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STRATEGIES, ALLOCATION & PERFORMANCE

Preserving capital in turbulent markets

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Three multi-strategy funds of funds and one equity market-neutral fund of funds which came through 2008 relatively unscathed offer some lessons for wealth-protection in stormy times. By *Martin Steward*.

It was easy enough to make money in hedge funds through 2008 - if you picked the right short sellers, global macro managers or CTAs you could have doubled your assets – but, perversely, things were tougher for those using them as risk-management tools. HFR’s Fund of Funds Index finished the year down almost 20 per cent, while its general industry index gave up 18 per cent: on average, investors who paid funds of funds to diversify their risk ended up sacrificing nearly 170 basis points of performance.

The average is not the whole story. Larger funds seem to have struggled more than smaller ones – even the better examples were clustered around the 10 per cent mark at year-end. The largest among our list, Stenham’s $1.5bn multi-strategy programme (down just 7.99 per cent in 2008), is a minnow compared with some institutional behemoths, and it may be significant that smaller funds necessarily have a higher proportion of partners’ money riding on decisions.

“Family wealth takes decades to build-up,” says Stenham’s head of institutional business development Harry Wulfsohn, in an office dedicated to documenting his grandfather’s exploits in the central African cattle trade. “When you cash-out a family business you move from a wealth-creation to a wealth-protection mindset.”

LESSON 1: TRUE DIVERSIFICATION REQUIRES CONCENTRATION

The Stenham strategy is capped at about 35 managers, which is why it has spawned three funds over its 26-year life. The $60m Hurdle Fund run by Channel Island Alternatives (CIA), flat for 2008 but up for sterling and euro investors, will not go much higher than 20; and the $260m-plus Culross Global Fund, up 3.16 per cent in 2008 and 5.16 per cent in sterling, invests with around 20-25.

“The industry needs to open its eyes to the routine over-diversification of funds of funds,” says Nigel Blanshard, Culross Global Management’s co-founder. “Over-diversification dilutes the impact of your theme- and manager-selection, and, more importantly, over-exposes to all sorts of operational and systemic risks."

FA Conservative, which last year made 6 per cent from equity market neutral funds, is concentrated in around 10 funds – and that is not just because it only just started raising serious third-party money. Whereas CIA and Culross both like early-stage and niche managers, Amir Sajjadi, manager, describes his portfolio as "two-thirds blue-chip" – this is about diversification from the pack by conviction. "The better funds in our peer group are closely correlated," says Mr Sajjadi, suggesting that many have favoured more aggressive trading strategies and sleepwalked into a major small-caps bias.

Staying focused forces true diversification discipline, rather than diversification by spurious hedge fund classifications.

LESSON 2: THROW OUT THE STRATEGY RULE BOOK

"There is a lot of thinly-veiled indexed management going on - the typical institutional funds owning standard hedge fund styles in very similar proportions that don't move very much," says Mr Blanshard. "We think the presumption behind that is that the hedge fund styles are not correlated with each other, and there isn't much evidence that that's the case. So from day-one we didn't bother looking at the usual hedge fund classifications."

Instead, Culross identifies several forward-looking macroeconomic "themes" and categorises its investments in those terms: instead of global macro, distressed debt or even special situations, the portfolio has 16 per cent in "Dislocation Insurance", for example, or 8 per cent in "Global Inflation Transition".

The CIA Hurdle Fund has allocations to freight, property, and media finance. Standard hedge fund categories are in there too, but the proportions are unusual: only 21.6 per cent long-short equity, for example - a quarter of which was a short-seller.

"We want to deliver an absolute return product and we'll build the portfolio as appropriate by going back to first principles," says co-founder Nick England. "It's important not to get caught-up in the correlation mix everyone else is caught-up in. The majority come from a long-only background and keep 40-50 per cent in equity because they're uncomfortable operating with more dimensions – volatility, skew, fat-tail risk, and so on. We think long-short equity can be hugely expensive without adding much alpha - we prefer to look at esoteric or niche managers."

Both approaches enable the funds to define their allocations on their own terms, and thereby remain disciplined in preserving their objectives at portfolio level.

LESSON 3: TAKE A FORWARD-LOOKING MACRO VIEW

2008 was one year when having the right macroeconomic view made a huge difference. All three multi-strategy funds made good calls in 2006-7: reducing credit risk; removing leverage; increasing liquidity; reducing net equity exposure; introducing portfolio insurance through long-vol strategies; addressing inflation.

“Those relying on both strategy views and manager selection have done better than those relying on manager selection alone,” notes Stenham’s Mr Wulfsohn. “It’s important to have both top-down and bottom-up approaches. Ours is also a very qualitative strategy, based on a forward-looking approach, rather than backward-looking quants.”

But how do you make the exposures of 15-20 hedge funds agree with your outlook on the global economy?

