AlphaQ

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FOR INSTITUTIONAL INVESTORS & ASSET MANAGERS

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Hugh Hendry

Eclectica Asset Management's founder and CEO strives to succeed in an unorthodox manner

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ELEANOR ROSTRON

Our cover story this month is a profile of Hugh Hendry, founder and chief executive officer of Eclectica Asset Management. He may be a maverick and as much familiar for his robust media performances as his money management skills, but his firm has achieved 9 per cent per annum since launch 13 years ago, having survived the loss of over two thirds of its assets. In our piece, he stoutly defends global macro, saying that the flat years were when the strategy was doing exactly what it is designed to do.

James Williams opens this edition with a look at direct lending, where hedge fund and other alternative managers step into the business of lending, taking up the slack from deleveraged banks.

In a similar vein and having examined crowd funding in the last issue, this time around we take a look at peer-to-peer lending, and in particular the challenge faced by fund administrators in administering the assets in this new investment strategy.

James also writes on insurance-linked securities setting out to debunk myths and explain the burgeoning private catastrophe bond market. Elsewhere he profiles the Pensions Infrastructure Platform that has received a GBP1 billion mandate to invest in UK infrastructure.

And in this holiday issue, *AlphaQ* goes global, looking first at high yield Asian bonds and then, variously, to Japan, where corporate reform is the order of the day; Vietnam, whose market is opening up to new investors and Saudi Arabia where the stockmarket is beginning a slow process of allowing foreign investors in.

I very much hope you enjoy this issue and as ever, please be in touch with new ideas for us of examples of skill-based, risk adjusted investing.

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Striving to succeed

Beverly Chandler interviews Eclectica's Hugh Hendry as he defends global macro, and reflects on the tough business of being a hedge fund manager.

Famously outspoken global macro hedge fund manager Hugh Hendry is turning contemplative as he reviews the 13 year see-saw of an experience that has been his time at Eclectica Asset Management.

He founded the firm in 2005, buying out the Eclectica fund he managed from Odey Asset Management's Crispin Odey, who described him – fondly – as a fellow pirate.

The big achievement of the early years for the fund was in 2008 when the main Eclectica fund returned 31.2 per cent when all around were losing their shirts, but subsequent performance has been volatile.

2009 showed a loss of 8.03 per cent; 2010 a gain of 2.65 per cent; 2011, a gain of 12.11 per cent; a loss again in 2012 of 1.72 per cent and then flat in 2013, before delivering 9.48 per cent in 2014 and 11.57 per cent YTD.

It is these last tiny losses that have caused something of a change in the media friendly Scot who suggested to Jeremy Paxman on Newsnight that panicking was the only reaction to the possibility that Greece might default on its sovereign debt back in 2010.

For Hendry, flat to minimal losses in his global macro fund are not necessarily a sign that he is doing something wrong and he feels that the wider world is missing the point.

"I don't wish to preach but I do feel that global macro has been given a hard time especially over the last three years with subdued returns," Hendry says. "Eclectica assets under management and those of a lot of our peers have shrunk while performance returns have been modest."

He continues: "A common refrain is how awful the performance has been and what rankles with me is there is another interpretation – that being flat isn't so bad. What differentiates global macro from other hedge fund strategies is that when we have an awful patch, we are flat, whereas when other managers have an awful environment they typically lose a great deal of investors' capital with large absolute drawdowns."

"When we get things right – we go for it."

Hugh Hendry, Eclectica

Hendry also believes that global macro vehicles are inherently bred to have a component of disaster insurance.

"Investors flock when there are concerns and worries on the nature of the capital markets, such as in 2008 – that is the appeal of global macro, but the last two and a half year period has seen no great catastrophe and so the embedded protection that you had in place was not called upon," he says.

"No one is satisfied with flat returns and if they stretch to three years you will lose a great percentage of assets under management, which may be fair or may be unfair but that's the rule of the universe. If I offer an explanation for Eclectica being flat it demonstrates our rigorous approach to risk management and the great deal of downside protection that global macro can offer."

His and his team's objective at the beginning of every year is to make a lot of money. "Every year we try and go for it, but the difficulty is that with that game plan you would need, as an example, an equity allocation of 100 per cent of assets in there in order to make a sizeable return."

"Periodically we are seeing 10 per cent drawdowns in stock markets and the difficulty is that if you push that through the prism of risk management you can be stopping yourself out on those dips, and that is where we found ourselves. It is unacceptable to be losing in the nature of 5 per cent in any one month so we reduced risk and were topped and tailed having to respond to every reversal in the markets."

Risk principals were still cherished but Hendry and his team realised that they had to, as he puts it: "Give the portfolio more oxygen, bandwidth and liberate a little risk".

"In the month of October 2014 we had a choice to make when European equities had a 12 per cent drawdown. Historically we would have been taking risk off the table but we recognised that would be a counterproductive folly so gave ourselves greater scope within our risk parameters and what would have been a drawdown of 5 per cent month, became a 4 per cent up month."

The new technique worked as performance turned around but for his business, times have been tough.

"2012 to summer 2014 was the toughest period in my career," he says. "We had this longevity of return, a distinguishing feature that we have endured and survived for 13 years, compounding at 9 per cent per annum, with no profound calendar year drawdowns, and when the market stumbled we made money."

But, despite this, assets suffered, falling from a peak in 2012 of USD1.2 billion across all the Eclectica funds while the hedge fund alone had USD750 million in it, to a total now for the whole group of USD300 million.

"We manage a small amount of money because we strive to succeed in an unorthodox manner, whereas the majority of macro managers seem to be content to invest in an orthodox manner," Hendry says.

The unorthodox recovery for the firm came from Hendry's time travelling stance. "I live in the future, and confuse a lot of people because I am talking to you from 2018," he says. "Perhaps I delude myself, but we are trying to capture the longer term narrative, looking two to three years ahead."

In formulating their feelings on the next three to five years, Hendry and his investment team partners at Eclectica are looking for the next wave.

"If you look back, we were very much at the forefront of the initial wave at the turn of the century, willing to ride that wave when commodities and gold was our largest asset exposure and 2003 and 2004 were strong performance years. Then late 2005 we re-orientated our expectations and prophesied that the US economy would be hit by a profound deflationary shock so we dialled down the risk, protected the downside, and achieved a flat return.

"In 2008 we got the prophesy right and made 31 per cent and then delivered a double digit year again in 2011, from going long the fixed income markets where we bet interest rates would stay on the floor for a long time. Then 2012 into the summer of last year, flat again until we hit the thrust of a cyclical upswing of returns."

From late August 2014 to end March 2015 the fund has returned 31 per cent.

"We were written off with a perception in the market place that we had become intolerant of risk taking and had become institutional and I hope we have abolished that viewpoint" Hendry says. "When we get things right – we go for it."

The turning point came post the meeting of central bank chiefs at Jackson Hole, Wyoming last August.

"Our impression was that the monetary authorities were endorsing the notion that the dollar would rise to facilitate economic growth in the rest of the world and the US economy was on the road to recovery," he says.

"So we tried to project and decided if the dollar rose at the margin, then growth would come to favour the rest of the world. We had a lot of money long US dollars and long equities outside the US, as they would capture that better GDP growth and thirdly if the US was willing to lose growth at the margin, then US Treasuries could converge with the low rates we saw in the rest of the world."

That policy worked until it started to unravel when the US Treasuries peaked at the end of January this year and the dollar and equity markets peaked in March.

