Searching for quality in hedge funds

FTfm survey

Eric Uhlfelder and **Jonathan Kanterman** take a detailed look at the sector to highlight what funds can offer

The inquiry has turned the spotlight on smaller funds that often escape notice Dreamstime

Most periodic hedge fund surveys that track the $2,000bn-plus industry highlight the best performing funds, the largest funds, and the top-earning managers. Few such studies look behind the numbers to discern the quality of returns: their accuracy, risk, management, and strategy adherence.

In a more refined look at the industry, FTfm looked back at the trailing five years of performance to the end of June 2011 and undertook significant due diligence to come up with five examples that highlight what hedge funds can best offer: well run, transparent operations that have delivered solid, consistent returns with low to moderate levels of risk relative to their strategies. The selection process started by surveying funds with assets between $100m and $500m.

Confirming common sentiment, industry consultant PerTrac Financial Solutions found smaller funds, especially below $100m, tend to be the top-performing segment of the hedge fund universe. The reason: managers of smaller funds appear to react more swiftly than do larger fund managers to a wider range of mispriced opportunities without moving markets.

However, most institutional investors, who control nearly two-thirds of hedge fund assets, do not generally venture into so-called emerging managers running less than $100m because of their frequent lack of dedicated risk and operational oversight, and limited investor services. In a recent survey of 2,500 institutional investors, the alternative asset research firm Preqin reported the average minimum fund size for institutional consideration was $320m.

Another bias discovered is that industry assets are disproportionately invested in large funds. PerTrac reported the number of funds with more than $500m represented 7 per cent of all funds, but 88 per cent of all assets.

This suggests mid-size funds with the "bells and whistles" to meet institutional requirements are not attracting much attention.

Despite this low weighting, PerTrac found in its survey of more than 4,800 funds between 1996 and 2010 that those with $100m-$500m in assets delivered higher returns than funds managing more than $500m (10.87 per cent versus 10.00 per cent) with virtually the same annualised volatility (5.94 per cent versus 5.96 per cent).

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There are risks associated with funds whose asset size is closer to the lower end of this study's spectrum. If a client whose investment represents a significant portio of a fund's assets decides to redeem, especially during a severe sell-off, management may opt to gate or suspend redemptions, or be forced to sell investments at a poor time.

Smaller funds also typically fly below most media and industry radars. They tend to be the focus of less formal external due diligence. That does not suggest malfeasance of any kind. But limited independent review may fail to address or challenge less-than-ideal operations.

And when not a part of a larger management firm, smaller funds are less likely to have their own dedicated risk management and compliance officers, and may not be able to afford top-tier service providers.

BarclayHedge, the US-based hedge fund database, customised a survey of these mid-size funds for FTfm. It initially identified more than 100 hedge funds – with assets between $100m and $500m and with 60 months or more of verifiable performance history – that had the highest total returns over the past five years through the end of June 2011. This time-frame captured among the most challenging investment environments ever tracked and among the longest surveyed in a periodical hedge fund review.

(We excluded sector, commodity, and country-specific funds because of their tendency to produce outlying results. Funds of funds were also excluded.)

Though following 6,000 active hedge funds and 180 data fields, BarclayHedge's database presented a study bias – excluding funds that do not report to this database from being considered.

Reliance on this single source, however, makes the search parameters precise and less arbitrary. It also ensures inclusion and consistent treatment of all specified data fields, including strategy, assets, performance, standard deviation, worst drawdown, Sharpe ratio, firm assets, and fees. Funds that made up this initial list were then sorted by strategy, 12 in all. Equity – including long/short, long-bias, market neutral, and emerging markets – accounted for half the list.

This was followed by six funds each tracking global macro, multi-strategy, and option strategy. Convertible and fixed income arbitrage and event driven funds were each represented by five funds. There were four mortgage-backed securities and emerging market debt funds, and two distressed securities funds. These strategies were then organised by five-year performance.

Ultimate selection of five featured funds was not determined by the best long-term returns, but performance consistency. We also wanted each fund to represent a distinct investment strategy to expand the reach of this story.

Not surprisingly, the initial screening of the top-performing funds revealed a strong correlation between high returns and high volatility across trailing one and five-year periods. High volatility was typically synonymous with high drawdowns, indicating that standard deviation was the product of both up and down performance.

Our screens also looked for consistency of returns across one, three, and five-year periods. Such performance typically correlated with relatively moderate to low volatility. And it identified funds with Sharpe ratios over 1.00.

