

The view from the top

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While success in the hedge fund industry may once have been about who-you-know, a wave of funds of funds are focusing on what they know about hedge fund strategies as a whole, and the world in general, to pursue asset allocation and thematic investment ideas when building portfolios.

Those leading the wave, and those providing independent top-down advice, say taking a less manager-specific view can help not just to add returns, but also in marketing and differentiating FoHFs, and in avoiding 'group-think' prevailing among small teams.

A key industry proponent of taking a macro view before putting money to work is David Murrin, CIO at Emergent Asset Management.

Why? He believes the world fundamentally changed on 11 September 2001. "Before that, investment was about pure economics," he explains. "After that, it became more about geopolitics."

The trend was exacerbated by the simultaneous trough in the commodity cycle in 2001. Since this time, we have been in the early stages of a 25-year commodity demand cycle, he says, which has been exacerbated by the massive growth of China and its eastern neighbours. This has in turn increased the importance of the commodity-rich emerging markets, while the inflationary drag of the commodity cycle will have its worst effects on the slow-growing western economies.

In this environment, the inescapable importance of geopolitics in investing makes it increasingly important to have a coherent top-down investment strategy, he says. The alternative of creating a well-diversified portfolio of hedge funds and 'hoping for the best' will struggle to deliver a competitive performance in the increasingly challenging environment, he adds.

Emergent's Murrin believes the new paradigm in global investment is characterised by the increased importance of emerging markets, and a corresponding decline in the importance of the west. Portfolio construction has to take this into account, Murrin says.

He says global macro managers are well placed to take advantage of these trends, though he notes most managers in this strategy are based in the West and have backgrounds in areas such as G7 currency trading. A better perspective may be held by emerging markets managers, he says.

THE EMPEROR'S NEW CLOTHES

The very visible challenge to the perception of the US as an omnipotent superpower that came in September 2001 rocked the foundations on which its economic might were based, Murrin explains. "Its financial structure is only maintained by its military superpower status," he says. "With Iraq, Afghanistan and the crisis over Iran now, the king is having his clothes removed," he says.

Murrin predicts the next major financial shock will be centred around the US and, as such, will affect all markets in a wave of risk-aversion, but emerging markets will be the quickest to recover. The old days of the US being seen as a safe haven and benefiting from a flight to quality in times of market stress are over, he says.

One FoHF house taking strong top-down views on themes driving returns, before then finding managers it feels will best express those themes in portfolios, is Caliburn Capital.

"Caliburn Capital Partners' belief in the importance of top-down themes, both valuation and structurally driven, has been forged by the partners' two-plus decades of experience in hedge fund investment management and capital markets," explains Jeremy Rowlands, founder and CEO. "This belief is also aligned with a robust body of academic research, supporting the thesis that asset allocation drives returns," he adds.

"Caliburn focuses on themes to drive its asset-allocation process, as opposed to strategies, as we believe that the themes focus will enhance our ability to tailor portfolio exposures to specific, attractive opportunity sets," Rowlands says.

"We believe a clear quantitative understanding of the risk factors in our portfolio, combined with robust qualitative risk management, help us to maintain diversification. Because we do not use hedge fund strategies for portfolio allocation and risk management, the phenomenon of rising hedge fund correlations (between strategies and to traditional asset classes) does not impact on our process."

Caliburn's top-down, thematic approach to investing, firstly identifies "rich opportunity sets, or 'themes' on a global basis," Rowlands adds, then "seeks to unearth specialist managers to populate these themes on a bottom-up basis."



"The observation that these rich opportunity sets stem not only from investment views but also from structural attributes informs much of Caliburn's strategic asset-allocation process. The structural attributes that the partners find attractive are those areas that combine a low level of competition with a promising, near term catalyst."

(Caliburn's top-down view may also reap benefits in that its selecting more specialist managers for specific top-down themes also means, in the view of its founders, that the firm invests in managers "generally closer to their underlying market and (who) may hold an advantage over 'generalists' in seeking to exploit opportunities in highly specialised markets.")