"It's been fantastically difficult to make money for the last three months," Hendry says. "So we have reassessed and no longer believe a stronger dollar is good for the world economy. Now we are predominantly long non-US equities where we still think there is scope for monetary policy and low earnings expectations to propel markets higher."

He is also encouraged by the emergence of a unified central banking policy that has spread beyond the US and the UK, to include Japan, Germany and even China.

"The falling oil price spooked central bankers at the end of last year and now the Germans have accepted the need for radicalisation of monetary policy, the Japanese have suspended additional consumption tax hikes and the Chinese have joined the fray using quantitative easing and cutting interest rates so equities look like the only asset class in town."

At the moment, the firm has returned to stability. Assets have stopped flowing out and this year is looking like another double digit return year, up 10 per cent through to July.

And Hendry is resigned and reconciled about his colourful media reputation. He briefly disappeared from the media, even joking that his clients had banned him from media appearances.

"I am who I am," he says. "Since 2012 I did everything to make myself more appealing and kind of lost myself. It was as Dickens wrote, the best of times and the worst of times but thankfully I am persistent and robust. I was trapped behind a curtain like the Wizard of Oz with a perception of mystique and unapproachability, but ultimately lonely, and I made a decision that I would suit myself, adhere to my own principals and if that meant we would maximise our returns on our lowest assets, at least we would have integrity and confidence. So I have gone back to being true to myself again."

And now Hendry's calendar is full again of appointments with large institutional clients. "After 2008 and the bounty of the performance fee, we could invest money into the operations of the business so we have the best in class risk and back office systems which cost a great deal of money, especially with today's regulatory burden" he says.

"Owing to the integrity of the structure of our business, and high visibility post 2008, several large North American pension schemes invested over USD100 million in our hedge funds; sadly that is no longer the case." In a familiar irony, Hendry says: "They held us for two to three years and they bailed just before we made 31 per cent."

Nowadays, the firm has a USD60 million account with one institution and a franchise which can extend into the institutional market. "But our true characterisation is the great number of clients, in the hundreds, that span from tiny investors to family offices to large institutions," he says. ■

Strong drivers

Direct lending markets in Europe are enjoying a period of growth, writes James Williams.

According to alternative data provider Preqin, the private debt industry has more than tripled in size since 2006 as assets under management have climbed from USD152 billion to USD465 billion.

A recent report by Deloitte suggests that direct lending funds in Europe could raise in excess of EUR15 billion over the next 12 months, underscoring the extent to which the opportunity set in Europe is expanding. It still has a long way to go to get close to North America's private debt market, where it is estimated that 80 per cent of financing comes from institutional players, in stark contrast to the dominance of traditional bank financing across the pond. Nevertheless, these are exciting times for fund managers and European investors as they feverishly look for alternative sources of yield.

"The development of markets such as Europe and strategies such as direct lending provides numerous opportunities for investors to build dedicated and diverse allocations to the asset class," said Ryan Flanders, Head of Private Debt Products at Preqin, in a statement.

Mike Dennis is managing director and co-head of Ares Capital Europe LP (ACE), the European private debt lending arm of US firm Ares Management, a USD56 billion alternative asset manager specialising in credit.

A lot of direct lending funds are actively fund raising and attracting new inflows and Dennis says: "I think people continue to recognise that the opportunity set for direct lending is growing. We are seeing the banks do less and less middle market corporate lending, and at the same time, market acceptance of direct lending is improving. This year, we have been doing deals with sponsors who have never used anything other than their banks' capital.

"Overall, there are some pretty strong drivers in play for the continued growth of direct lending."

Mike Dennis, Ares Capital Europe

"Overall, there are some pretty strong drivers in play for the continued growth of direct lending. There are a lot of assets sitting on banks' balance sheets that need to be refinanced in 2017, and there is significant private equity dry powder in Europe. So yes, there's more capital in direct lending, more competition, and more direct lending funds being launched, but at the same time, the addressable market is also increasing."

Last year, and to date in 2015, has been a record period for Ares Capital Europe in terms of deployment. This year, so far, the team has completed around 15 transactions in its current fund offering, Ares Capital Europe II. Throughout 2014, Dennis says the team completed 26 loan originations: "We're not encountering any issues at all in terms of finding good deal flow and attractive risk-adjusted returns."

One leading European direct lending fund manager, who asked not to be named as they are currently in fund raising mode, says that, within Europe, they target strong, well-positioned companies within stable and non-cyclical industries that are seeking a tailored financing solution to finance a specific event such as acquisition, growth, liquidity, and so on. The firm provides financing across a range of European countries, with a focus on Northern European countries.

The manager notes that while Europe's DL market is in the early stages of its evolution, it is a growing and attractive market due to the continuing structural imbalance between the supply of and demand for capital in the European credit market, as well as the growing awareness and use of direct lending funds. "Despite this, we have relatively few competitors pursuing a similar investment strategy and we are therefore continuing to see robust deal flow, enabling us to continue to source and originate attractive deals."

Dennis says that the ACE II fund has been active in France and the UK in particular, less so in Germany and the Nordics.

"A lot of what we do is focused on first lien senior and unitranche debt that is yielding high single digit annualised returns. These types of investments have been consistent since we started the business in 2008," confirms Dennis.

One firm that is taking a somewhat different stance to direct lending is New York-based Firebreak Capital. The firm was set up by Goldman Sachs veterans Rob Allard and Jonathan Egol. The Firebreak fund, which is expected to launch later this year, is a private debt hedge fund focusing on the rich opportunity set wrought by financial regulatory reform and bank capital requirements.

With the rapid evolution in financial services, Firebreak aims to be an alternative balance sheet in the illiquid lending and investment sector, leveraging the emerging disruptive trends in consumer and commercial direct lending, as well as providing private credit, asset-backed and structured finance solutions.

In other words, Firebreak's strategy will be to lend to peer-to-peer lending platforms, who themselves originate loans to consumers and small businesses. Prosper and Lending Club are the two most prominent examples operating in the US currently.

"The overall thrust of regulation is to make banks more liquid and less complex. They are using stricter lending criteria and that is leading to underserved parts of the borrower community. That's a big driver behind the growth of DL businesses in consumer credit, commercial lending, commercial real estate and residential," says Allard. "This will be one of our core focuses: providing wholesale finance solutions to those businesses that have a complexity that doesn't lend itself naturally to finance that banks want to take on.

"Away from DL, we see broad opportunities to work with banks and larger industry players to provide asset-based financing, structured financing e.g. contractual cash flows, infrastructure, transportation assets. There are different areas of the market where banks have historically been big providers of capital but the challenges for them to do that are increasing all the time. So there are opportunities away from the pure DL space that we hope to capitalise on."

"For all the risk management and structuring expertise, sourcing is what really helps you to build a differentiated portfolio in this sector."

Rob Allard, Firebreak Capital

Firebreak will look to finance platforms not just in the US, but also Canada and the UK.

Allard notes that, as banks reposition themselves, some high quality teams are leaving commercial bank divisions to set up their own businesses. "One big trend is originators partnering with their original bankers to turn the bank's origination platform into a lending platform. They both see the opportunity that banks are not willing to further push the envelope with respect to commercial lending, yet their core expertise lies in finding opportunities. They see the demand, so it's a natural marriage bringing together the guys that worked as their bankers into the business and switching from originators to lenders," says Allard.

One of the people Firebreak has hired in the UK has 30-plus years' experience in commercial banking and until 18 months ago was running

the consumer finance division of a UK bank. "He has a large network of connections both to UK commercial banks as well as a lot of these start-up businesses," says Allard, who stresses that technology is an important differentiator to the way Firebreak will operate.

