HEDGE FUND SURVEY

Finding five exceptional hedge funds

ANNUAL REVIEW

Progressively lower fees and smaller funds will help increase investor returns

ERIC UHLFELDER AND JONATHAN KANTERMAN

"But I still haven't found what I'm looking for"

Pop group U2's refrain may be an apt description of how those running alternative investments at Calpers, the largest US pension fund, felt last year when they decided to pull the plug on their long experiment with hedge funds. Ted Eliopoulos, the fund's chief investment officer, said too much effort was expended for too little exposure for a $300bn fund.

But if management believes in hedge funds, why not commit more resources to the search and boost asset exposure to produce performance?

That is the issue explored in this year's annual industry review.

Calpers is not alone in its retreat from hedge funds. The UK's £20bn Railways Pension Scheme wants to reduce its £1bn exposure. The same is true for the £39.6bn BT Pension Scheme and the third-largest pension fund in the Netherlands, PMT, with €55bn.

Such institutional rumblings should not come as a surprise. Last year's survey revealed the paradox of rising net flows into an industry delivering lacklustre performance while stocks continued to shine for a fifth straight year.

Fidelity Investments' institutional arm, Pyramis Global Advisors, which manages more than $200bn, recently reported that nearly one-third of US institutional investors felt hedge funds fell short of expectations. According to Stephen Benjamin, vice-president of market and business intelligence at Pyramis, this contrasts with the more benign sentiment investors expressed in 2008, when hedge fund losses were about half that of the market's.

Mr Benjamin says: "When Calpers announced it was withdrawing from the space, almost every US institutional investor hit the pause button to re-evaluate its hedge fund investments." Meaning: hedge fund exposure is no longer a given.

Calpers' $4bn sell-off does not mean there will be a rush out of the asset class. But Mr Benjamin does feel there is more palpable risk in the sector now than in recent years.

BarclayHedge reports hedge fund asset growth in 2014 is set to accelerate past the 8.35 per cent annual expansion rate witnessed since 2008. This is occurring despite hedge funds continuing to underperform the S&P 500 for the sixth straight year. In the year to November, the average fund was up 3.5 per cent while US stocks rose nearly 14 per cent. The MSCI World Index in dollars was up over 7 per cent.

However, pure long-only stock portfolios are volatile, with exposure to chunky drawdowns over the long term. These concerns have been driving institutional investors into hedge funds.

Citi Investor Services reported that 12 years ago, 80 per cent of hedge fund investors were wealthy individuals and family offices. Parity with institutions was reached in 2007 as market fears were building. Now, two-thirds of hedge fund dollars are owned by pension and sovereign wealth funds, endowments and foundations. Sandy Kaul, US head of business advisory at Citi Prime Finance, expects that figure will jump to nearly three-quarters of the industry's anticipated $4.8tn assets by 2018.

"Institutionalisation of hedge funds makes market outperformance less likely," says Jeffrey Willardson, a managing director at Paamco, which runs $10bn in hedge funds of funds. "Protection from downside volatility typically means lagging performance when stocks take off," he says.

With large investors still ploughing in, allocations are getting bigger. This favours larger funds that have the capacity to accommodate bigger flows. Industry tracker HFR says more than 80 per cent of hedge fund assets are now concentrated in fewer than 7 per cent of all funds, whose assets each exceed $1bn.

To generate better net returns, the industry has two basic options: one, increase focus on proven smaller funds that have delivered superior returns due to their scale and flexibility; and two, adopt progressive fees and strategy-adjusted hurdles.

The second point requires a realistic benchmark against which to measure hedge fund performance. Because hedge fund strategies rely on various asset classes, the most balanced gauge arguably blends 60 per cent exposure to the S&P 500 and 40 per cent in the Barclays US Aggregate Bond index. Hedge funds on average have underperformed this benchmark by slightly more than 1 per cent a year over the past decade.

Investors in hedge funds seem to agree with U2 — Stephane De Sakutin/AFP

Assume for this discussion that funds running less than several hundred million dollars require a 2 per cent management and 20 per cent performance fee to function securely.