LESSON 4: MANAGE TOP-DOWN AND BOTTOM-UP RISKS IN TANDEM

For FA’s Mr Sajjadi, it is all about managers’ behaviour patterns. When markets go bad, he argues, each falls back to a comfort zone – the sector or trading strategy that forms the bedrock of their career – and preserving capital is all about making sure they do not all run to the same place. As he observes, quantitative analysis adds little to this process. “My job is to identify where the managers’ comfort zones are and then think about how to combine them with other manager with similar skillsets,” he explains. “We call that our own alpha.”

For the multi-strategy funds, just as underlying managers balance risks, so the portfolio manager hedges his net-long equity risk (for example) with a corresponding exposure to, say, volatility-arbitrageurs or CTAs.“The first thing we do is try to determine how much risk we want to take, and where,” explains Mr Blanshard at Culross. “We then set about identifying our themes: some are risk-taking and some are hedging, with the latter extremely likely to be net-short one thing or another, and that means we have an estimated long and short book at portfolio level as well as the managers having theirs.”

How does this work when many of the underlying managers are themselves traders with shifting sensitivities? The answer lies in flexibility. For example, Culross’s “Global Inflation Transition” theme is about “the arm-wrestle between inflation and deflation”: Culross thinks inflation will replace deflation very quickly at some point, but doesn’t claim to know when or how – it sought-out managers who shared that view and “could use their expertise to decide how they would be positioned and when”.

LESSON 5: RISK MANAGEMENT IS COMMUNICATION

As Stenham’s Mr Wulfsohn observes, macro managers sum-up the challenge: they can become correlated around a handful of key trades and their shifting portfolios resist quantitative analysis; they, above all, can only be managed via regular contact and intimate understanding.

Interestingly, he describes Stenham’s macro view developing out of “what we are hearing from the 1000 managers we visit each year”. The top-down view emerges as a strategy that can readily be implemented by Stenham’s universe of managers – the approach is holistic, and avoids the problem of imposing macro views onto managers conceived as occupying certain fixed strategy categories.

That means that, although they differ on what constitutes transparency, all these managers see it as crucial to implementing their defined-but-flexible 6-12 month forward-looking views.

Expressing those views by trading illiquid hedge funds is inefficient. Turnover in these funds may increase slightly during re-positioned for a new market regime (such as now), but they are generally steady. Culross (unlike CIA and Stenham) has a facility to apply hedging overlays, but it has employed it less than a handful of times.

“You’re fixed with your positions for 3-6 months, essentially, so you’ve predetermined your journey and you have to make sure you are going to be happy with it,” as Mr England puts it. “You might have a good feel about where the market’s going to be in a year’s time, but you need managers who can make money in the meantime as well as be well-positioned for that environment.”

WHAT OUR MANAGERS LIKE FOR 2009...

■ Small net exposure to equity (Culross; Fund Analytics): But expect ongoing volatility and no sustained rally until well into Q4 2009 [FA] or “years away” [Culross]

■ Global credit (Stenham; Culross; CIA): But this will be a volatile spread-narrowing trade, so make sure your managers know how to trade tactically long-short (Culross); and investors need to be very selective (CIA)

■ Distressed debt (Stenham): Although not an opportunity until Q3 or Q4, and Stenham redeemed from one manager who already moved into the space

■ Convertible bonds (Culross)

■ Japanese corporate event-driven strategies (Culross)

■ Inflation-linked securities (Culross): But also cheap global macro exposure to inflation insurance, and the ability to trade deflation, in anticipation of a regime change as a result of excess liquidity

■ Liquid strategies (Stenham; CIA)

■ Short-vol CTAs (CIA): But these are difficult to find

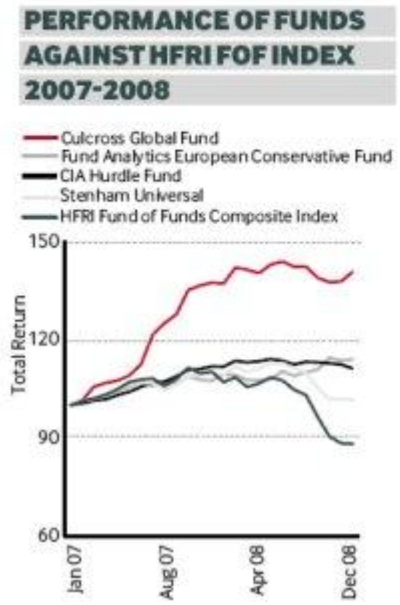
■ Spread-based global macro (CTA): Vol-neutral strategies

…AND WHAT THEY'LL BE AVOIDING

■ Illiquid strategies (Stenham; CIA)

■ Distressed debt (CIA): Concerned about it being a “market-timing” strategy and a “pure-beta” play

■ CTAs (Stenham; CIA): Culross doesn’t invest at all; Stenham and CIA both fear mean-reversion as volatility subsides and money floods in chasing last year’s outperformance.


PERFORMANCE OF FUNDS AGAINST HFRI FOF INDEX 2007-2008
Culcross Global Fund
Fund Analytics European Conservative Fund
CIA Hurdle Fund
Stenham Universal
HFRI Fund of Funds Composite Index
150
120
90
60
Total Return
Jan 07
Aug 07
Apr 08
Dec 08