"A lot of these DL platforms have a Fintech angle to them; maybe they are utilising Big Data, serviced by the internet and mobile devices. We want to make sure that we have the right infrastructure to speak that language. One of our key hires was bringing on a software engineer so that as we develop these relationships we can build APIs into these firms to facilitate the onboarding of loans.

"That should create a tech-friendly facility for the borrower, but more importantly, from our point of view, it will allow us to generate greater insight into the performance of the loan book and take action when needed. It'll be an important risk management tool," explains Allard.

To act as a wholesale finance provider and lend to the lenders requires significant expertise in analysing cash flows and looking, at the portfolio level, to see what structural protections and credit evaluations are in place.

"The US is a huge market. There are numerous business-lending platforms springing up. We're looking at one commercial real estate platform that focuses on the south-west, providing small balance commercial loans (less than USD1 million) over a relatively short-term period, less than two years). We can provide a facility for them to lend against that portfolio to grow their footprint and increase the velocity of their business," says Allard.

Over in Europe, the average size of direct lending deals is on the rise. As DL managers get bigger, they are better able to finance bigger companies and not just restrict themselves to small and medium-sized enterprises.

Dennis confirms that unitranche deals, in particular, have grown bigger in the last 12 months, noting that deals in the EUR200-250 million range are being seen regularly.

"Unitranche is definitely getting traction in slightly bigger deals today. We have the capacity to do the whole deal, which is obviously beneficial to us, and by and large we originate deals on a solo basis. Corporates can see the benefits of having a one-stop financing solution with a single direct lender as opposed to going to a bank."

He says that this is not just about banks deleveraging. Factor in the impact of Basel III, which imposes tougher Tier 1 capital ratio reserves on banks' balance sheets, and suddenly the profitability of this asset class is shrinking.

"The return on equity for banks is driven by the amount of leverage and the amount of regulatory capital they have to hold against these assets, and as such, returns on leveraged finance are falling. This is symptomatic of the problems that banks continue to face since the crash. They are using less leverage on their balance sheets at a time when returns on equity were already falling," says Dennis.

The loans that Ares Capital Europe originates typically have a legal maturity of six to seven years.

"We have to have confidence that over that time period the cash flows will be sufficient to service the loan. As such, we only lend to companies based on the sustainability of their cash flows, which typically exhibit low levels of cyclicality, high levels of cash generation and tend to be market leaders in niche markets. Also, we look for companies with high barriers to entry and sustainable competitive differentiation.

"All of these factors are involved in our assessment of a company's cash flows over the medium term," Dennis confirms.

Although the Firebreak fund is yet to officially launch, Allard confirms that the team is already working on a few transactions on a standalone basis with some of its prospective LPs. He says that identifying a pipeline of transactions to form the core portfolio is "hugely important" in order to deploy capital effectively at the time of launch so as not to create a drag on performance.

"For all the risk management and structuring expertise, sourcing is what really helps you to build a differentiated portfolio in this sector," says Allard.

"We believe that the strata of what we are looking at – USD5 million to USD30 million – is less competitive and should work to our advantage. We're trying to scale the fund around the opportunity set. As such we expect to launch with approximately USD150 million. Given what we're seeing right now, we think the DL space is scalable from USD150 million up to USD1 billion over a certain timeframe.

"From a performance perspective, in this environment we think we can sensibly generate a yield on the lending book in the high single digit range with performance mid double-digits over the cycle."

Firebreak will employ various hedges on a trade-by-trade basis with respect to sector-specific or idiosyncratic risks. "Once we construct the portfolio, we will layer more systemic or portfolio-level hedges to help manage the Sharpe ratio and volatility in the fund. Most of what we are doing is floating rate so there's only a small amount of residual IR risk," notes Allard.

Clearly, the structural reforms taking place in banks, and the growing awareness of direct lending strategies among institutional investors augurs well for the future; be it to invest in portfolios of originated loans or to gain exposure to more wholesale financing strategies.

"Banks still have quite a large share of the market, so there is plenty of runway for institutions to take more market share. The structural shift in the market will continue, and we're feeling pretty optimistic about the asset class," concludes Dennis. ■

P2P: be mindful of operational risk

Beverly Chandler interviews Maples FS's Tyler Kim and Greg Knapp on the operational issues within P2P lending.

Marketplace lending, also known as peer-to-peer lending, has become a worldwide phenomenon. While the industry is flourishing in the US, marketplace lenders can now be found all over the globe. Peer-to-peer (P2P) lending differentiates itself from crowd funding as it is debt based with formal contracts and specific terms. It also does not fit cleanly into any of the three traditional types of financial lending institutions – deposit takers, investors, insurers and is categorised as an alternative financial service.

This growth can be partially attributed to the fact that banks are applying more stringent lending standards post the financial crisis and looking at credit quality with a more discriminating eye, forcing borrowers to seek out these alternative channels. In exchange for generally higher levels of credit risk, peer-to-peer lenders are rewarded with higher interest rates.

"These peer-to-peer platforms originate billions of dollars' worth of loans with attractive yields," explains Tyler Kim, Global co-Head and Chief Information Officer at Maples Fund Services.

"In the current low interest rate environment, investors seeking yield become interested in the types of returns that can be achieved in this sector."

Rather than banks bearing the credit risk of loans that they make, with peer-to-peer lending, this risk is borne by individual investors – large and small. Hedge funds are facilitating the introduction of larger institutional investors to this space.

"Hedge funds are essentially offering the risk to outside investors. Credit risk is something that investors are ostensibly willing to accept when they get into peer-to-peer loan funds," Kim continues. "However, the operational risk associated with maintaining the books and records these loan portfolios is also something that investors also need to consider."

Peer-to-peer loan funds can be comprised of thousands of individual deals, each with specific terms and performance, and that turnover frequently.

"These peer-to-peer platforms originate billions of dollars' worth of loans with attractive yields."

Tyler Kim, Maples Fund Services

The role of a third-party administrator is to ensure data integrity within peer-to-peer loan funds – including verification of existence and valuation. Additionally, an administrator can monitor crucial processes such as: tracking interest accruals; accounting for paydowns; tracking defaults; looking at recovery rates and accounting for late payment penalties.

Administering a portfolio of peer-to-peer loans requires the same disciplines that apply to all the hedge funds that Maples Fund Services administers, Kim explains.

"It's not a matter of doing anything differently; it's just bringing these funds in line with what we normally do for pools of assets like this."

Earlier this year, the firm hired Greg Knapp as Senior Vice President – Client Solutions/Relationship Management.

Peer-to-peer lending

Peer-to-peer (P2P) lending started roughly ten years ago and the sector has grown rapidly, with the five largest platforms for consumer lending: Lending Club; Prosper and SoFi in San Francisco and Zopa and RateSetter in London issuing nearly one million loans and lending more at the rate of well over USD10 billion a year.

P2P lending has grown on the back of the post global financial crisis restriction in credit, combined with a low interest rate environment. What started as a relatively unsophisticated opportunity for individuals to lend to each other has become increasingly corporate, with P2P lending moving into real estate, small businesses and student loans.

The 2015 European Alternative Finance Benchmarking Report, from Robert Wardrop, Bryan Zhang, Raghavendra Rau and Mia Gray, found that in terms of the alternative finance models, excluding the UK, P2P consumer lending is the largest market segment in Europe, with EUR274.62 million in 2014; reward-based crowdfunding recorded EUR120.33 million, followed by P2P business lending (EUR93.1 million) and equity-based crowdfunding (EUR82.56 million).