PEAK PRACTICE

To illustrate the importance of top-down, Rowlands cites one of Caliburn's 11 favoured themes – that of 'peak oil', developed from a discussion with a hedge fund manager.

"The main assumption behind this theme is that oil is reaching a peak in production," he explains. "The main drivers of this theory are supply factors, which leave the market equilibrium very much at risk. A further important dynamic that is sometimes overlooked in pure 'peak oil theory' is that of demand. Our long-term macro view is that oil prices must rise to reflect increasing demand from growing industrial economies and the simultaneous decline in supply from ageing fields worldwide.

"Oil discovery peaked in the 1960s with no major fields being discovered since the 1970s. Since then there have been limited discoveries and with new exploration and extraction techniques failing to result in sufficient production increases, growing capital expenditure is required to develop new sources of energy generation.

"This situation is exacerbated by an inability to accurately predict the rate of decline of oil production from any given field and wildly divergent 'expert' opinions. For example, the Cantarell field in Mexico, the second biggest producer of crude oil in the world and a major supplier to the US, has reduced its near-term output targets three times in the last year."

As demand for oil from developed nations remains strong, Rowlands says, there is also an increase in demand from emerging markets, particularly China and India, with "rapidly industrialising economies and growing populations.

"The emergence of a rising middle class in these countries and their emphasis on infrastructure development puts extra strain on the equilibrium, forcing a fundamental rise in oil and oil-related services."

Another FoHF firm with a strong element of top-down analysis is Collingham Capital Management (www.ccmhedge.com).

David Thompson, partner, and director of business development at the company, says while Collingham feels it can add value both from sector selection as well as manager selection for the Collingham Investment Fund (CIF), top-down does play an important part in the investment process at the London fund of hedge funds house.

The mixture of the two has produced a FoHF that has generated average annualised dollar returns of 9.73% (or Libor plus 6.17%) since 1999, on volatility of just 4%, and only two months in eight years of drawdowns exceeding 1%. CIF is diversified between 25-35 underlying managers.

"We look at three factors to decide which sectors we should allocate to," he says.

The first is macro factors, such as geopolitical events, or trends in FX or interest rates, for example. The second is micro factors, such as the state of corporate balance sheets, with the third being technical factors, such as whether sufficient scope remains for funds in a specific sector to generate alpha "or is it all arbitrated away?"

"We will then tilt our portfolio strongly towards the sectors we believe where it will be possible for the underlying hedge funds to generate alpha," Thompson explains. Collingham displays roughly a 30% annual turnover.

Regarding the first, macro factor analysis, for example, Thompson says: "If we think there is a trend in interest rates and they will be falling, or rising steadily around the world, for example, because the economies are

strengthening or weakening, we will increase our allocation to macro managers. However, CCM presently believes conditions are not conducive to macro, and has halved its allocation to the strategy from 10% last April, and currently projects it to remain at 5% this April.

On the micro front, Thompson explains, Collingham feels corporate balance sheets are generally healthy, suggesting continued strong M&A activity and opportunities for event-driven managers. Collingham's analysis can drill down to specific regions in this regard, with bottom-up work seeking the best specialist managers in that area.

Supporting this, Collingham has increased its exposure to event-driven strategies, such as merger arbitrage and distressed/high yield, from an aggregate of 25% last April to 31% in January, and is expected to increase it again to 35% in April.

On the technical factor front, Thompson points towards the fewer opportunities in a strategy such as fixed-income relative value for managers to generate alpha.

CCM has also withdrawn from convertible bond arbitrage, where Thompson notes alpha is difficult to find, where much of the strategy's 2006 returns have come from style drift, and some managers are simply taking outright bets on equities or credit.

PAST PERFORMANCE

"If a fund of funds has a bottom-up only approach, they will be increasing their weights in sectors as that sector's weighting grows in the index. These are the sectors that have done very well over the past three years, either because more money has been allocated to them because of their success, or simply due to organic growth." Thompson adds.