Jon Hansen, director of hedge funds at C/A Capital Management, which has nearly $10bn in assets under management, thinks management fees should be progressively reduced to at least 1.5 per cent as funds get larger. "This reflects growing operational efficiency that comes with scale," he says, "and a belief that management fees should not be profit centres."

There is also mounting consensus that 20 per cent performance fees are too rich as funds grow into multibillion-dollar operations, suggesting a progressive reduction in this fee should be considered too as funds get larger.

Establishing hard strategy-specific hurdles would further boost net performance. For example, a long/short fund should generate more than 4 per cent before realising a performance fee on profits that exceed the hurdle.

Mr Hansen believes a rethink about fees would boost returns beyond the blended benchmark, discourage underperforming managers from staying in business and better align investor and manager interests.

Returning to the first point: many reports have found smaller funds deliver higher and more consistent returns than bigger funds. But Bailey McCann, senior editor at Opalesque, the industry tracker, explains large institutions are not in the former because of "headline risk, the fear of making news by being the only large public investor caught in a smaller, lesser-known manager that badly trips up".

The much safer and easier road, she says, is simply making a few larger allocations to big, well-known managers that are fiduciarily sound and a lot easier to get approved by pension fund chief investment officers and boards of directors.

But therein lies the cause of industry dissatisfaction.

The cost of vetting sub-$1bn funds should not undermine their potential return advantages. "Institutions would discover a number of smaller funds have been able to generate double-digit returns with muted downside volatility and drawdowns, while not compromising operational standards," says Bruce Amlicke, chief investment officer of UBS's A&Q Hedge Fund Solutions.

Even when excluding one of the five selected funds, whose numbers would skew averages to the upside excessively, this year's selection, whose average AUM is less than $400m, has generated five-year annualised returns of 14.6 per cent through June 2014, with annualised volatility of 8.1 per cent, and an average worst drawdown of 11.1 per cent.

Several common traits help explain these funds' compelling numbers, features that Paamco's Mr Willardson says he also targets: creative search for asset mispricing, especially due to non-economic factors; disciplined buying and selling; concentrated portfolios that demonstrate a high conviction in research; the confidence to alter net exposure to exploit opportunities or to become more market neutral ; a willingness to raise cash levels to preserve capital; managers keeping a significant portion of their wealth in their funds; and set asset capacity to help sustain performance.

We are not recommending these funds, and past performance does not assure their forward behaviour. But this perennial review does show what investors can turn up by digging into various strategies and asset classes.

Tom Williams, chief investment officer of FRM Pine Grove, believes adding proven, well-vetted and diverse managers can smooth performance over the long term, and that is what investors should be looking for from hedge funds.

Methodology
Most thorough vetting of any annual survey

Funds in the Financial Times annual hedge fund review are more thoroughly vetted than those tracked by any other periodical survey. Working exclusively with BarclayHedge's database, which tracks 4,500 funds, ensures 13 main data fields, including strategy, assets, performance, worst drawdown, standard deviation, and Sharpe ratio are treated consistently.

More than 900 funds were screened that manage broad strategies with assets of between $100m and $1bn. We then looked for consistant performance and risk over a minimum of five years to June 2014. This timeframe is the longest tracked by a periodical survey. The same manager(s) must have been at the helm over this time. Funds that suspended or gated were avoided.

Those that survived the first cut went through substantial document review. These included the private placement memorandum, due diligence questionnaire, regulatory databases, last three years of audited financials, presentations and service providers.

Cross-checking these sources helped confirm significant issues, including performance, liquidity that was in sync with a fund's strategy, leverage, valuation and potential conflicts of interest. This was followed by extensive manager interviews.

Yellow flags included incomplete documentation, pending lawsuits, regulatory sanctions, wide geographic separation of key personnel, inaccurate benchmark comparisons, lack of an administrator and dubious effectiveness of board members.

This work represents about two-thirds of the due diligence that should be done before investing. On-site visits help confirm investments, operational risk management, compliance processes and presence of vital personnel.

If we were not getting straight, candid answers and felt our time and questions were not appreciated, we dropped the fund.