We did find that over the trailing year when the market went virtually straight up through the end of June 2011, funds with desirable risk-return profiles tended to underperform their respective average strategy returns. Looking at their performance longer-term, however, suggests that such management often outperforms during down and volatile markets.

After a fund was selected, it then went through a substantial due diligence process. (See box for details of this review, which included 10 key operational and performance issues.)

The process, which rejected several funds initially selected, found instances where valuations were marked to model rather than to market. This under-reports volatility and drawdowns and raises question about accuracy of returns. We also discovered funds that had been suspended or gated, and failed to provide sufficient transparency surrounding these events.

This process does not assure or imply future performance of the selected funds. However, the findings describe characteristics that advisers and investors should be looking for when seeking relatively consistent returns with low to moderate volatility.

These include independent search for undervalued securities, transparent portfolios, and investments that are consistent with fund strategy. Portfolios are diversified, avoiding concentration risk, with positions that are relatively liquid. Managers rely on limited or no use of exogenous leverage, and employ risk management that helps limit losses and drawdowns.

Jonathan Kanterman is a veteran fund of hedge funds manager and industry consultant

Due diligence: our methodology explained

Our source for data, BarclayHedge, like all hedge fund databases, does not materially vet information submitted by funds.

So in initially reviewing returns, volatility, and worst drawdowns, we looked at monthly performance figures, making sure they made sense in their own right and were in line with strategy and market averages, and that worst drawdowns and standard deviation correlated.

We reviewed the private placement memorandum. In essence a prospectus, this document is legally the most important disseminated by the manager, and it is liable for its content.

Since all US-based managers with more than $150m in assets must now be registered with the US Securities and Exchange Commission, the related registration document – Form ADV – was reviewed. Found on the SEC website under the investment adviser public disclosure section, the form provides descriptions of firms, their funds, assets, investor composition, managers' background, important disclosures, and identification of any related businesses that might be owned by the fund's principles. The website also includes material negative findings derived from SEC investigations.

The due diligence questionnaire answers many questions about a fund's structure, strategy, risk controls, managers and operations. Examination of trailing three years of fund audits, prepared by their respective independent auditors, reveals matters of performance, valuation, and taxes. This step confirmed all funds used well-known auditors and all had received unqualified opinions, meaning they were satisfied with their own findings. And marketing and presentation materials were reviewed to reconfirm investment strategy, process, and performance.

This due diligence provides a fair degree of transparency and assurance about 10 essential management issues. These include confirming all key third-party service providers – administrators, prime brokers, custodians, auditors, and lawyers. All were found to be top tier.

Liquidity was found to be in sync with the funds' respective strategies, and valuation methods were deemed proper. External leverage ranged from zero to moderate. Manager tenure extended for at least the last five years, and their backgrounds were considered relevant. The same conclusions were drawn about the funds' operational teams.

No relevant conflicts of interests were found. These included no cross-ownership or association with any investments, broker-dealers, or service providers that are being used.

None of the funds had gated or suspended over the past five years. And none had restated their financials over the past three years.

This review represents about one third of due diligence that should be executed before an investment is made. Additional work should include on-site confirmation of investment, operational, and risk management processes along with compliance. This helps link document review with reality.

Eric Uhlfelder and Jonathan Kanterman

Five funds that show what the sector does best

Survey

Eric Uhlfelder and **Jonathan Kanterman** find mid-size funds with leading performance consistency

Finisterre Sovereign Debt fund
Strategy: **Emerging market debt**
Manager: **Paul Crean**

Around the turn of the millennium, after a series of seismic events emanating from Bangkok to Buenos Aires set off more than $100bn in defaults, many investors fled emerging market debt.

According to co-fund manager Paul Crean, "we believed as a result of this turmoil, emerging markets were finally compelled to become more transparent and accountable".

Eight years on with many western bond markets now reeling, Finisterre's decision proved prescient.

Through the first half of 2011, its long/short Sovereign Debt fund has generated consistent total returns averaging 10.4 per cent a year (in US dollar terms) since inception in April 2003. That was 641 basis points a year better than the benchmark Barclays US Aggregate Bond Index during the same period.

While Finisterre only slightly outperformed the JP Morgan Emerging Market Bond Index over that time, it did so with lower annualised volatility: 7.69 per cent versus 9.23 per cent. And its worse drawdown of 21 per cent during the financial crisis, matching the index, would have been half that, according to Mr Crean, if he had not been forced to replace Lehman-underwritten credit default swaps at a significantly higher cost.