"They may have grown through their performance, but there is no reason that sectors that have performed well over the last three years will perform well over the next three." Thompson also cites equity long/short, with managers whose long bias helps performance, but whose beta does not come cheaply compared to long-only options.

Thompson notes institutional investors will expect both top-down and bottom-up from a fund of hedge fund's investment process. "I think statistics will show underperformance or outperformance by most fund of hedge funds will come from strategy selection.

TYRANNY OF SYMMETRY

Gulamabbas Lakha is CEO and CIO of Providentia Capital, which he founded in 2004 and built a team of experienced strategists to manage a global tactical asset allocation (GTAA) hedge fund. The investment process he created offers a different perspective on economics and returns from bond, equity, FX and commodity markets worldwide.

Lakha's approach integrates the art of GTAA-based portfolio construction with the mathematics of asymmetry. He recently also launched a GTAA overlay service for funds of hedge funds when an investor in his hedge fund asked for assistance in GTAA, to add a top-down perspective to its FoHF construction. FoHFs' move towards top-down is what Lakha sees as "a function of an industry that's maturing and becoming more institutional."

Lakha brought with him to Providentia experience as a global markets strategist and economist at Baring AM, alongside his present colleague and former BAM group economist Ian Bright, while another colleague at Providentia, César Molinas, was previously former MD and asset-allocation strategist at Merrill Lynch.

The fourth member is Kevin Garrett who was heading derivatives at ANZ and GIB.

Providentia runs econometric modeling for different hedge fund categories to determine the key drivers of returns. This has created a framework by which to allocate across hedge fund categories driven by a top-down view about the economy and asset classes globally. The seven hedge fund categories are based upon the HFR indices: Hedged Equity, Fixed Income Arbitrage, Global Macro, Convertible Arbitrage, Event-Driven, merger Arbitrage and Distressed Securities.

Providentia's service is not a monthly allocation advice 'e-mail shot,' rather it is bespoke advice for each FoHF client, however Lakha emphasises Providentia does not advise below the index level, so does not recommend target funds.

"There is a real power in having an outwardly focused strategy team come in from outside because it avoids atrophy and the 'group think' that can develop in teams."

He adds, of course, that lower returns from single-strategy funds and higher correlation within hedge fund categories have driven a move favouring some top-down input. However, with not all fund of hedge funds teams

possessing the necessary resources to take on full-time economists and strategists, outsourcing the task of top-down analysis is useful.

Providentia provides a team of four strategists and Lakha would deliver that research to clients at monthly rebalancing meetings, and before providing advice on GTAA takes into account criteria such as the client's return and risk requirements, liquidity, portfolio and the time horizon. (Providentia does not need to know which funds the FoHF client holds, only portfolio breakdown at the index level.)

Lakha notes that having top-down views and input into portfolios can also help smaller funds differentiate themselves from the aforementioned bottom-up bias. Those family offices who may not have large staff numbers could also benefit from these services, he adds.

"2006 has been for many groups a particularly challenging year and funds that have delivered cash returns having taken 'cash-plus' risk may find it helpful to say they have added top-down input by bringing in an independent team," Providentia Capital's Lakha says.

Employing global tactical asset allocation "puts the overall environment on the agenda, not just the areas managers already know and understand.

"It asks you: 'what do you need exposure to in order to build a better portfolio?' It changes the discussion from 'who do I know?' to 'what is a good portfolio?'"

Lakha adds that implementing the results of a top-down analysis can add returns, but can also mitigate risk in a fund of hedge funds portfolio. "It improves your Sharpe ratio because it affects the numerator by adding global tactical asset allocation-based alpha and even if you do not do much about top-down input the risk analysis can improve the denominator."

ON CORRELATION

"One hears of scenarios where the best-performing single strategy in the worst-performing category may well underperform the average manager in the best-performing category.

"So someone with a good macro manager, for example, may underperform someone with an average emerging markets equities manager.