Hedge fund analysis: top five funds

TOP FUNDS

The pick of this year's crop all turned financial adversity into profit

ERIC UHLFELDER AND JONATHAN KANTERMAN

Bloom Tree Partners
Manager Alok Agrawal
Strategy Long/short equity

Soon after leaving the comforts of Julian Robertson's lair (Tiger Management) in May 2008 and setting up his own shop, Alok Agrawal was tested. The financial tsunami that was building subsequently took the US market down more than one-third by year's end.

But the tiger cub, whose fund was seeded by his mentor, showed his mettle. He was down less than 3 per cent by the end of that year, and then made more than that back in just the first month of 2009.

Mr Agrawal's outperformance during the financial crisis has helped sustain the fund's superior performance over the S&P 500 through June 2014, driving fund assets over $300m. During this time, he has generated net cumulative returns of 10.4 per cent, while the S&P returned 7.8 per cent and the MSCI World 4.5 per cent.

Bloom Tree's outperformance was realised with annualised standard deviation under 10.5 per cent, while the S&P 500's exceeded 17 per cent and MSCI World's was nearly 19 per cent. It is no surprise that Bloom Tree is virtually uncorrelated to US and World equity markets.

But perhaps the most compelling statistic is that Bloom Tree has outperformed the US market 23 out of the 27 months the S&P 500 was down, by an average of 6 per cent a month.

Mr Agrawal attributes much of his success to lessons learned at Tiger Management: "It taught me never to be long a poor business, and never short a good business." Such determinations, he says, can only be made with thorough research and due diligence, a clear understanding of a company's operations, finances, and by investing only when one has a high level of conviction. His top 10 long and top 10 short positions recently represented two-thirds of his equity.

Last year, Mr Agrawal saw the financial and operational benefits of the evolving business of privatised emergency medical services provided by TeamHealth. The company was well positioned to benefit from greater outsourcing of emergency-room services, and generated a 23 percent return for the fund.

On the short side, Mr Agrawal saw how market misunderstanding of corn production fuelled the rise of American Vanguard, the pesticide maker. The ethanol mandate, draught and rising prices led to the overfarming of corn and corresponding boost in demand for its products. Shares quintupled to $35 between 2011 and 2013.

Mr Agrawal was the only institutional investor to short the stock in November 2013, at $28. He believed demand for AVD's crop-specific products would falter due to a need for crop rotation and rising prices of other crops. By May 2014, he was out of the investment at around $14.50.

Latigo's David Sabath and David Ford

Latigo Ultra
Managers David Sabath and David Ford
Strategy Event driven

As young analysts, David Ford and David Sabath came together shooting hoops at Spalding's test gym during a break from muddling through the sporting goods manufacturer's messy restructuring.

Seven years later, they merged their talents into the Latigo Ultra fund and sailed smack into the financial crisis, which cut more than 20 per cent off their book over the first 14 months through 2008. Despite that, the managers generated annualised gains through June 2014 of more than 13 per cent since inception, versus the S&P 500's 5.9 per cent. Its standard deviation has been 11.6 per cent versus the market's 17.2 per cent.

Latigo's strategy is to target idiosyncratic event-driven opportunities and be asset-class agnostic to find the most compelling trades.

"Identifying viable dislocations is the first task," says Mr Sabath. "But understanding the nuances of the capital structure is key to finding where the best risk reward lies." They have profited from bankrupt legacy equity shares of American Airlines and preferreds of Royal Bank of Scotland, whose dividends had been suspended.

Latigo's contrarian thinking led them up the Norwegian fiords into once AA-rated bonds of a government/banking export-financing operation that had quickly sold off by 40 per cent. The trigger was Oslo's announcement in late 2011 that it was pulling out of the joint venture to create its own dedicated scheme. The sudden downgrade of Eksportfinans's bonds to junk by Moody's, the rating agency (based on the fear that the government was abandoning its remaining commitments), resulted in forced selling by institutional investors who could only hold investment-grade debt. "Panic selling followed," says Mr Ford.

The managers believed Oslo had not wavered in its implicit backing of the company. And, in the worst case, Mr Sabath felt "Norway would guarantee its obligations to avoid jeopardising its well-earned haven reputation".

At the end of 2011, Latigo started moving into the bonds and, at its peak, the position represented 9 per cent of the fund. Within a year, the bonds had recovered, producing a 17 per cent return.

