The Interview – Jonathan Sharpe, Ratio Asset Management: “The returns from what might seem quite boring stocks can be highly attractive, and it helps us sleep at night”

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Jonathan Sharpe, chief executive of Ratio Asset Management, says the long/short small and mid-cap equity Ratio European Fund benefits from the limited attention the sell-side pays to the fund’s investment universe, which increases its inefficiencies, while the sharp decline in the level of assets on the buy side from its peak has increased the available opportunities.

GFM: What is the background to your company and its funds?

JS: Ratio Asset Management was founded at the end of 2005 by myself, the former head of European smaller companies at Gartmore, and partner Ralph Jainz, who had been head of the Cazenove German small/mid-cap research team. The firm was set up to run the Ratio European Fund, a hedge fund investing in small and medium sized companies in Europe. I had been running this strategy successfully for almost five years at Gartmore before leaving to found Ratio.

Ralph and I had known each other for over seven years before founding the firm. We saw a great opportunity to exploit inefficiencies in the European small-cap marketplace by doing our own very detailed fundamental analysis. Ralph has a very strong background in financial modelling and valuing companies, while I have spent many years researching companies and managing funds.

The Ratio European Fund invests in European small and mid-cap companies with a market capitalisation up to EUR5bn and aims to achieve attractive and consistent returns of 10 per cent-plus using a fundamental, value-driven approach. The emphasis is on managing risk and preserving capital while seeking to make money primarily from stock selection.

Launched in February 2006, the fund has limited correlation to the market and low volatility. It is run with low net exposure (typically 10 to 30 per cent) and some leverage (40 to 50 per cent). The fund has assets under management of USD90m out of a total of USD130m for the strategy, and is managed by Ralph and myself.

The Ratio European Opportunities Fund, launched on May 1 this year, is run along the same principles of low net exposure, volatility and correlation and being value-driven as the European Fund, but invests in large and medium-sized companies. The new fund has USD15m in assets and is managed by Ton Tjia, a new addition to the team.

GFM: Who are your key service providers?

JS: Our auditor is PricewaterhouseCoopers, our legal advisors are Schulte Roth & Zabel and Maples and Calder, our administrator is Citi, and our prime brokers are Morgan Stanley and Credit Suisse.

GFM: Have there been any recent changes to the management team?

JS: Ton Tjia joined the business as a partner in January, bringing more than 30 years' investment experience including 11 years running long/short money. Ton was the founder of Olympus Capital in 1997 and one of the pioneers of the European hedge fund industry. He ran the Olympus Europe Fund for eight years until the end of 2005, when he returned capital to shareholders, subsequently running a book at Millennium Capital Partners between 2006 and 2008. He produced a 10.5 per cent compounded annual net return for investors over 11 years with a Sharpe ratio of 0.7.

Alice Squires recently joined the firm to head marketing and investor relations activities. Until 2005 she ran the European small and mid-cap equity sales team at Deutsche Bank, the top-ranked sales team by the Reuters small/mid-cap survey from 2001 to 2003.

GFM: How do you distribute the funds, and what is your client base?

JS: The funds are distributed directly. Our current investors are a mixture of family offices, institutions and funds of funds.

GFM: How would you assess the impact of the recent global financial crisis and economic downturn on your business?

JS: The biggest impact was the wave of redemptions at the end of 2008. Our assets under management went from USD500m to USD100m between September 2008 and March 2009, when our investors needed cash quickly and used us as an ATM.

We decided not to gate any investors and returned all the capital. It was the right thing to do but clearly a painful experience and impacted performance severely. Up to September, we had been performing well but had a very difficult few months as the redemptions hit the fund.

We learnt a number of lessons and introduced new liquidity and stop-loss rules. The liquidity rules limit exposure to less liquid names. On average we can now liquidate 75 per cent of our portfolio within five days. The stop-loss rules limit downside when momentum goes against our fundamental analysis, and although we are stock-pickers, we now take a more pragmatic approach to macro and country-specific risks.

The impact of the downturn on the business operation has been limited. We are a small, stable, efficient and profitable operation, and remain so despite the downturn and reduction in assets.

The small/mid-cap asset class is highly geared to the economic cycle. Stocks are more exposed to lack of financing and can be marked down indiscriminately in a flight to safety. The impact of the downturn has created some interesting valuation anomalies and allowed us to buy some fantastic companies cheaply.

GFM: What is the firm's investment process?

JS: There are more than 3,000 stocks in the small/mid-cap universe, and we typically hold between 60 and 80 positions at any one time. Ideas come from screening, company meetings, brokers, themes and trends arising from internal debates.

Our long experience of investing in the asset class and extensive contacts mean we have good corporate access and see more than 600 company managements a year. We build detailed models, focusing on cash generation and return on capital employed. We believe there are persistent inefficiencies in the small-cap market in Europe and that detailed independent analysis can exploit those inefficiencies on a consistent basis.