"A macro manager would really be over the moon if they got 25% in 2006." (According to Eurekahedge figures, 235 emerging markets managers of the 743 reporting figures returned investors more than 25% in 2006) "There is an industry imperative in the way the markets are changing that's affecting volatility and asset classes.

"The strategies are reflecting what's happening in the underlying markets," he explains. "In this environment, the need for having a top-down input is imperative because so much alpha is left on the table by people who do not look at it."

Lakha notes hedge funds grew from being a cottage industry with manager selection, "but now it is time to have the discussion the long-only industry had 15 years ago on the mix of top down and bottom up."

This global tactical asset allocation approach is not only for taking a structured approach to future events and portfolio construction, Lakha adds, but also to be able to dissect a portfolio that may have been constructed largely bottom-up, and reveal what top-down bets are implicit in its current positions – both of which services Providentia provides to its clients..

HIDDEN BETS

"People see funds of hedge funds as a business of picking managers you 'trust', but when you do the maths and analyse the fund of hedge funds portfolio, there are clear macro leanings that may be subconscious.

"For example, a whole lot of equity and emerging markets exposure with limited fixed income funds may create an implicit view on markets and the economy.

"If you just pick managers you like, you may have macro risks you are not acknowledging. Whether you explicitly acknowledge it in the investment process or not, that's another question. You may not even be conscious of it" Providentia's Lakha adds.

"We hold up a mirror and say: 'this is what your portfolio looks like, these are the implicit macro risks in the portfolio'."

Quantitative analysis typically employs multi-factor, backward-looking models, Lakha notes, "but correlations keep changing which is why you need someone who can look forward and ask: 'how are the tectonic plates

underlying the global economic markets moving and what are the ramifications of these for hedge fund strategies?"

At Providentia fundamental research is combined with quantitative models and a game theoretic analysis of geopolitics to anticipate investment themes across asset classes. A view of how relations between markets are evolving is provided by a set of dynamic models which analyse correlations across major markets.

The danger of heavy emphasis on a top-down view leaving a fund of hedge funds portfolio with a range of possibly disparate themes nevertheless all being exposed to similar factors, is not one lost on Caliburn's Capital's Jeremy Rowlands.

"We strive in the portfolio-construction process to create a portfolio with an option-like profile: capturing a large part of the upside of underlying markets while limiting the downside. We would be unable to achieve this goal without the intense, ongoing analysis of the underlying factors that drive our themes' returns.

"Qualitatively, this is aided by the partners and analysts drilling down into the investment case of each hedge fund and the specific types of securities the hedge fund trades. Various stocks and sectors within the energy and commodity space will have different reactions to different types of supply/demand regimes.

"For example, companies specialising in shipping crude from one region to another may see a sharp drop in earnings if the country they focus on is facing 'peak oil'. This short-sell candidate can be paired with a long in a company set to benefit from shifts in the distribution of oil and gas pipelines to where the marginal cost of producing remaining oil is lowest.

"On the emerging markets side, some countries are net exporters of a given commodity, while some are net importers and, thus, there will not be a uniform reaction to a commodity price movement.

"This is overlaid with a multi-pronged regime of quantitative analysis and stress-testing. Each manager's risk factors are analysed and the same multi-variate factor approach is applied to our own themes and overall portfolio. We regularly shock the portfolio for events such as LTCM and the Asian crisis, even while realising that the fiscal position of most emerging markets is vastly stronger than it was during these 1990s stress events.

"Indeed, many emerging economies are now generating the savings surpluses that are financing the trade/budget deficits present in the OECD. It is hard to argue that these large build-ups in reserves and savings could disappear overnight."

ILLIQUID CONUNDRUM?

Some may argue that with hedge funds getting more involved in illiquid instruments and strategies, global tactical asset allocation's value is limited if it is meant to revolve around altering allocations more rapidly.

However, Lakha notes global tactical asset allocation need not only be implemented by disinvestment from some strategies and reinvestment in new ones. Lowly or negatively correlated exposures can be taken on with new capital to offset existing heavy macro bets, he says, at least until the existing positions can be safely unwound.