Mr Ford and Mr Sabath closed their initial venture, the Latigo Master fund. The event-driven strategy, established in 2005, had weathered 2008, down 18 per cent. But geared fund of funds investors, who had lost their financing, needed to get out. In 2009, the managers unwound the once-$1bn fund in eight months while realising a nearly 24 per cent gain. All investors were made whole.

Chenavari Toro Capital IA
Managers Frederic Couderc and Benoit Pellegrini
Strategy Asset-backed securities

Our research looks for hedge funds that deliver consistent, moderate returns across full market cycles. Chenavari Toro is not our typical fund.

Its operations meet our standards. But Toro was set up to exploit extraordinary credit mispricing spreading across Europe because of the financial and banking crises. And the management admits — despite the fund being well into its sixth year, with annualised gains topping 50 per cent, moderate volatility and low drawdowns — this strategy has a limited lifespan.

The European asset-backed securities fund started in June 2009, just after the worst of the crisis had hit. Co-managers Frederic Couderc and Benoit Pellegrini moved into distressed mezzanine tranches of residential and commercial mortgage-backed securities, consumer loans, and collateralised loan and debt obligations. While concerns that the eurozone could shed peripheral countries have lessened, the managers have kept attention focused on core markets.

The managers were so convinced of the opportunities that they each sold their Parisian apartments to seed the fund. "While the European ABS market was in trouble, it was in better shape than US subprime-linked securities because of stricter lending standards, security originators typically maintaining skin in the game, and underlying borrowers unable to walk away from their mortgages," Mr Courderc says.

Opportunities were made even more compelling due to forced selling by banks to delever and raise capital, says Mr Pellegrini. "Mezzanine tranches of RMBS in Britain were selling down to 20 pence on the pound." The managers thought underlying cash flow justified prices of at least 50p. When they saw non-performing loans and defaults reach 25 per cent and 5 per cent respectively, they felt a

Looking back

How are previous top funds doing now?

While the S&P 500 continues to outpace virtually everything over the past three years through June 2014, our initial 2011 select five funds have slightly outperformed the average hedge fund, the MSCI All Country ex US index, and US debt with far less volatility.

Harvest Small Cap long/short equity continued to drive our returns, last year climbing 26.3 per cent on manager Jeff Osher's successful targeting of under-researched, mispriced stocks. A selected number of high-conviction trades, low net exposure and a focus on tech defines his portfolio.

Finisterre's Sovereign Debt added 10 per cent last year through a variety of trades, including being short Russian debt and long local Mexican bonds.

Steelhead's Pathfinder Convertible Arbitrage's performance remained steady, rising 7.9 per cent last year, assisted by low interest rates, rising equities and a benign economic outlook. Trading volatility also helped, but interest rate hedging costs cut into profitability.

The negative outlier that has been a drag on our performance is Forum Global Opportunities. When selected in 2011, the global macro fund had performed well across difficult markets. But declining market volatility and growing asset correlation after the crisis has generated irrational results, according to manager Ray Bakhramov, especially in emerging market credits and foreign exchange. Portfolio management style has not changed, with positions still built around six main themes, which Mr Bakhramov believed should have offered inherent hedging. However, over the past three years they have not. Annualised losses averaged more than 15 per cent.

This decline emphasises the need for persistent due diligence after investing, especially when there has been significant performance deviation from the past.

Comparable concern is raised when managers leave. While Wexford Credit Opportunities was up 8.5 per cent last year, a new manager came on board in January 2014, which would require the fund to be revetted.

HEDGE FUND SURVEY

bottom had been reached and added to positions.

Toro frequently traded around 30 different UK RMBS, which represented up to 30 per cent of the fund's net asset value and 25 per cent of its returns. Exposure like this helped the fund soar more than 150 per cent over its first 19 months through 2010. The fund closed to new investors in just two years as profit-taking built up cash balances. But opportunities remained, with subsequent returns running at 30 per cent a year.