The $395m fund has achieved this compelling risk-return profile through a top-down approach and credit analysis to trade mispriced credits and currencies.

It relies on liquid US-dollar-denominated securities, applying stop losses, requiring two-way counterparty risk, and limiting leverage to four times net asset value.

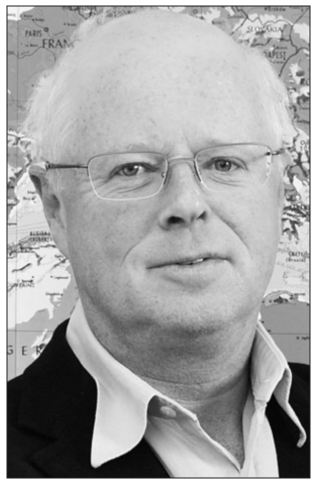
In 2011, his major country positions were long Hungary, Qatar, and Abu Dhabi, based on fundamental macro improvements, and short Ukraine and Venezuela, where he thought credit spreads were too tight.

When the Arab Spring sent investors fleeing the region, he bought Qatar government-backed debt when yields on nine-year bonds widened 50 basis points to 200 bps over US Treasuries, reaching 5.2 per cent.

With few attractive yield opportunities, Mr Crean sees growing demand from local pension funds and foreign investors driving emerging market debt markets. But he worries a protracted western debt crisis will restrain global growth and lead to further market imbalances and risks.

Forum Global Opportunities fund
Strategy: **Global macro**
Manager: **Ray Bakhramov**

In early November, as derivative bets on eurozone bonds wiped out the $41bn broker-dealer MF Global, macro strategist Forum Global Opportunities continued to thrive on related volatility.



Paul Crean: prescient decision

Ray Bakhramov: highest yielding fund

Jeff Osher: 'performance driven by events'

"Since continental debt conditions started unravelling at the end of 2009, we've been profiting from this longer-term thematic trade as well as from tactical trades, betting on temporary trend reversals when intervention sparks hope," says manager Ray Bakhramov.

Whether long or short credits, equities, currencies or commodities, Forum thinks in terms of secular and short-term trends.

The result has produced low and uncorrelated performance to all major markets and positive returns every year since the fund's inception in August 2005, averaging 26.8 per cent a year.

Forum is the highest-yielding fund in this study. Over the past five years, it returned nearly 32 per cent a year – more than five times the BarclayHedge global macro average, albeit with higher volatility of 17.7 per cent. Its worst drawdown was 7.8 per cent. And in 2008, when hedge funds suffered their worst year on record with the average fund losing 21.63 per cent, Forum was up by more than 36 per cent.

Mr Bakhramov explains the $189m fund "makes money during volatile times when we identify global macro distortions and buy options cheaply". His team defines "cheap" based on the long-term value of the asset, and targets returns of at least three times the cost of the options.

Other thematic trends he is watching include the Chinese economic slowdown, the morphing of the eurozone credit crisis from peripheral to core economies, emerging market sovereign repricing, inflation, and high dividend-paying developed market stocks. Such investment themes, along with tactical bets, are played directly and indirectly in other markets that are likely to be affected by these trends.

The fund manages risk by maintaining a transparent portfolio and investing in very liquid markets and securities.

It is able to sell 98 per cent of holdings within one day during normal markets. It uses no leverage beyond what is embedded in the options it buys. It performs regular thesis reviews, analyses correlation of investment themes, and limits single theme losses to 5 per cent.

Harvest Small Cap Parterners Strategy
Strategy: **Long/short equity**
Manager: **Jeff Osher**

Looking for temporarily mispriced securities does not sound like a high-octane strategy. But by focusing on small-cap shares and catalysts that may significantly drive prices higher or lower, manager Jeff Osher has produced a compelling long-term track record that not many equity managers can match.

Over the past five years, till the end of June 2011, his San Francisco-based Harvest Small Cap Partners Strategy has generated net annualised returns of 16.8 per cent. That topped the BarclayHedge Equity Long/Short Index by 12.7 percentage points, the S&P 500 by nearly 14 points and the MSCI Eafe by more than 15.

Mr Osher has produced these gains with mild volatility. His $320m fund's annualised standard deviation over the same time was 9.33 per cent. US and international benchmark volatility was 17.73 per cent and 21.18 per cent, respectively.