The report also found that average growth rates are also high across Europe: P2P business lending grew by 272 per cent between 2012 and 2014; reward-based crowdfunding grew by 127 per cent; equity-based crowdfunding grew by 116 per cent and P2P consumer lending grew by 113 per cent in the same period.

Collectively, the European alternative finance market, excluding the UK, is estimated to have provided EUR385 million worth of early-stage, growth and working capital financing to nearly 10,000 European start-ups and SMEs during the last three years, of which, EUR201.43 million was funded in 2014 alone.

The report found that including the UK, the overall European alternative industry is on track to grow beyond EUR7,000 million in 2015, if the market fundamentals remain sound and growth continues apace.

Growth within the UK should be spurred on by the summer budget which confirmed plans to introduce from next April a third type of ISA, the Innovative Finance ISA, allowing for up to GBP15,240 tax-free investment in the P2P lending sector.

However, a survey from Yorkshire Building Society has found that fewer than one in five (18 per cent) of financial advisers would invest, or already have invested, their own money into P2P lending schemes. Advisers are concerned about UK consumers' low levels of understanding of the potential risks of P2P lending, which is not covered by the Financial Services Compensation Scheme (FSCS).

P2P – a manager speaks

Spyros Papadopoulos, Chairman and CEO of Synthesis Multi-Asset Architecture SICAV-SIF S.C.A. based in Luxembourg explains how his firm invests in peer-to-peer lending. Synthesis P2P Lending is the first authorised, regulated Fund in the EU, and will also open to institutional and professional investors its Structured Commodity Trade Finance (SCTF) marketplace lending "platform," the first in the world.

What attracted you to investing in P2P loans?
Within our overall investment strategy, we seek asset classes which are fairly de-correlated with the global equity and fixed income markets and have stable return characteristics in relation to their risk profile. P2P loans are, of course, a very vast area that can be quite risky if not managed properly. Despite their recent growth, they remain a fairly unexploited area as few managers have sufficient expertise to deal with them, both from an operational as well as risk management point of view. At Synthesis, we invest in P2P segments that we understand well so that we can assess and mitigate credit risk fairly accurately using proprietary systems and people with expertise in lending operations.

How do you evaluate them for a portfolio?
Prior to undertaking any specific transaction we evaluate many factors, including the characteristics of each obligor in quantitative as well as qualitative terms, transaction specifics, collateral, and microeconomic conditions. In-depth due diligence is also performed. In addition to individually selected transactions, we also invest in pools of outstanding P2P transactions such as those offered by LendingClub. In these cases we examine the overall selection criteria at pool-level and assess how the overall characteristics blend well with our existing portfolio's profile.

Was the operational risk a concern for you?
Yes of course, a great concern. Typically, IT systems used by the investment fund industry have not been well suited to addressing the operational issues and reporting requirements specific to P2P loans. This is where an independent administrator can provide tremendous value. The administrator provides verification of the existence and valuation of the loans and also ensures the integrity of our data within the funds themselves which can be helpful in mitigating some of the risks associated with investing in P2P funds. In addition, we invest in our own systems and we also use a "six-eye" principle before any transaction takes place.

Can you comment on the returns achieved from this strategy?
Our annualised return has exceeded 8 per cent since inception with an annualised volatility of less than 1 per cent. This is a huge improvement over most major indices, both in absolute as well as relative terms.

Knapp previously held senior positions with a number of global fund services and fund administration firms where he was tasked with seeking new ways to differentiate his firm.

"One of the ways to achieve this was to focus on alternative markets that other fund administrators might not have been aware of," he says. "I was based in San Francisco where peer-to-peer lending started so it made sense to turn my attention to this growing sector. Four or five years ago I helped build one of the first platforms for larger institutional investors to invest in these types of securities or micro loans."

As the peer-to-peer lending space matures and evolves, Kim and Knapp believe that operational risk management will become even more important and prevalent. As hedge funds and banks move to securitise pools of P2P loans, risks become distributed to a whole new array of investors through bond markets. However, beneath layers of financial product wrappers remain the same basic pools of loans that need to be accounted for.

"Administrators can help to ensure that the state of affairs is what everyone thinks they are."

Greg Knapp, Maples Fund Services

"As these loans move around from place to place, someone needs to keep track of what is actually happening. Administrators can help to ensure that the state of affairs is what everyone thinks they are." ■

The Voldemort zone

Our regular columnist, Randeep Grewal, calls on Harry Potter to explain the complicated nature of currency relationships.

The defining events in financial markets so far in 2015 have been (i) the (continuing) Greek saga (ii) the break of the Swiss peg to the Euro (iii) the Chinese stockmarket bubble and retreat (iv) the fall of Chinese demand for commodities and (iv) the break of the Chinese peg to the dollar.

The unifying issue through all of these events has been currency – either in the form of pegs or unions and the consequences. The difference between a peg and a currency union can be compared to the difference between cohabitation and marriage. In both cases one can find examples that have lasted and others that have ended in bitter regrets and recrimination.

Some relationships are harder to define – for instance Panama's currency is the 'bilbao' which is pegged at a 1:1 ratio to the US dollar. Banknotes were printed on 2 October 1941 but then withdrawn from circulation and burnt a week later. Ever since Panama has relied on US banknotes, though it does produce its own coins. Both the bilbao and the US dollar are recognised as legal tender in Panama.

Incidentally there is a thriving community of 'entrepreneurs' who sell 'artistic' impressions of bilbao banknotes on internet e-commerce sites.

In Europe the Danish Krone and the Bulgarian Lev are pegged to the Euro – and for all practical purposes both countries are part of the Eurozone.

The most complicated relationships are those where the parties are entwined and interdependent but in self-denial as to the extent or depth of their relationship; thus they dare not mention their relationship by name. Let's call this kind of currency area a 'Voldemort zone' after 'he-who-must-not-be-named' in the Harry Potter books; or VZ for convenience.

I would contend that the Chinese Renminbi and the US dollar have been in such a 'Voldemort zone' – and like many such unions it goes through periods of stability and episodes of turbulence. Neither side can quite bring itself to admit how dependent they are on the other; and though the terms of the relationship (i.e. the peg) may be reset on occasions the underlying dependency remains.

In the Harry Potter books some characters' commitment to Voldemort is ambiguous (e.g. Lucius Malfoy) – so it is with some currencies which are pegged to a basket or 'track' rather than are formally pegged to the dollar or are linked in more complex ways to the dollar (e.g. commodity exporters) – indeed one might include a significant number of Asian and South American currencies in this group (the 'Malfoy clique?').

Over the last few years the 'assumption' by many market participants has been that the Renminbi would continue to strength and flows continue to pour into China. One can argue about the difference between capital and current account flows, or FDI vs 'hot' money, but at the end of the day a currency peg means that as money flows into a country its foreign exchange holdings go up – and China's peaked last year at nearly USD4 trillion.

A peg can be in many forms – hard or soft, fixed or crawling – but ultimately any kind of peg to the dollar means membership of the VZ. Inevitably inflows for any pegged currency lead to rising foreign exchange holdings; and also increased liquidity in the local economy. The PBOC, faced with this situation, was unable to fine-tune the monetary base by raising interest rates as that would, if anything, increase inflows (and probably not be appropriate for the local economic conditions). Indeed the Swiss Central Bank, faced with inflows after pegging to the Euro, took rates negative but those pesky investors did not get the hint that they really were not welcome!