Equally compelling is that volatility has been averaging 12 per cent a year, with Toro's worst drawdown around 5 per cent. This stability has been achieved by initiating positions near the bottom of the crisis, regular profit-taking and reallocation to better risk-reward opportunities, a willingness to sit on cash and buy into sell-offs, hedging and the regular accrual of high coupons.

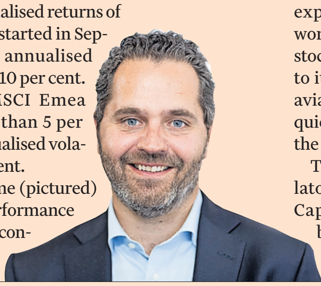
When double-digit gains are no longer in the offing, management plans to return investors' money. But with Europe far from healed, Mr Couderc believes the fund can generate 10-20 per cent annually over the next few years.

> 'Niche industries offer compelling opportunities that big credit investors skip over'
> MICHAEL APFEL, MIDOCEAN

JabCap Emea
Manager Carl Tohme
Strategy Emea equity long/short

Targeting developing eastern European markets, Middle East oil fiefdoms and emerging African economies has not been easy of late. In addition to dealing with challenging regulatory, political and financial regimes, the Emea index has been down three of the last four years, still trading below pre-financial crisis levels.

Nevertheless, the fund has been able to generate annualised returns of 16.4 per cent since it started in September 2008, with annualised volatility of less than 10 per cent. In contrast, the MSCI Emea index has risen less than 5 per cent a year, with annualised volatility close to 30 per cent.



Manager Carl Tohme (pictured) has delivered this performance by shifting between a concentrated number of high-conviction trades informed by top-down analysis, using strategic hedges and throttling back into cash when the outlook became clouded.

Mr Tohme targets this subregion of emerging markets because he found "better valuations, plentiful energy opportunities and expanding capital liquid markets". Last year, MSCI elevated Qatar and the UAE from frontier to emerging market status, and this year Saudi Arabia plans to expand foreign investor opportunities. Mr Tohme also found much of the Middle East and Africa under-researched.

Towards the end of 2011, Emaar Properties, a leading real estate developer of premium hotels and shopping centres in Dubai, was trading at a 44 per cent discount to book value due to residual fallout from the financial crisis. But strong domestic growth had returned, propelled by rising foreign direct investments, credit market liquidity and business and tourist travel. Mr Tohme also liked Emaar's revenue split: half from development, half from recurring shopping centre rent.

In mid-2013, Mr Tohme's position in Emaar peaked at 9 per cent of the fund's NAV. The stock rallied sharply, especially due to the partial initial public offering of the company's shopping centre division in September 2013, and MSCI's upward rebalancing of Emaar in its regional indices.

Mr Tohme sold out last autumn as oil prices began falling, locking in an annualised gain of 1.6 per cent to the fund's NAV.

Falling oil prices then informed Mr Tohme's 3 per cent position in Turkish Airlines. With largely unhedged fuel representing 40 per cent of operating costs, seat costs one-third the industry's average, aggressive fleet expansion, Istanbul building the world's third-largest airport and the stock trading at a 33 per cent discount to its peers, the manager saw a rare aviation opportunity. It generated a quick 22 per cent gain for the fund at the end of last year.

There are long-since resolved regulatory issues associated with Jabre Capital's founder. However, we believe Mr Tohme operates his fund largely independently while benefiting from the extensive operational support and infrastructure of a $1.7bn asset manager.

MidOcean's Jim Wiant and Michael Apfel

MidOcean Credit Opportunity
Managers Michael Apfel and Jim Wiant
Strategy Credit long/short

The name suggests a strategic venture into the deep space of credit. But the fund's managers actually operate in shallower, less turbulent waters that largely go unfished by big sellside shops that drive debt markets.

"Extraordinary misvaluations six years back was the catalyst for starting the fund," says co-manager Michael Apfel. "And we saw structural issues in the credit market that still enable us to uncover opportunities in little-known leaders in small, essential industries well after markets had corrected."

This approach requires more original research and out-of-the-box thinking than traditional credit plays. Co-manager Jim Wiant believes the risk-return scenario is worth it. The fund's numbers have borne this out.