Even more impressive, the fund's worst drawdown since starting up in April 2005 was 8.12 per cent. For the US and international indices, those figures were more than 50 per cent.

Several drivers propel Mr Osher's performance. First, small caps are generally under-researched, enabling him to uncover value before others do.

Second, his fund has a bias toward technology, media and telecom shares. An exaggerated response to news and momentum often make these industries volatile over the short-term, setting up investment opportunities.

Third, his portfolio construction tends toward market neutral, generally being no more than 10 per cent net long or short. "Our performance is driven by specific events," Mr Osher says. Fourth, if he finds he is wrong about a catalyst – that it does not happen, its timing, or impact – he is quick to pull the plug on an idea.

A recent investment, news provider Global Traffic Network's stock plummeted 20 per cent when it failed to meet May 2011 sales and earnings estimates. In knowing many of the company's customers, Mr Osher saw GNet's business was not slowing down, but some sales were just pushed into the following quarter. So while consensus estimates were being moved lower, he was increasing his position. August earnings came in $0.14 over estimates, and the stock soared 20 per cent.

Steelhead Pathfinder Strategy
Strategy: **Convertible bond**
Manager: **Scott Schaefer**

During the financial crisis when shares of a leading software company, Cadence Design Systems, collapsed

Continued on next page

Selected hedge fund and market performance histories
July 1 2006 to June 30 2011

Fund name	Firm name	Resident	Date of inception	Fund assets ($m)	Strategy	Annualised net returns (%) Five year	Three year	One year	Standard deviation (%) Five year	One year	Worst drawdown since inception (%)	Five-year annualised Sharpe ratio	Firm assets ($m)	Management fees (%)	Incentive fees (%)
Finisterre Sovereign Debt Fund	Finisterre Capital	London UK	Apr 2003	**421.2**	Emerging market debt	**11.79**	**13.58**	**9.46**	**9.66**	**3.46**	**21.00**	**1.05**	**1,701**	**2.0**	**20**
					EM debt fund average †	**2.23**	**-1.87**	**8.47**	**14.21**	**8.46**	**32.53**	**1.04**	**–**	**–**	**–**
Forum Global Opportunities Fund *	Forum Asset Management	New York US	Aug 2005	**188.6**	Global macro	**31.75**	**21.65**	**2.45**	**17.72**	**5.97**	**7.80**	**1.68**	**298**	**2.0**	**20**
					Global macro fund index average †	**5.16**	**2.66**	**5.48**	**5.42**	**4.73**	**6.42**	**0.64**	**–**	**–**	**–**
Harvest Small Cap Strategy	Harvest Capital Strategies	San Francisco US	Apr 2005	**298.2**	Equity long/short	**16.80**	**10.33**	**8.29**	**9.33**	**7.52**	**8.12**	**1.40**	**1,401**	**2.0**	**20**
					Equity long/short equity index average †	**4.14**	**3.43**	**10.09**	**5.75**	**4.26**	**14.25**	**0.42**	**–**	**–**	**–**
Steelhead Pathfinder Strategy **	Steelhead Partners	Seattle US	Nov 2005	**321.1**	Convertible bond	**10.96**	**11.83**	**13.71**	**6.30**	**2.57**	**12.50**	**1.36**	**1,300**	**1.0**	**20**
					Convertible arbitrage fund index average †	**6.92**	**10.39**	**12.75**	**10.42**	**3.05**	**31.53**	**0.50**	**–**	**–**	**–**
Wexford Credit Opportunities Fund ***	Wexford Capital	Greenwich US	Feb 2003	**281.4**	Distressed securities	**10.57**	**12.39**	**4.19**	**8.44**	**3.97**	**12.55**	**1.05**	**6,881**	**1.5**	**20**
					Distressed securities fund index average †	**3.81**	**4.36**	**12.56**	**9.39**	**4.64**	**35.26**	**0.22**	**–**	**–**	**–**
S&P 500 Total Return Index						**2.94**	**3.34**	**30.69**	**17.73**	**13.17**	**50.95**	**0.07**			
MSCI EAFE Total Return Index ****						**1.48**	**-1.77**	**30.36**	**21.18**	**17.50**	**58.24**	**-0.14**			

* Performance data refers to Forum's larger offshore fund ** Performance data refers to the larger onshore Steelhead Pathfinder fund
*** Performance data refers to the larger Wexford offshore Credit Opportunities fund **** EAFE is measured in dollars
† Barclay Hedge Strategy averages based on data from April 1997 to June 2011

Sources: BarclayHedge; individual hedge funds

Hedge funds that passed the quality examination

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below $3, Steelhead manager Scott Schaefer started watching the company's busted convertible.