So, to remove liquidity from the market the PBOC had been raising the reserve ratio requirement (which peaked at 21.5 per cent for major banks 19.5 per cent for smaller banks) – and perhaps unsurprisingly the RRR started falling as the foreign exchange reserves started falling. A falling RRR increases the ability to lend but does not mean that a bank ought to lend; one suspects that this lesson was forgotten as the stockmarket rallied in China – with an undefined amount of the flows due to increased margin.

The Fed manages interest rates according to economic conditions within the US – and other members of the 'Voldemort zone' such as Panama or Ecuador have historically been too small to be relevant. Even Saudi Arabia, whose Riyal is pegged to the dollar, represents only 4 per cent of US GDP. However nominal Chinese GDP in 2014 was approximately 60 per cent of that of the US; and on a purchasing power parity basis at par with the US. Should the Fed consider monetary conditions in China when it sets rates? Indeed one might suggest that the Governor of the PBOC would have more 'gravitas' on the Federal Open Markets Committee (FOMC) meeting than some of the current members. If not now, perhaps when China, Saudi Arabia and other members of the VZ

"The difference between a peg and a currency union can be compared to the difference between cohabitation and marriage."

Randeep Grewal

represent more than 80% of nominal US GDP? Or maybe at 100 per cent?

Given it is unlikely that the Governor of the PBOC will be attending FOMC meetings, an interesting questions to ask as investors is what is the unintentional consequences of the 'soft' devaluation of the Renminbi against the dollar?

One might argue that over the last decade China's most successful export has been deflation to the US; or that the US has successfully exported inflation to China. Either way, a Chinese devaluation means lower inflation than otherwise in the US; but higher inflation in China.

Another way to consider the above is that as the Fed has printed money through quantitative easing and this 'liquidity' has been travelling across the VZ to China where the PBOC, as if with a swirl of its RRR wand, has been trying to neutralise it.

The fall in forex reserves is, so far, not a major issue for China. But the risk is that speculators and those of nervous disposition will conclude that if China is going to devalue that it will do it again, and again so best to switch to dollars sooner rather than later. Clearly there is a risk, despite capital controls, that this becomes a self-fulfilling prophecy. Thus going forward we might face a scenario where the PBOC seeks to create liquidity at home (e.g. further falls in the RRR and maybe outright QE). The outflows will lead China to sell its US Treasury holdings at the same time as the Fed is unwinding QE and potentially raising rates. Add in the potential of Gulf oil producers running budget deficits so no longer recycling petro-dollars (indeed possibly selling some) and fixed income ETFs being in loose hands and susceptible to sentiment and its cousin momentum. We may be living in 'interesting times'.

As long as the dollar and Renminbi are intertwined the two central banks can never act truly independently – however just like a couple that is in denial of their relationship sometimes the actions are in the same direction and at other times they are diametrically opposed. Other countries which track (the Malfoy clique) or are pegged to the dollar are competitors to China in the export market, and may also react.

Amongst many consequences to consider are: Will Chinese investors sell their NYC and London properties? Will there be a switch in demand from Chinese high end consumers pursuing luxury brands such as Gucci and Bentley to US middle class demand for Hugo Boss and Ford, for example? Will the loss of appetite for commodities in China be offset by increased demand from the US? Will speculators switch their attention from emerging markets to Europe?

In an earlier age Winston Churchill spoke of 'a riddle, wrapped in a mystery, inside an enigma'. Solving this riddle will ultimately drive investors' returns…

…of course Voldemort's original family name was 'Riddle'. ■

Randeep Grewal is a portfolio manager for the Trium Multi-Strategy Fund. This article is written in a personal capacity; the views and opinions are those of the author and do not necessarily reflect those of Trium.

Keeping it liquid

Beverly Chandler talks to Neal Berger, chief investment officer of Eagle View Capital Partners.

"The world doesn't need another hedge fund and the world certainly doesn't need another fund of funds", says Eagle's View's chief investment officer Neal Berger. "If we didn't think that we added substantial value and had an approach that was unique, we would not have had the desire or the need to launch Eagle's View Capital Management."

The USD300 million company started life as an advisory business in 2007, offering a series of customised portfolios for ultra-high net worth individuals, but the firm sought to offer a product with a lower minimum investment requirement, so in 2010 launched its first fund, the Eagle's View Capital Partners LP. The current business has a five year track record.

"I hate to call our product a fund of funds," says Berger. "It's really a multi-strategy absolute return fund. Our approach is unique. We don't invest in the mainstream hedge fund strategies that others do. We seek to capitalise on structural inefficiencies in the marketplace. Historically, this has been a reliable source of non-correlated alpha within liquid strategies."

Berger started his quest for alpha at Izzy Englander's Millennium Partners, working as a global macro manager some 20 years ago when

the hedge fund industry had approximately only USD50 billion under management. That amount has now risen to some USD3.2 trillion.

"This asset growth is driven by the largest investors in the world" Berger says. "And because of their size, writing a USD10 or USD20 million cheque is not meaningful, so they gravitate towards main stream strategies and the same managers. We kind of recognised this trend early on. What we are trying to do, in an otherwise saturated environment, which is increasingly unfertile for investors, is find arbitrage opportunities in non-mainstream, capacity constrained markets where there are fewer investors who are able to invest in these areas."

Simply put, Eagle's View invests in niches. "Few institutions write cheques to smaller guys," Berger says. "We are trying to fish in a pond with 5,000 fish and five players who can fish rather than a pond where there are five fish and 5,000 players trying to find those fish."

The firm is invested in 27 non-correlated strategies from equity volatility arbitrage; electricity trading; algorithmic pattern recognition; quantitative global macro and various other non-correlated 'niche' strategies, including shipping derivatives.

"It's the equivalent of being a casino owner who has a collection of house edge games," Berger says. "No casino owner worries about losing money on gambling, as each game performs independently of the other. The common thread is that for each game they have a positive expectancy for the house and a negative expectancy for the player. We try to put together a collection of positive expectancy investments that are internally non-correlated to each other and externally non-correlated to traditional asset classes."

Returns for the Eagle's View Capital Partners LP over the last five years, when traditional funds of funds have had a difficult time, are all positive. 2014 saw the fund return 10.07 per cent and in 2011, when the HFR Fund of Funds Composite Index reported a loss of 5.72 per cent, Eagle's View returned 5.91 per cent.

"Most importantly, it's not just our absolute returns but the risk-adjusted returns which we believe are impressive," Berger says. Annual volatility on the fund is 3 per cent and the Sharpe Ratio is 2.4. "We have been profitable in approximately 80 per cent of all months and have avoided making beta bets. We are different from a manager that is hoping that their market will go up or down to make money."

"We are trying to fish in a pond with 5,000 fish and five players who can fish rather than a pond where there are five fish and 5,000 players trying to find those fish."

Neal Berger, Eagle View Capital Partners

One of their niche strategies is electricity arbitrage, a strategy that arises from a market inefficiency in the US, whereby all the utility companies of all sizes are privatised.

"There are literally thousands of private utility companies in the US, some are big and some are very small and they are trading power every day. They are the largest participants in power and these are the largest and most liquid markets in the world," Berger says. These utility companies are driven by supply management rather than being profit motivated with respect to their purchases and sales of electricity.

A manager in the electricity arbitrage sector trades financial transmission rights contracts, or other financial instruments tied to power congestion such as Virtuals and UpTos, and prices are valued every day.

Inefficiencies are created as firms trade one destination point against another. "Electricity is an idiosyncratic market. The main players are supply and demand motivated so financial players can step in and take advantage of inefficiencies that have been created across the US electricity grid," Berger explains.

Shipping derivatives are similarly done through funds that invest in forward trade arrangements in the dry bulk cargo market, as profiled in last month's AlphaQ.