Options or futures can also be employed to offset, of course, although not all groups will possess the requisite mandate to manage a book of such exposures via derivatives.

Hence the global tactical asset allocation approach may be useful to manage these risks and tap into a new source of alpha.

WITHER BOTTOM-UP?

For those who feel top-down is not the be-all and end-all in making money from funds of hedge funds, it is comforting to know even those who may emphasise top-down analysis still seek to find what they believe are the best managers expressing their top-down themes.

Collingham Capital Management's David Thompson notes, for example: "We have found our outperformance comes from both top-down and our portfolio managers' extensive experience both as hedge fund managers and fund of funds managers to determine which funds can truly generate alpha in all market environments. Indeed, our manager selection has played a larger factor in our performance since our inception in 1999.

Nor does Caliburn dismiss bottom-up selection when expressing its top-down view in its portfolio.

"Our bottom up manager-selection process has two important characteristics.

The first is its contribution to the overall strategic asset-allocation (SAA) process: new ideas generated through talking to managers feed back to the SAA process, ensuring new macro themes are explored and current themes evaluated," Caliburn's Rowlands says. "Secondly, once themes are identified, we use our substantial

analytical resources to drive in depth research into each theme, allowing us to identify and then select the best managers in each highly specialised field.

"This portfolio-construction process allows us to pick managers with an appropriate risk profile, exposure to a certain directional play or to a strategy and then to access the skills of the best managers in the industry. "This can also help us lean towards a certain area of conviction within a theme. For instance, in our 'Directional Emerging Markets' theme, we currently favour Chinese directional plays but tilt away from India.

"Bottom-up manager selection provides diversification across sectors and strategies and helps us achieve better risk-adjusted returns, not only assisting in the capture of upside, but also in limiting the downside.

THEMES NOT DIRECTIONS

Thematic exposures can be constructed using both directional and non-directional strategies providing the portfolio with an important driver of investment returns and also an important risk-management tool."

Rowlands cites Brazil as an example of the need to select expert managers who can "differentiate winners and losers of the current regime.

"In Brazil, the economy is both an agricultural net exporter and a manufacturer. Commodity exports and vastly improved fiscal discipline have led to a rising currency. This strong Real has in turn 'hollowed out' some segments of the exporting economy. Managers able to differentiate the winners and losers of the current regime will be able to provide the portfolio with the captured upside and limited downside Calburn is seeking.'

Calburn's manager selection has left its fund of hedge funds outperforming indices that illustrate the themes the managers pursue top-down, at least since its recent launch in June 2006 to 31 December 2006."

The 'peak oil' theme has generated 1.3% for Calburn, despite the GSCITR Index being down 18.4%, Rowlands says, while the 'commodity' theme has delivered 9%, even though the CRB Index has lost almost 11%.

Daniel Murray, portfolio manager and head of research at EFG Asset Management, says portfolio construction at a fund of hedge funds is "not just about going out and picking a handful of funds that you think are diversified and will provide you with the index return."

"But equally," he adds, "if you want to describe the general characteristics of how a style will work doing it on a top-down basis adds to your repertoire. If you have a strong belief about how particular factors will behave over the coming year that will give you an idea of which sub-styles will perform," Murray says.

He adds, when constructing portfolios to weather severe market downturns while capturing upside, a mixture of top-down and bottom-up is advisable such that "choosing funds to implement a strategy is an important part of constructing a portfolio. If people just do bottom-up there's nothing wrong with that, but our research suggests that if they do it that way they're often behaving as if they were acting top-down," Murray adds.

(In regard to asset allocation, Murray noted on page 42 of January's edition of Hedge Funds Review that, using the broad HFRI Fund of Funds index, analysis suggested around 80% of variability in funds of funds is due to asset allocation.)

In terms of top-down analysis EFG Asset Management looks to see which hedge fund styles is expected to perform the best over the next six to 12 months, before then finding managers best able to exploit such styles.