (who chairs the board); and John Stuckey, long-serving corporate consultant with the BIS Shrapnel Group and who left McKinsey & Co as Australian managing partner after more than 25 years.

The three founders worked up the concept, then brought in Justin



Long-time corporate consultant John Stuckey is a co-founder of the new fund manager.

Photo: JAMES DAVIES

Herlihy, another BGI quantitative investment expert, as chief executive officer and chief investment officer to supervise the complex quant model process that selects stocks.

BCS is owned by its directors, executives and staff, with a shareholding by Brookvine, an independent group which encourages and develops new fund management companies. So far, BCS has only \$12 million of seed capital invested in its Australian equity long/short fund, which has been operating for just less than six months, establishing a track record.

The concept of the company emerged over more than four years as Bowers and Stuckey tested and refined their theories, but the connections go back even further to Harvard in 1976 when the two Australians were doing their PhDs. Stuckey later went down the industry economics and strategy path and Bowers went into investment and finance.

But when Bowers returned to Australia in 2005, both he and Stuckey (who had kept in touch) were looking at what to do in

retirement. They found themselves speculating over lunches on whether economic insights could be used to manage shares. At the same time, David Clarke was between jobs and the three, who had all worked together with roles involving MLC, got together again.

Stuckey's experience at McKinsey convinced him that the macro-economic factors did drive share prices and Bowers' contribution was that this approach was not being

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used in the funds management industry. Stuckey believes they probably are the only ones using the approach here.

The theorising moved from the lunch tables to white boards and the work moved from being a hobby to a possible project. Then they financed a small research project at Macquarie University, using the

banking industry as a trial — and when the results came in Stuckey says they found themselves saying "this just might actually work".

Next they rented an office, formed the company, later hired Herlihy and in 2008 started to do the rounds of investors and consultants talking about a new Australian long/short manager using a quantitative input.

The go-ahead decision was taken in May 2009 and the first fund was launched in October last year.

Brookvine director Greg Hickling says his group was impressed with the four years the partners had spent on the preliminary work, building the models, testing them and showing that their approach worked.

"What they brought to us was essentially an institutional fund manager, ready to flick the [starting] switch," Hickling says.

The manager essentially is a stock picker that uses publicly available economic and industry data to build a six-step model of how a company's profit responds to various economic factors by focusing on the expected changes in its share price.

That means its researchers collect, test and use information to build a computer model for each of more than 150 companies, which produces forecasts of added value in the stockmarket for each share. It then executes trades daily to beat other market players to capture the benefits of the information.

Herlihy says all fund managers are after insights about what might affect share prices early in the game — and, importantly, before it is reflected in the market.

A traditional stock-picking manager might go to the company and ask it about the fundamental profit drivers for the company. He says BCS instead looks at the macro-economic picture and the company's industry economics and how those things link to changes in the share price.

Once the model identifies a stock as a buy (or a sell), BCS puts it in its portfolio. As CIO, Herlihy has very limited powers to change the decisions to avoid any emotional biases in portfolio selection.

The approach is the quantitative tactic of taking a lot of small bets a lot of times.

The portfolio normally has about 100 stocks, split between long and short positions.

In such an over-supplied funds management market as Australia, he says there's little point in being yet another commoditised, long only, local equity manager. Rather, you need a unique approach.

He notes that the model and the factors are updated regularly and in cases where the market has changed — for example, with a takeover offer — the stock is put on hold and any positions are taken off.

BCS Capital's model doesn't consider the skill (or otherwise) of management. Instead, it leaves that to the other managers who may have insights.

On the topic of management, Herlihy quotes Warren Buffett's quip that you should buy a company that any fool can run because, eventually, one will.