Quant fund Dalton Street and its secret black box

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"I'll bring out my black box, if you show me your crystal ball."

That is the challenge laid down by Alan Sheen to the "fundamental" stockpickers who scoff – and there have been many – at his highly successful quantitative trading strategy.

In the age-old conflict between the systematic traders who use models to invest and the fundamental investors who investigate companies to work out their value, it's clear where Sheen and Nick Selvaratnam of Dalton Street's allegiances lie.

Alan Sheen and Nick Selvaratnam of Dalton Street both trained as engineers before being drawn into finance. **Ben Rushton**

Both are engineers by training. But they took remarkably different paths before they found themselves working together at Credit Suisse, where Sheen was head of proprietary trading and Selvaratnam was head of equities.

Last year, they teamed up to set up Dalton Street, a hedge fund with a unique strategy that draws on Sheen's trading system to exploit the subordinate relationship of Asian stock markets to the US, with a portfolio of 50 stocks in the Asia region.

The story of this unique hedge fund and the unlikely partnership behind it is as much about serendipity and science as it is about investing.

Sheen, a country boy with an aptitude for maths and science, moved to Melbourne to study on an air force scholarship before he began an eight-year career as an aeronautical engineer, researching and developing gas turbines. On many days that involved hurling through the air at high speeds.

"People say I never get stressed in the markets. I think it's because I spent so many hours in the back of cockpits getting aircraft to stall."

Sheen was often forced to accompany the pilots to "stress test" new technology.

"[The idea was] – you have done the work, and to ensure you've done a good job, you're going up!"

But Sheen had an itch to get into financial markets. That drive was probably instilled by his grandmother, who invested her salary as a supervisor of cleaning at a hospital, which helped her own an expensive house far beyond the reach of her peers, and who took him to the Sydney Futures Exchange to see the trading pit.

When a wealthy American married his friend's Australian mother, Sheen and his mate convinced the father-in-law to give them roles at a multi-million-dollar Louisiana family office. It was overseen by the elder brother – an ex Fidelity analyst – and had them picking stocks the old-fashioned way.

After two years, and after meeting countless CEOs who would describe how wonderful their company was and why it would outperform all its competitors, only to under-perform, he cracked.

"I thought this is absolutely ridiculous. I cannot believe people invest this way."

Back when he was studying mathematics he had started exploring the newly created VIX index and whether volatility and liquidity was a better short-term predictor of markets than price-earnings ratios.

He'd also had his head in Charles Darwin's *Origin of the Species* and thought the concept of anchoring applied to markets. That led him to build a trading system that took leads from the US market to trade Asian markets.

"We cannot get around our own unconscious biases. In Australia – and Asia for that matter – the first thing we hear in the morning is about US markets.

Whether you hear it on the radio, from Kochie on breakfast TV, or in a morning meeting it's the first thing we hear. So we anchor on that. The next thing we anchor on is what the market did the day before."

His trading system that took signals from the US close to trade various Asian markets including Australia seemed to work.

The first two people he took this idea to – the father and the elder son of the family office – "said it was an absolutely stupid idea and no one trades this way".

But rather than be downtrodden, Sheen – summoning the words of the famous investor Sir John Templeton that you don't make money by doing what everyone else does – was encouraged by the idea his approach was unique.

So he and his friend traded single contracts and after winning nine days out of ten, the idea didn't seem so stupid. Six years later they were trading $100 million of the family office money that way.

Sheen says his approach to markets also reflects his time spent with aircraft, and in crash rescue. "Over 90 per cent of aircraft accidents are when the pilot's hands are at the stick. When you are on autopilot, rarely if ever do aircraft crash. I have carried that across to finance – the concept of fundamental investing and guessing is an anathema to me."

When he returned to Australia he ran volatility funds at AMP before becoming chief investment officer at Challenger when it was owned by James Packer.

He then moved on to Austock before joining Credit Suisse as a prop trader before heading up the desk. And that is where he met Selvaratnam, who he said took a overly keen interest in what he was doing.

"To my frustration at times, most mornings Nick was sitting at my desk wanting to talk about what's going on."

Nick Selvaratnam too came from an engineering background and studied civil engineering in Britain.

"Unlike investment markets where you can make a lot of money being right 60 per cent of the time, in engineering you have no option but to be right 100 per cent of the time so it instils a keen sense of focus."

But Selvaratnam says he was "addicted" to the world beyond engineering and a chartered accountant qualification allowed him to pursue a degree in financial services.

He found himself at audit firm Deloitte at a time when many of Australian finance's most successful careers were being launched. Fund managers Peter Morgan and Anton Tagliaferro, Quadrant's Chris Hadley, RARE Infrastructure's Richard Elmslie, Mike Wilkins, the former IAG chief executive and former Woolworths chief financial officer Tom Pockett were among his colleagues.

His area of expertise was insurance, but at a time when there weren't many listed insurers on the exchange. That was about to change and he was courted for his expertise by stockbrokers working on pending deals.

"I found myself being increasingly lunched every Friday and I worked out after three or four weeks that they were sucking out knowledge so they could do their job as analysts and stockbrokers."

Selvaratnam eventually joined broker BZW and later Credit Suisse, where he became one of the most successful insurance analysts at a monumental time for the industry. The rise and fall of HIH, the demutualisation and listing of National Mutual, AMP and NRMA, and the creation of Reinsurance Australia and Cap Re, all occurred in a short period around 2000.

"For my luck I was involved in all of them – so it was a case of being at the right place at the right time."

After a distinguished career in banking, including a stint at Goldman Sachs, Selvaratnam was appointed head of equities at Credit Suisse before he and Sheen left in May to start Dalton Street, which is backed by Steve Tucker's Prodigy Investment Partners.

The fund is permanently invested a portfolio of 50 stocks in the Asia region. But during each trading day it deploys the futures trading strategy, adding positions as each Asian market opens, before closing out all derivative trades through the day.

"In principle we are trying to leverage up the good days and neutralise the bad days," says Selvaratnam.

While Dalton Street, which has so far raised $12 million of external capital, only opened its doors in July last year the strategy has been deployed by Sheen at Credit Suisse since 2007. Over five years it has had an average gross return of 35 per cent. But it's during crises that it has delivered big gains – returning 71 per cent in 2008 and 77 per cent in 2009.

Sheen has little faith in the value of human judgement. But he admits that at times his faith in his system, which has served him well for two decades, has wavered.

"The last time I felt this way was at the start of 2007. By June of that year, I thought 'I've had a good ten-year run with this thing, I should be happy'."

It seemed to him that maybe the Asian markets were becoming less subordinate to the US.

"And then boom – August 07 happened – the quant funds collapsed and the performance took off. As soon as volatility takes off, that relationship actually strengthens."

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