BOB TREUE

Long Rationality

Barnegat Fund manager Bob Treue, who has been known to turn away investors if he feels he can't do enough for them, isn't your typical hedge fund manager. BY ERIC UHLFELDER

ASSET MANAGEMENT SPOTLIGHT

THESE DAYS, INVESTORS HAVE A RIGHT TO be suspect of hedge funds. Not only have they been regularly underperforming the stock market since 2008 and charging rich fees to boot, but hardly a month seems to go by without some allegation of malfeasance.

But Bob Treue, who manages the Barnegat Fund, appears to be the antithesis of Wall Street's fat money mentality. The 43-year-old manager has based his fund outside of Manhattan, with its high rent, across the Hudson River in the more modest environs of Hoboken, N.J. He returns money and turns away investors when he doesn't see sufficient opportunities to effectively deploy their cash. And when introducing his fund to prospective investors, he sends out a fact sheet that explains 10 reasons why they may not want to be in his fund.

Either Treue is one of the shrewdest marketers around or is extremely confident about his investment acumen. Likely both.

"Many investors, even those who think of themselves as sophisticated, will move into a fund with impressive numbers without really knowing what they're getting into," observes Treue. "For my fund to function at its best, I need my clients to know how I function and have the foreknowledge and patience to realize that most of my trades may take one to two years to work."

And work it has. Since setting up shop in January 2001—in the middle of a bear market and just months before 9/11—his Barnegat Fund has had compound annualized returns of 19.58% through February. Over the same time, the S&P 500's annualized returns were less than 3%, and U.S. bonds were 5.47%, according to Bloomberg.

Virtually all of Barnegat's trades have ended up in the black. One exception was in 2008, when he bet Norway's inverted yield curve would revert to its normal upward-sloping shape. It eventually did, but only after Treue sold out of his position to build up a cash cushion for his larger trades as the financial crisis deepened.

Another underperformer, still on the books, is a bet that European interest rates would move back above inflation rates. Instead, negative real rates have persisted across Europe, in part because of quantitative easing, which has cost Barnegat about 6 percentage points.

Despite targeting annualized volatility of 10%, Barnegat's standard deviation has averaged nearly 16% over the past decade, reflecting the turbulence that buffeted his positions especially hard in 2008. But unsettled markets—when asset prices deviate from underlying valuations—are precisely the conditions in which Treue thrives.

While investors' normal reactions are to pull out at such times, Treue encourages them to be adding to their positions. This happened in 2008, when Barnegat was one of the few funds that enjoyed net cash inflows, despite having taken a vicious hit.

A massive price-valuation disconnect chopped off more than 37% from Barnegat that year—the fund's only down year in 12. But Treue felt his exposure was still largely sound. The following year, as valuations corrected, the fund soared nearly 133%, producing a cumulative two-year gain of 47%. Both the average hedge fund and fixed-income arbitrage fund lost money over this 24-month period, according to BarclayHedge, a global hedge fund database.

A Manager Unleashed

The Barnegat Fund has several distinctive characteristics that Treue wants his investors to know about:

1. *A market neutral strategy.* The fund profits when markets correct a short-term mispricing between two assets, irrespective of whether the market is heading up or down.

2. *A limited number of positions.* Barnegat does not believe in significant diversification to enhance performance and usually takes no more than 20 high-conviction positions.

3. *A small, efficient office of people with their own significant exposure to the fund.* Because he's responsible for the portfolio, Treue has only about six front-office staff members with a collective 25% stake in the fund.

4. *Managerial discretion.* Treue has complete control over his investments, and he does not use stop-loss triggers because he believes his discretion is key to the fund's long-term success.

5. *Significant leverage.* Barnegat has no restrictions on leverage and the fund's net asset value is typically levered 15 to 25 times, a rate that can go higher on individ-

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ual positions. Keeping half its assets in cash and cash equivalents has enabled the fund to meet margin calls.

Barnegat seems to be a compelling example of what a hedge fund is supposed to be: a manager unleashed to find unique opportunities who can use the most appropriate investment vehicles to realize profits.

Because Treue doesn't operate an extravagant shop—he doesn't spend money on unnecessary perks, fancy office space or lavish investor functions—his fees are low. His annual management expense is half the 2% industry standard, and his performance fee—the amount managers' earn when funds exceed their high watermark—is 15% instead of the standard 20%. Treue has never suspended withdrawals and investors can pull out 25% of their investments with 30 days' notice and 100% with nine months'.

Pricing Opportunities

Barnegat's fixed-income, relative value strategy is based on identifying mispriced assets, which arguably could be easier to target than forward corporate growth or credit improvement. Leverage is applied to enhance returns.

The strategy was popular in the 1990s because managers had shown that certain typically correlated assets could temporarily decouple because of macro events or government action. Once such an opportunity is found, the manager can hedge key external risks, such as changing inflation, interest and foreign-exchange-rates. The risk that remains is that the spread between the two assets could widen rather than contract.

If that happens, a fund manager is then required to increase collateral to sustain positions that are moving against him. Otherwise, he's forced to liquidate and realize a loss, which leverage exaggerates. This is why the Wall Street gurus running Long-Term Capital Management (LTCM)—the hedge fund that went bust in 1998—couldn't meet its margin calls.