Investments are made with a one- to two-year view (we are investors, not traders). In general, we are looking to go long companies that consistently achieve returns above their cost of capital and short those that fail to meet their cost of capital, ideally with poor or deteriorating balance sheet. We use a discounted cash flow valuation to set a price target and calculate whether the upside justifies investing.

GFM: How do you generate ideas for your funds?

JS: The most important source of ideas is the rigorous schedule of company meetings that the team undertakes. The investment team of four sees more than 600 companies a year, split between trips to company headquarters and plants, meetings in our offices and company roadshows. These meetings give great insight into the individual companies and also provide information about the sectors they operates in as well as the wider economy.

The team also runs screens based on financial databases to identify anomalies in terms of valuation and growth, as well as other financial metrics. These screens are invaluable in generating ideas in the less well known parts of the large investment universe.

Finally, the team pulls all the micro data gathered from companies together with macro trends in an attempt to spot longer-terms trends and the companies that might be impacted by them.

GFM: What is your approach to managing risk?

JS: Risk control is a priority at Ratio. Stock-specific risk is a key risk for both funds and is mitigated through the detailed analysis that is carried out and carefully gauging position sizes against the risk/reward for each company.

The overall portfolio is managed within strict guidelines for net and gross exposure, while individual position sizes also have limits. There are strict liquidity rules in place to ensure that the portfolio liquidity corresponds to the funds' liquidity terms. Stop-loss rules are also used at position level.

The risk function is run independently of the investment team, with daily risk monitoring and a detailed weekly risk report. Breaches of liquidity or stop-loss rules are correctly swiftly.

GFM: How has recent performance compared with expectations and track record?

JS: Performance this year has been good and we are currently up around 9 per cent in 2010, with a gain of 2.03 per cent in October, in line with our target of around 10 per cent per annum. In what has been quite a difficult year for long/short funds, the fund has shown little correlation to the market (for instance, the fund was up slightly in May) while generating an attractive return.

What opportunities are you looking at right now?

JS: In a low interest rate world where many uncertainties remain, we are focused on companies with strong franchises and managements that offer attractive free cash yields and a high degree of predictability. This leads us to what might often seem quite boring stocks, but the returns from such companies can be highly attractive, and it helps us to sleep at night.

Divergences within Europe present many opportunities for stock selection. Shorting poor-quality companies in weak economies (Spain, for example) remains an interesting proposition, while certain exporters in Germany are faring very well.

We are encouraged by the limited attention the sell-side is paying to our universe, which increases the inefficiencies, while the level of assets on the buy side has sharply reduced from its peak, again increasing the opportunities.

What events do you expect to see in your sector in the coming year?

JS: Our sector is certainly off the radar screen for many investors, which creates an opportunity, and we do start to see interest increasing. Many investors shunned Europe earlier in the year but I think we have shown that money can be made in the current market environment.

We will probably see more M&A activity in our universe. Corporates generally have strong balance sheets and can see M&A as a way of growing when organic growth is more difficult. Private equity funds are also returning slowly as buyers. We have had a pretty good record of having companies bought out from our portfolio – the sort of companies we like buying (strong businesses with good cash flow and balance sheets on low valuations) are often attractive to other acquirers.

GFM: How will these developments affect your own portfolio?

JS: We expect divergences in Europe to remain and will continue to seek to exploit them. Hopefully some of the assets coming back into European markets will find their way to Ratio.

GFM: How do you assess investors' current expectations?

JS: Mixed! We meet investors who are extremely bearish, some who believe equities are undervalued versus bonds and will rally further, and plenty who just don't know. Many have had a difficult year and are looking to bolster performance.

There has been a flight to investing in larger blue-chip funds, but reassurance has perhaps come at the price of performance. Investors rightly expect decent returns for their fees and are frustrated by their experience this year. We hope that in 2011, a return to focusing on performance will encourage investors to look at some of the smaller names with good track records and conservative strategies.

GFM: What differentiates you from other managers in your sector?

JS: Experience and discipline. We have one of the most experienced teams in the European small-cap market, plus Ton Tjia's 30 years in the European markets. That counts for a lot. We have all lived through some very difficult markets and have the scars to prove it.

Our disciplined research approach is tried, tested, and it works. While we always look to improve what we do, we firmly believe that rigorous and detailed analysis, focusing on the long term, yields results. We have been doing this for many years. It doesn't work every month, but in the long run it generates decent returns.

GFM: How do you view the environment for fundraising over the coming 12 months?

JS: It's clearly tough for smaller players and is likely to remain so, but we are seeing increasing interest and remain optimistic our strong performance and consistent strategy will attract new money.

GFM: Do you have any firm plans for further product launches?

JS: Not currently, but we are monitoring developments in Ucits, and we always look at opportunities in line with our investors' needs. One area we see as offering strong upside is the micro-cap space, and for an investor prepared to take the liquidity risk in a dedicated fund, this could be an interesting area in the future.

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