Berger says: "We believe that hedge funds should be complimentary to a portfolio in terms of producing a non-correlated source of alpha that is truly differentiated from beta exposure whether its equity beta, fixed income beta, or commodity beta. Unfortunately the majority of hedge funds fall short in this regard which, broadly speaking, have become a diluted proxy for the equity market. I wanted to create a product that produced a return stream that was truly uncorrelated to essentially anything else that's out there, including the hedge fund industry itself." ■

Debunking the myth

Private catastrophe bonds offer enhanced returns in the insurance linked securities market, writes James Williams.

Issuance in the catastrophe bond market during the second quarter of 2015 topped USD3.16 billion according to Artemis's quarterly Catastrophe Bond & ILS Market Report. On a year-to-date basis, that figure is USD4.4 billion, making it highly likely that total catastrophe bond (cat bond) and insurance-linked securities (ILS) risk will exceed the USD8.8 billion issued in 2014.

Cat bonds were developed in the 1990s as a way to help insurers and reinsurers transfer tail risk off their balance sheets in the form of bonds, which could then be bought and traded in the capital markets by global investors. Generally speaking, they pay a coupon of Libor plus a spread of between 3 and 20 per cent. The USD52.8 million Twelve Falcon Insurance Opportunities Fund – one of five cat bond funds managed by Twelve Capital, a leading insurance investment manager with approximately USD3.5 billion in assets under management, – last year returned 9.1 per cent.

"What's pleasing to us is that the market is opening up to private cat bonds and that's an area where we've been particularly active. We've invested in three such bonds in quarter two," confirms John Butler, Managing Partner and Head of Sourcing at Twelve Capital.

Publicly traded catastrophe bonds account for the vast majority of ILS transactions and offer non-correlated returns to traditional equities and bonds but the market has become crowded, making it harder to source well priced bonds.

It is the emergence of the private cat bond market, which is still a fledgling one (there were seven deals representing USD206 million of issuance in the second quarter), that is particularly exciting for ILS managers to source alpha.

"From our perspective, we've found that more traditional counterparties who wouldn't have previously been active in the ILS space have become interested in transacting in a private cat bond format.

"Because we have a cost-effective platform at Twelve Capital, we are able to structure the private cat bond on behalf of our end investors. It takes about ten days to put one of these together. The benefit to this is we can introduce our investors to more diverse risk through new counterparties who wouldn't ordinarily have had the chance to issue cat bonds on the public markets," explains Butler.

As their name suggests, cat bonds pay an annual premium to the investor throughout the bond's maturity. However, should the insurer be hit by a natural catastrophe, such as a hurricane or earthquake, once the losses on their portfolio of property insurance reach a certain limit the cat bond sponsor would be required to cover the insurer's claim.

Luca Albertini is CEO and CIO of Leadenhall Capital Partners LLP, a London-based ILS specialist investment manager. He notes that anticipated mark-to-market declines in the cat bond market in Q1 and Q2 pushed Leadenhall to offload part of its cat bond allocation, which has been partially reinvested in the 1 June and 1 July private placement of reinsurance risk.

"We expect ILS pricing to recover over the summer and our allocation will increase in the coming weeks," says Albertini. "Most new issuance has been well received and priced around the mid-point of the initial price guidance."

The reason for the sell-off in cat bonds during the first half of 2015 was a function of seasonality, as investors looked to free up cash ahead of 1 June reinsurance renewals. Price declines averaged in the high single digits.

Private reinsurance market

On the private ILS side, the potential market is growing. These are reinsurance contracts which offer many of the same benefits of publicly traded catastrophe bonds, but are non-tradable and typically only have a contract duration of six to 12 months. Private cat bonds fall into this

"We can introduce our investors to more diverse risk through new counterparties who wouldn't ordinarily have had the chance to issue cat bonds on the public markets."

John Butler, Twelve Capital

category, but at a broader level, the private ILS market includes other types of perils.

"We have been more active than others in terms of introducing other classes of insurance risk on the private side. We are generally active in the property, terrorism, fire, physical damage to the energy market and aviation arenas. What we don't get involved in are insurances linked to legal liability or life transactions," says Butler. "These private ILS transactions are mandate-based only for larger individual investors although we are in the process of developing a standalone fund. So far this year, we've structured around 50 private ILS transactions."

This rise in the private reinsurance market represents a threat of sorts to traditional reinsurers, who have long relied upon insurance companies to take out reinsurance contracts to diversify the risk in the underlying portfolios. As more deals take place in the private markets, it offers ILS specialists the ability to offer their investors enhanced yields; as is becoming the case in private cat bonds.

"Prices have become softer in the past year but interestingly, we're starting to see the beginnings of a price bottom, even a slight uptick in pricing for peak US wind perils. That has been a pleasing move and we've managed to exploit that in the private cat bonds that we've structured recently," confirms Butler.

Albertini sees a number of positive developments in the private reinsurance market following the 1 June reinsurance renewals.

- The price of business with heavy backing from capital markets capital has held or has even slightly increased or hardened compared to the 1 January renewals.
- Some of the most aggressive attempts to achieve double-digit price reductions have been met by solid market resistance.

"Most of the protection buyers came back in the last few days with improved pricing and in some cases struggled to complete."

Albertini believes there is a combination of reasons why they are seeing the above trends:

- Traditional reinsurers have shown a willingness to walk away at technical prices that no longer make sense in a traditional reinsurance pricing model.
- Over USD2 billion of additional reinsurance limit was purchased, which has helped satisfy market appetite for hurricane risk in Florida.
- The price decline in cat bonds and the AuM reductions of some of the large ILS players have signalled to the market a reduced overall capacity available for property business from the capital markets. This further supports the view that replacing further traditional capacity with capital markets capital was not a credible threat.
- Risk free yields in the bond market are trending upwards and are eroding interest in low yielding reinsurance opportunities.

"As such, we are positive about the developments seen in the private reinsurance market and have adjusted our portfolio weightings accordingly," confirms Albertini.

Private cat bonds: fertile ground?

Most of the private cat bonds being structured are in the USD20 million range with ILS managers looking to generate high single-digit yields. These instruments work such that the buyer of protection would need to take a hit before triggering the indemnity in the case of an abnormal severity of risk.

In other words, it would require a one in 75 or one in 100-year event to strike during the bond's maturity.

"We're looking to handle financial risks which can't be borne by the insurer's balance sheet; severity risk or extreme frequency risk. We screen counterparties carefully. We look at who has performed well over a period of time. Once we've established that there's an expression of interest, and the insurer includes Twelve Capital on their panel of reinsurers, the insurer will typically provide us with information on how the portfolio is protected. That will include exposure data, and granular detail on every building (for instance) protected by an insurance policy. It's then a case of applying soft factors on the specific counterparty in order to interpret the data they give you before it is modelled," says Butler, confirming that Twelve Capital has structured four such bonds so far this year.

There is no doubt that the private cat bond, and wider private ILS market, is likely to provide fertile ground for managers to demonstrate a clear alpha-generation edge over their competitors by targeting specific geographies or perils that wouldn't ordinarily come to the traditional public cat bond market.

"Private cat bonds are basically an interesting enhancer for investors who are already investing in publicly traded cat bond funds. Whereas the US market has long favoured the ILS asset class we are now starting to see more reception to the product globally, which is encouraging," adds Butler.

Private ILS reinsurance premiums are driven in part by supply and demand of capital and secondly, by the willingness of protection buyers to buy reinsurance protection from capital market parties as opposed to traditional reinsurers.