The $772m fund has generated annualised returns in excess of 17 per cent since its April 2009 inception, with annualised volatility under 5 per cent and a worst drawdown below 3 per cent. These exceptional risk numbers have been achieved by initially buying near the bottom of the crisis, regular accrual of high coupons, regular profit-taking and hedging.

"Niche industries such as contract pharmaceutical manufacturers, publishers of professional training materials and writers of call-centre software offer compelling opportunities that big credit investors skip over," says Mr Apfel. The latter targets larger offerings that typically exceed $600m, where MidOcean focuses on under- tracked bank loans and high-yield bond issues in the $300m -$600m region.

The likes of Fidelity and Pimco want substantial liquidity and market depth to ensure efficient entrance and exit, says Mr Wiant. And they avoid smaller industries because their exposure cannot be large enough to budge their own returns.

The price of a five-year, 10.6 per cent coupon bond of the second-largest inland barge operator in the US, American Commercial Line, slid 25 per cent toward the end of 2011 on a series of non-systemic events.

There was lousy global shipping news, recalls Mr Apfel. But he thought ACL should not have been affected, given its niche service and limited competition. Europe's sovereign debt and banking crisis smacked all but the strongest of credits. And there were torrential rains and flooding, which temporarily disrupted barge operations.

What convinced the managers that the CCC+, five-year senior unsecured debt was solid value was the leveraged takeover of ACL by a big private equity shop committed to unlocking value.

No brokerage covered these bonds when MidOcean invested $30m in March 2012. The rains stopped. The euro crisis eased. Shipping sentiment turned less gruesome. And the bonds were refinanced at 105 in April 2013, enabling MidOcean to lock in an annualised return of 30 per cent.

FTfm hedge fund review - five selected funds

Eric Uhlfelder and Jonathan Kanterman

Fund name	Start date	Fund assets ($m)	Fund strategy / Index average	One-year return (%)	Three-year annualised return (%)	Five-year annualised return (%)	Annualised return since inception (%)	Worst drawdown since inception (%)	5-year standard deviation (%)	5-year sharpe ratio (%)	Firm assets ($m)
Bloom Tree Partners (New York)	May 2008	316	**US-Bias Equity Long/Short**	**11.28**	**14.12**	**12.19**	**10.38**	**9.89**	**9.13**	**1.32**	966
			Equity Long-Short Index	10.15	5.41	6.35	10.11	14.25	5.09	1.23	
Chenavari Toro Capital 1A (London)	Jun 2009	549	**Asset-Backed Securities**	**36.18**	**26.63**	**52.24**	**53.76**	**5.11**	**11.78**	**4.43**	2,008
			ABS Strategy Average	14.63	16.45	30.89	16.27	18.49	10.90	3.85	
Jabcap Emea (Geneva)	Sep 2008	220	**EMEA Equity Long-Short**	**12.07**	**5.53**	**13.88**	**16.35**	**10.02**	**9.12**	**1.19**	1,700
			Emerging Market Index	6.25	0.11	5.80	9.27	42.51	9.48	0.60	
Latigo Ultra (New York)	Nov 2007	242	**Event Driven**	**21.70**	**13.39**	**17.87**	**13.17**	**21.91**	**9.57**	**1.83**	470
			Event Driven Index	13.26	6.45	8.86	10.01	19.62	5.43	1.62	
MidOcean Credit Opportunity (New York)	Apr 2009	772	**Credit Long-Short**	**10.81**	**9.23**	**14.61**	**17.17**	**2.69**	**4.55**	**3.22**	1,452
			Credit Long-Short Strategy Average	7.80	6.68	11.23	8.27	7.80	5.70	2.11	
BH Hedge Fund Index	Jan 1997			**10.77**	**5.28**	**7.84**	**9.51**	**24.09**	**5.76**	**1.35**	
S&P 500 Total Return Index	Jan 1980			**24.61**	**16.58**	**18.83**	**11.76**	**50.95**	**13.29**	**1.41**	
MSCI EAFE Index (USD)	Jan 1975			**20.33**	**4.91**	**8.57**	**8.15**	**58.24**	**17.09**	**0.5**	

Source: BarclayHedge, including all index and strategy averages

Special thanks to BarclayHedge's Marina D'Angiolillo for all her data research