He discovered a company with a solid business model, net cash, leading market share and strong customer retention.

In early 2009, still trading with no option value, he bought the 2013 convertible at an average price of $85 and a 5.9 per cent yield.

Cadence's earnings doubled over the past year, and in 15 months, Steelhead's position was up 15 per cent.

This investment is typical of the yield plays that have helped Steelhead's $321m convertible bond strategy deliver annualised returns of 10.8 per cent since its inception six years ago through June 2011.

And it has produced these returns with volatility that is averaging 5.9 per cent. Its worst drawdown was 12.5 per cent in 2008, but it managed to end the year down only 2.83 per cent – the fund's only losing year.

The other side of Steelhead's strategy is shorting the common stock while being long the convertible when spreads are narrow. Mr Schaefer does this when he believes the convertible is cheap and its option undervalued.

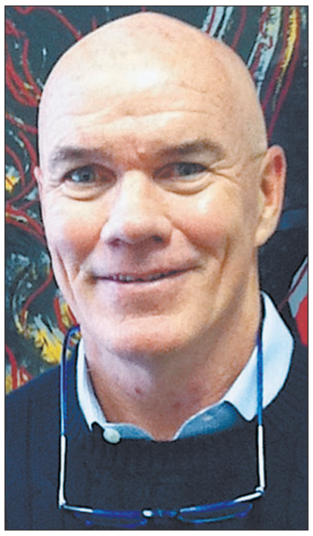
This arbitrage seeks to capture gains when volatility starts to increase by constantly adjusting its hedge to neutral as the convertible's equity sensitivity changes.

Steelhead generates its favourable risk-return profile by being market agnostic – alternating between yield and volatility investing based on whatever market conditions are offering. It applies fundamental and credit analysis to uncover pricing inefficiencies, often focusing on unrated credits with net cash on their books that the market may be undervaluing.

Currently more than 80 per cent of positions have more cash than debt as of their convertibles' "put dates" (when investors can sell back to the issuer) and maturities, which are typically less than five years out. Mr Schaefer has limited his derivative exposure to interest rate hedging and typically keeps leverage below two times net asset value.

He sees eurozone debt as the key systemic concern, but believes credit volatility resulting from this uncertainty is not necessarily bad news for the fund.

Scott Schaefer: hedges interest rates



Jack Doyle: little leverage

Wexford Credit Opportunities fund
Strategy: **Distressed securities**
Manager: **Jack Doyle**

After Lehman Brothers defaulted in autumn 2008, manager Jack Doyle's team determined that the market was significantly underestimating the value of the brokerage's real estate, derivatives book, and private equity.

Before the end of 2008, 5 per cent of the fund was in unsecured Lehman debt at an average cost of $0.10. This past spring he sold out in the mid-20 cents.

Mr Doyle generates consistent gains and minimises losses by focusing on hard-asset industries whose deeply discounted bonds have been misunderstood by the market.

Over the five years to the end of June 2011, including the time when credit markets seized up, the fund managed annualised returns of nearly 10.6 per cent with an annual standard deviation of 8.44 per cent. Mr Doyle relies on little to no leverage. He sells losing positions before they can become drags on returns. (His worse drawdown was less than 13 per cent.)

And he maintains a liquid portfolio so when the market offers up the potential for outsized gains, he can jump. This was evident in 2009 when the fund rose 41 per cent. In addition to Mr Doyle's 25 years in bonds, his three-person team draws substantially from the diverse expertise of the fund's parent, Wexford Capital, an alternative investment manager with nearly $6bn of assets.

"We especially leverage our firm's private equity operations, to help evaluate personnel, operations, business assets, and strategies of every investment we consider," says Mr Doyle.

He buys bank debt, secured and unsecured high yield bonds, sovereign and corporate credit default swaps, and bankrupt debt that converts into post-reorganisation equities.

Six months after Nortel Networks filed for bankruptcy in January 2009, Mr Doyle started buying unsecured debt at $0.40 believing the market was substantially undervaluing the firm's intellectual property.

It turns out it did so by a factor of three.

This sent the bonds soaring past par, reflecting pre-petition interest that will be paid.