SPOTLIGHT

QuantZ Capital's Milind Sharma on Applying a 'Macro Overlay' to Quantitative Investing

Milind Sharma, CEO of New York-based **QuantZ Capital Management Ltd.**, spoke to Bloomberg's Nathaniel Baker about his views on the global macro picture and how these are incorporated into his hedge fund's strategy.

Q: Your fund was in the top 3 percent in the Bloomberg database last year and recently won the Battle of the Quants. What's the strategy, exactly?

A: We're 'quantamental,' which means a hybrid of quantitative-driven on the securities selection side with some macro adjustment/macro overlay, if you will.

Q: Quantamental. I like that. How does the macro overlay work?

A: It's taking our house view and combining it with a regime-switching approach. Basically forecasting probabilities, which then drive the portfolio tilt and overall portfolio orientation. There's a lot of moving parts.

Q: So what are your macro views then?

A: We sound like a broken record in terms of our perma-bearish outlook but that's because frankly we see either a 'checkmate' or a 'stalemate.' We don't see any great scenarios that can come out of this massive deleveraging cycle. We're in the camp of this being a great stagnation/deflationary bust or secular bear market.

Q: What are your big concerns? It sounds like this goes beyond Greece and European sovereign debt?

A: That's right. All of the above plus of course the domestic issues: your fiscal cliff, the $46 trillion of unfunded liabilities, trying to solve the debt overhang with more debt and the possibility of a disorderly default or disorderly decline in one of the major reserve currencies. At the end of the day, we believe that enough cans have been kicked down enough roads in enough countries that something's got to give at some point soon.

Q: Will this be a big event or more like a slow, gradual thing?

A: We're really betting on the second order effects. Regardless of whether you have the big event or not, it's going to be a big unwind because there's no ways to get rid of the debt instantaneously. The real issue near term is whether Angela Merkel and Europe can take a page out of our history book from Alexander Hamilton's experience and apply it to Europe. Even if they do, it's difficult to see how the world can magically heal itself. Because we're still looking at a potential hard-landing scenario in China, India's not in great shape with inflation, the Japanese have plenty of their own debt to worry about and are only 23 years into their bear market, and we're 13 years into ours. We see the 'lost decade' in stocks – not the one that just happened, but the one that's likely to come – to act like a dampened oscillator. This means that each successive episode of quantitative easing will be less and less effective. As an example, this is the third year in a row that we've seen a very serious déjà-vu script playing out; you get a very strong first quarter, market peaks in April or May, then you get a summer swoon. For the third year in a row we've been justified in being cautious that once the sugar high of quantitative easing wears off, the same script plays out. What I'm saying is that at some point you're going to have an episode of QE perceived not as a license to melt up, but as sheer desperation on part of the Fed.

Q: How are these views translated into your strategy exactly? How does that mechanism work?

A: As I mentioned we're more interested in the higher order effects, namely what does that do to vol and dispersion and stock correlation and all those things. The macro stuff translates directly into the fact that in the last couple of years you've seen record high stock correlation. That makes it very difficult for a fundamental, bottom-up stock picker to outperform. The other issue is that when you're in a sideways to downward bear market, the typical long/short process doesn't work well. Because most long/short funds are essentially levered beta riders. They see a rally, they load up and jump on. Not to mention that with the pressure on expert networks and Reg FD it's gotten much harder for many of these managers to do what they used to do. Plus, with the relative volume in ETFs rising dramatically, you've got an environment where a process-driven strategy can tweak the right levers to take advantage of these issues.

Q: Isn't there a lot of upwards/downwards/sideways movement as we go along here?

A: Exactly. In general, one should expect much higher volatility and correlation in these bear market cycles. That's something a quant process can take advantage of. We for instance are always implicitly long vol/long dispersion. But we can choose to be long correlation/short correlation by tweaking our ratio bets on idiosyncratic versus common factor risk.

Q: I think you just lost me.

A: It's very difficult for fundamental managers to even measure their idiosyncratic versus common factor levels, much less take advantage of that.

AT A GLANCE

Age: 40

College/University/Grad School(s): Oxford, Vassar, Carnegie Mellon, Wharton

Professional Background: MLIM, ran proprietary stat arb portfolios at RBC and Deutsche Bank AG, the latter under Boaz Weinstein.

Mentors: Boaz Weinstein; Bob Doll, vice chairman of BlackRock.

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