"It wasn't that the fund's investments were inherently flawed," explains Treue, who at the time was the head trader at Litchfield Capital Management in London—a relative value shop.

For example, months before the euro was launched, LTCM saw the gap that was forming between the value of the original constituent legacy currencies of the euro and the preset launch price of the euro itself at $1.16. Conversion demand prior to the euro's launch in January 1999 was actually sending the value of the new common currency above $1.18.

"The managers' two key problems," explains Treue, "was their timing was a bit off, as the spread continued to widen, and they had insufficient cash on hand to meet margin calls." The cash shortage was LTCM's Achilles' heel, says Treue. And it's the reason he keeps half his fund in unencumbered cash and equivalents, because, as Treue quips, "The market can stay irrational longer than you can stay solvent."

Triple-digit leverage and margin calls were a lethal combination for LTCM. While Barnegat is not levered to the same degree, its high leverage and its exclusive reliance on Treue for risk management should be primary investor concerns. However, the manager's investments, cash defenses and sense of risk has so far protected the fund from killer margin calls for more than a dozen years.

Moreover, Treue has benefited from the collapse of fixed-income relative value funds in the aftermath of LTCM's meltdown and, more recently, from the shuttering of many prop trading desks at banks that had been making such trades because of Dodd-Frank. With far less money pursuing this strategy, the price gaps that periodically form are taking longer to arbitrage away. Thus, there are more potential opportunities for the remaining practitioners of the strategy.

Long On TIPS

A clear example of what Treue looks for was provided by the Bank of England when, in early 2009, it embarked on quantitative easing to keep interest rates low and stimulate spending and growth. Unlike the U.S. Federal Reserve, the U.K. Central Bank announced its £197 billion ($317 billion) program would target bond (a.k.a., gilts) maturities, ranging from five to 25 years.

The resulting increase in demand for five-year gilts pushed down their yields to 2.8%. Meanwhile, with less capital chasing the four-year gilts, those yields remained steady around 3%.

Quantitative easing produced a kink in the British yield curve that Treue knew would eventually be smoothed over, most likely by the four-year gilt rising and the five-year gilt falling in price when intervention stopped.

He invested big—1.5 times the fund's NAV. Treue went long on the higher-yielding, shorter-term gilt and shorted the lower-yielding, longer-term gilt. He then used currency options to hedge any negative foreign exchange effects on his dollar-based fund.

A year later in March 2010, the Central Bank halted quantitative easing and bond prices moved the way Treue had expected. The trade added 6% to the fund's performance.

The financial crisis fueled another opportunity involving the spread that developed between medium-term Treasurys and Treasury Inflation-Protected Securities (TIPS). As investors became increasingly nervous in early 2008, they poured into Treasurys, driving yields down on the six-year bond from a peak of more than 5% in mid-2007 to below 3% by the end of the first quarter of 2008.

Yields on the equivalent TIPS maturity had been moving in unison with nominal Treasury rates until the collapse of Lehman Brothers in September 2008. Lehman had relied extensively on TIPS for collateral in its repo trades. These positions were dumped on the market as creditors aggressively unwound the bank's assets, temporarily driving down their prices, especially those of six-year TIPS. Within two months of Lehman's bankruptcy, their yields had spiked about 5%—twice that of traditional six-year Treasurys.

Convinced that this discrepancy couldn't hold, Treue made his largest trade ever, investing four times his fund's NAV. He went long on TIPS, expecting their prices to recover, and shorted the Trea-

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surys, anticipating their prices would decline. Since inflation was a key variable that could hurt this trade, Treue purchased inflation-rate swaps to hedge this risk. By March 2009, the spread between six-year TIPS and Treasurys narrowed to 50 basis points. The trade boosted Barnegat's performance by eight percentage points.

The European financial crisis also fueled a huge run-up in the value of the Swiss franc—long considered to be the pre-eminent safe-haven currency. Having traded between 1.45 and 1.68 per euro between the common currency's inception in 1999 and 2007, the Swiss franc then started rallying in the second quarter of 2008, from 1.67 per euro to 1.30 by year-end 2010.

By July 2011, it had soared to 1.09 as euro zone investors poured across its borders fearing banking and possibly currency failure.

Fearing the impact of an overvalued franc on the country's huge export sector, the Swiss Central Bank set a ceiling of 1.20 Swiss francs per euro in September 2011. This was actually 10% lower in value than where the franc had just been trading.

In addition to buying foreign bonds, the bank deflated the currency by setting overnight interest rates at 0%. But foreign exchange market activity was so aggressive that short-term FX swaps actually had negative interest rate yields. That meant that if a foreign investor wanted Swiss franc exposure, he would have to pay for it.

Treue saw this disconnect between FX market and Central Bank rates. So he deposited Swiss francs he bought into a 0%-yielding account and agreed to sell francs through one- and three-month FX swaps that yielded him an annual rate of up to 2% because the swaps were paying a negative yield. They also protected him against any foreign exchange moves against the dollar. He continuously rolled over these transactions for a year and half into the beginning of 2013, when the spread no longer made the trade worthwhile.

"These trades weren't intended to make us wealthy," explains Treue. "They were an effective way to boost returns on up to 20% of our sizable cash position that we maintain." RW