FINANCIAL TIMES

MONDAY NOVEMBER 5 2007

FTfm

Flight to a high-performing arena

PROFILE

Caliburn Capital was set up in 2005 to pursue juicier returns. **Phil Davis** checks its progress

Most institutional investors lack the experience to invest directly in hedge funds and have little option but to use funds of hedge funds. But many – privately and publicly – have grown sceptical about the quality of the offering and have long grumbled about poor returns and high fees. This deepening dissatisfaction was the main reason Jeremy Rowlands decided three years ago to quit running hedge funds and move into the asset allocation arena.

His decision to set up Caliburn Capital in March 2005 was, however, greeted with some scepticism. An investor in Bayard Partners, the hedge fund firm that he co-founded in 1992, wearily asked him: "Does the world really need another fund of hedge funds?"

Mr Rowlands was sure it did. He says evidence for the need of a better type of fund of funds can be seen in the poor approach and returns of many of them. "After 2000, institutions became terrified of the downside and the risk-managed fund of funds proposition became very interesting. But it did not deliver on performance."

This did not come as a surprise to Mr Rowlands, who had spent years dealing with funds of funds while running Bayard Partners, which managed about $900m in 1999 before performance tailed off in 2000 and it returned capital to outside investors in 2002. Most of the analysts he encountered from fund of funds firms were not experienced investors and relied on tick sheets, which passed as "process". In addition, funds of funds were polarised into very large firms that invested in too many underlying funds to produce adequate returns and sub-scale firms that had insufficient resources to fund research.

"In the middle there was a big gap," says Mr Rowlands. "We wanted to create a more entrepreneurial proposition, but with all the risk controls and diversification that serious investors expect."

'Four years ago, you just bought the index. But the frontier moves as everyone catches on'

Mr Rowlands is emphatic about the importance of an "entrepreneurial" outlook, an alien-sounding concept in an increasingly institutionalised sector. "We think all good investors are entrepreneurial. That means change excites them rather than destabilises them. That is how we see ourselves and that is what we look for in a manager."

He points to opportunities in China as an example. "Four years ago, you just bought the index. But the frontier moves as everyone catches on and managers may then specialise in small-caps or in a certain sector. Others may then go on to invest in non-performing loans, volatility arbitrage or whatever. Our job is to find the frontier. And it is moving fast – the process started in 1991-92 in Europe and took a decade, but in China it all happened in a year or two."

Caliburn claims to add value through strategic asset allocation, manager selection and portfolio construction. "The whole industry says it does this, but very few actually do," says Mr Rowlands. Caliburn, which now manages $700m, is relatively rare in allocating assets by themes rather than styles. Most funds of funds focus on whether a manager is long-short, event-driven, or arbitrage. "There is massive dispersion within these strategies, so the method is not helpful," says Mr Rowlands. "The real issue is to develop an investment thesis and find frontiers where active management can make a real difference. We also make sure there are no unintended risks such as large-scale exposure to the S&P 500."

Only 30 per cent of funds of funds add value in their selection of managers, Mr Rowlands believes. Caliburn hires predominantly experienced portfolio managers or analysts with a strong research background rather than those with a fund of funds history. The analysts search for early adopters – hedge funds with the ability to dig deep and specialise before others discover their niche and dilute returns.

And most funds of funds employ flawed portfolio construction techniques, Mr Rowlands says. "A lot of people believe that risk management equals volatility management. This is wrong – we like diversified volatility and actively look for it." Funds of funds that aim to deliver Libor plus 6 per cent often fail because they interpret that mandate as stopping them from seeking high-performing managers, Mr Rowlands believes. This means they invest in low-risk underlying managers targeting Libor plus 8 per cent. But since few of these managers will outperform because of their risk-controls, it only takes one or two to underperform and the Libor plus 6 target is shot to pieces. "That is essentially the story of the post-2000 period," says Mr Rowlands.

Jeremy Rowlands: looks for an 'entrepreneurial outlook'

Caliburn says it aims to control drawdown rather than volatility. It tries to build a call option type profile, which "inhibits the downside without inhibiting the upside". The firm's ability to seek out promising new firms is dependent to a large extent on the size of its team, which has swelled to 38. It has been able to hire quickly due to the $25m in working capital injected into the firm by Mizuho, the Japanese investment bank. Mr Rowlands says: "That $25m was very important, or else we would have been sub-scale."

Returns have surpassed many in the industry. Caliburn's $580m flagship fund returned 18 per cent in the 12 months from June 2006, when it was launched. It is up 19.14 per cent for the year to date and made 3.24 per cent in July when most other funds were down by 1-2 per cent.

And there is no lack of confidence about the future: Caliburn charges 1.5 per cent management fees and 10 per cent performance fees, which are right at the top of the scale. Mr Rowlands says: "We believe you pay for value added in this industry."