Following several years of large capital inflows, which have lowered price levels, Albertini says that prices are now showing signs of 'bottoming out' due to pushback from protection sellers.

"Brokers and reinsurers are now more concerned about losing or reducing quality players in their reinsurance panel and replacing them with lesser quality, more opportunistic players, as opposed to further lowering prices. Due to strong relationships with brokers and (re)insurers, Leadenhall has remained in a strong market position during this development and has managed to double its allocation success ratio. We expect this strength will remain an important factor in winning reinsurance allocations in 2016.

"We are positive about the developments seen in the private reinsurance market and have adjusted our portfolio weightings accordingly."

Luca Albertini, Leadenhall Capital Partners

"We may also consider increasing the allocation to cat bonds in the third quarter should market conditions point to a future improvement," confirms Albertini.

Asked whether there could be more private cat bond deals structured by Twelve Capital during the second half of the year, Butler responds: "We only consider investing a certain limited percentage of AuM of any one of our cat bond funds, dependent on investor appetite, in these private notes since they are relatively illiquid compared to public issuance.

"Whether or not we consider more transactions is really a factor of our seeing attractive opportunities which fit this appetite." ■

Added value

In the first of a two part series on unconventional alternatives, Marianne Scordel, Founder of Bougeville Consulting, looks at litigation funding.

One of the questions many of us working in financial services ask ourselves at one point or another is: "How does my work add value to society?"

Some readily find an answer to that question. However, for others, including investors facing a choice on how to deploy their assets, making sense and creating value may be the result of a quest: for the job, the product, or the approach that will fulfil a wider purpose, alongside the objective of generating financial returns.

In the following paragraphs and in our next article, we will explore two different ways in which some of our clients have raised – and at times answered – the question of 'values', understood as 'acting responsibly', to coincide with monetary targets, taking into account the broader stakeholders' community and with sustainability in mind.

The first of these two ways we will be talking about has to do with a specific product, rather than with an unconventional approach to a more traditional offering.

Litigation funding is not widely thought of as an asset class in itself, however this section of alternative investments has similarities with hedge funds and private equity funds. While the purpose is to generate a return, it has, at times, been encouraged as promoting a sense of justice.

Eve Ellis, a Partner at Mishcon de Reya, explains that Litigation Funding often takes the form of a self-managed offshore company, the purpose of which is to pay out the legal fees for the cases the fund, on advice from a litigation adviser, decides to back (or to "invest in"). Unlike hedge funds or private equity, these products are not financial instruments – and hence litigation advisers do not generally need to be regulated by the FCA. However one can easily draw a parallel between their risk profiles and investment strategies and those of "traditional" fund portfolios:

- Liquidity profile: these funds are typically illiquid, in the sense that one invests in a case and keeps funding it until the end, in the same way as a private equity manager might invest in a company they wish to turn around, knowing this might take a few years. In terms of hedge funds, this would be similar to a value, or an activist, investor, whose strategy is to extract the value of a company based on fundamentals, which, again, may take some time and does, at times, require having resort to court cases for the purpose of uncovering what's right, or fair (as in 'fair value').
- Unlike value investors though, those involved in choosing legal cases to invest in, will not

have control over the cases "during the life of the investment", for obvious reasons of independence. One could argue that this is healthy in terms of the relationship between this type of activity and civil society, in the sense that it supports rather than perverts its functioning and balance of powers. The flipside of this though is that as in distressed asset investing, the result of each case is dependent on 'the J factor', or the take a given judge may have on each given case. This is, to some extent, imponderable.

- Ellis also points out the fact that, as in venture capital, "a few cases do well, while others may not" – hence the need to take this into account when constructing a portfolio of cases. The payouts on a given case can be interesting. However, this is indeed a risky business, which may lead to some choices in terms of diversification or level of concentration.
- Finally, when asked the question – obvious for someone with experience in hedge funds – of whether the 'manager' of a litigation funding operation can sell his cases short, Rowena Herdman-Smith, also a Partner at Mishcon, says that this would effectively consist of funding the defence, and unless they have a counterclaim, defendants are not due any payment, other than probably their legal costs, if they succeed in defending the claim. No arbitrage between the two parties then (similar to what happens to the stock of two companies involved in an M&A, for instance), and no betting on a loser, which, in a hedge fund context, some might deem value creating rather than destroying. The latter point is controversial of course, but some 'faith based approaches', such as Islamic finance, incorporate those concerns when it comes to considering long/short strategies. This is the topic we will discuss next time: how religious endowments make their investment decisions to remain in line with the principles they advocate and values they believe in.

Litigation funding happens more or less formally – which is why total AuMs can't be easily quantified – and its development as a substantial and structural part of our industry may take a while. Herdman-Smith insists that she has seen cases where individuals could win cases against large companies. Some of these cases would never have been brought to justice, or would have lasted too long and been too intricate to have been sustained financially if it had not been for litigation funding. To paraphrase Keynes, the judiciary, as well as the market, can remain irrational longer than one can remain solvent. This is how long-sighted fund managers, as well as litigation "fund managers", can come in handy. ■

"Litigation funding happens more or less formally – which is why total AuMs can't be easily quantified – and its development as a substantial and structural part of our industry may take a while."

Marianne Scordel, Bougeville Consulting

Marianne Scordel is the Founder of Bougeville Consulting, which provides customised assistance to hedge fund managers setting up or effecting changes to their businesses. Over time, she has dealt with a variety of structures and strategies. Prior to setting up Bougeville, she worked for Nomura and Barclays Capital. She is an Alumna of St Antony's College, Oxford.

High yield in Asia

James Williams talks to firms who are trading Asian bonds to leverage a strong RMB.

Until recently, China's currency, the RMB, had appreciated some 20 per cent on the Euro since last year, allowing fund managers running Asia-focused fixed income strategies and hedging US dollar-denominated bonds back to the RMB to enjoy some strong performance.

Then, seemingly out of nowhere, on 10th August 2015 China's central bank, the PBOC, allowed the RMB to devalue by nearly 2 per cent against the US dollar in a bid to support its cooling economy and bolster exports, which fell 8.3 per cent in July. This is a sign that China's transition to an internal domestic consumption growth model might not be altogether smooth.

This is, in all likelihood, a temporary blip. The RMB is not about to tank. It is a short-term measure. And as such, Asia remains awash with opportunities, both in investment grade bonds and high yield bonds.

Most of the value this year has been in domestic Chinese dollar issues, according to Andy Seaman, Partner at Stratton Street Capital LLP. Seaman is the portfolio manager of Stratton Street's USD1.2 billion Renminbi Bond Fund, which launched in 2007.

"There's been a lot of issuance in the dollar space which has yielded opportunities in AA-rated credit in China. We've stuck to our positions in Russia, and the Middle East has also been a good performer in the portfolio," says Seaman.

The fund primarily invests in US dollar-denominated Asian bonds. China's domestic bond market is the third largest in the world at USD4 trillion yet it remains largely closed. China's authorities do not rush into anything.

Since 2010, they have been running a pilot test in Hong Kong in the form of an offshore CNH bond market; referred to as the Dim Sum bond market. Over the last few years, as China's domestic quota system (the RQFII system) has widened, the two markets have steadily converged.

The problem with the Dim Sum market, however, is that issue sizes remain small; a USD200 million issuance is considered large. This means that liquidity is thin. Seaman notes that the average size of bonds that Stratton Street looks for is USD1 billion. "In the near eight years that we've been running the fund, we've yet to find a single Dim Sum issuer that offers value," says Seaman.

Once the average issuance reaches USD500 million, the offshore CNH bond market will achieve greater liquidity, but in the long term, international investors want access to the domestic market, which is some 50 times bigger and offers higher yields.

The Chinese authorities will not open up the domestic market too quickly. With short rates at around 3 per cent for a AA-rated sovereign, the volume of inflows would be substantial. For now, international fund managers have to rely on being awarded an RQFII licence to access domestic Chinese bonds and equities.

One of the first to be granted such a licence was Ashmore Group, one of the UK's biggest emerging markets fund managers.

"There will come a tipping point when large international investors can get access to the size of deals they need, and then there will be a mad scramble, much like we've seen with Chinese equities," says Seaman, when discussing the opening up of China's bond market. "The authorities were much keener to open China's equities market. For a balanced fund, you'll normally go in to cash or bonds if you're selling equities but investors in Chinese equities do not yet have that option.

"It's all part of the process. It will come in due course, but who knows how long? We therefore trade largely US dollar-denominated bonds in Asia, which are hedged back into RMB. We've got a 4.5 per cent yield on our fund for a single A credit rating. When you hedge into RMB the interest rate differential does vary – anywhere between 2 and 3 per cent – so if you take 2.5 per cent as an average, that produces an aggregate 7 per cent yield for a pan-Asian investment grade portfolio. You can't get anything like that in investment grade Dim Sum issues, or even in the domestic market."

Another firm that is leveraging the performance boost of a strong RMB to trade Asian bonds is Hong Kong-based Income Partners, one of the pioneers of Asian fixed income trading. The firm has been running the Income Partners High Yield Bond since July 2011 and has achieved annualised returns of 10.33 per cent through April 2015.

This June, the strategy joined Nordea Asset Management's multi-boutique Nordea 1 SICAV.

Unlike Stratton Street, the trading strategy employed by Income Partners is to invest in Asian high yield bonds although they too invest in US dollar-denominated bonds which are then hedged to RMB. The strategy also invests into CNH-denominated Dim Sum high yield bonds, although these currently account for just 10 per cent of the portfolio.

"We believe it will continue its remarkable growth as the RMB itself continues to internationalise."

Shen Tan, Income Partners

"Going forward, the allocation between USD and CNH bonds depends on further development of the offshore CNH high yield bond market, and relative values between USD and CNH high yield bonds," explains Shen Tan, Managing Director at Income Partners. "As the Dim Sum bond market's high yield universe is still developing, we have decided to invest the majority of our assets in USD Asian HY bonds, a space dominated by Chinese issuers.

"The Dim Sum market has grown from zero to USD107 billion in five years, and we believe it will continue its remarkable growth as the RMB itself continues to internationalise and potentially becomes a reserve currency. However, the CNH bond market remains limited and we believe there is a lot of room for improvement."

Income Partners' methodology of investing in USD Asian HY bonds and hedging to CNH, has the benefit of additional carry. Theoretically, bonds issued by the same issuer should have equivalent yield across currencies, but in reality there is a disparity.

"When our fund's USD exposure is hedged to CNH by selling USD:CNH forward contracts, there is a positive carry of between 2 and 4 per cent that becomes another source of yield for our portfolio. This means, in CNH terms, that we get a higher yield for buying USD bonds hedged to CNH than buying the CNH bond directly issued by the same issuer," says Tan.

Seaman concurs on this point. He notes that the RMB has been one of the best performing currencies since 2007. "The simple premise is that countries that run current account surpluses see upward pressure on their exchange rate. We think over the long term the RMB can appreciate 2 to 3 per cent per annum. Add that to the carry you get of 2 to 3 per cent and you're looking at between 4 and 6 per cent returns just by owning the currency, let alone the bond returns," comments Seaman.

One particularly interesting area of alpha generation is that of "quasi-sovereign" bonds. These are corporates with close links to their governments, and in some cases, wholly owned by them.

"Across Asia the price of quasi sovereigns is interesting because they pay you more than the government owns them. For example, the 2041 dated AA-rated quasi-sovereign – International Petroleum Investment Company – trades in Abu Dhabi on a spread of 167 basis points," confirms Seaman.

These are USD1 billion-plus issues with deep liquidity. The team at Stratton Street will only invest in countries who have the strongest capabilities to pay back their debtors and whose debt:GDP levels are significantly lower. The problem with fixed income benchmarks is that they tend to be overweight the most heavily indebted nations and underweight the creditors such as China, Russia, Qatar; which incidentally are the top three weightings in Stratton Street's fund.

Within these nations, there are hundreds of mispriced bonds, including quasi sovereigns, and identifying what those mispriced opportunities are – all of which, remember, are investment

grade – is how Stratton Street is able to demonstrate its edge.

"All the countries in our portfolio are Asia's wealthiest countries: Turkey would qualify in the fund geographically but doesn't because of the high levels of indebtedness. Lending to wealthy countries on high yields is quite attractive in our view. So far we're up 7.3 per cent YTD (10.23 per cent annualised). Over a 12-month period the fund is up 7.48 per cent (through 24 July 2015)," confirms Seaman.

Over at Income Partners, the team employs a rigorous bottom-up credit selection process on a name-by-name basis rather than specific ratings. There is, says Tan, a limited amount of CCC-rated bonds in the Asian bond market. Most of the value lies within BB and B-rated bonds.

"The key is to detect valuable names with upgrade potential and get out of deteriorating credits earlier than others through fundamental analysis," says Tan.

This was evidenced in a position the fund held in Kaisa Group, a BB-rated Chinese property developer (8.875 per cent paper due 2018).

"In early October 2014, when another Chinese property developer, Agile Property's Chairman was involved in an anti-corruption related investigation we made the call to underweight the sector, as we sensed that there was a potential contagion risk for the whole Chinese real estate sector. That December, the first negative news about Kaisa emerged when China's Shenzhen local government blocked all of Kaisa's projects for sale. We made a call to cut the rest of our position to prevent further losses," says Tan.

The bond dropped to as low as 35 cents on the dollar in January 2015 and eventually defaulted on the coupon payment for its USD bonds.

This then, was a trade that Income Partners realised early on could run into trouble. The fact that it exited early to prevent further losses is an example of how active fund

"Without a stronger RMB, global imbalances have little chance of being corrected."

Andy Seaman, Stratton Street Capital

management is not only about shooting out the lights; it's also about taking proactive steps to limit the downside.

Still, Tan thinks that there is value in China' real estate sector based on fundamentals and valuations.

"From a relative value perspective, for the same credit rating, Chinese real estate names offer more attractive yields than names in other sectors and countries. China's stable currency policy will also make Chinese credits less volatile on further dollar strengthening and potential Fed hikes than credits from other EM countries," says Tan.

Being on the ground and having extensive knowledge of Asian issuers is clearly a benefit to fund managers like Income Partners. Its database contains every HY bond issued in the region, which the firm has built up over its 22-year history. In 2009, it set up a Beijing office in anticipation that Chinese issuers would issue CNH bonds in Hong Kong and as Tan points out: "The combination of understanding the Asian bond market as well as Chinese credits/bonds, being the first to launch a CNH bond fund in 2010, and having run an Asian bond fund since 1993 gives us an edge in understanding the market's dynamics."

From an investor's perspective, while the double boost of attractive yields and currency appreciation in Asian investment grade and HY bonds is compelling, like any investment there are associated risks. Historically, Asian HY bonds have a lower default record compared to western HY markets, but there are liquidity, political and currency risks that need to be navigated.

With respect to liquidity, Tan says that they monitor bid-ask spreads from multiple dealers, and portfolio beta in market downturns. 'Fair weather' brokers are avoided to ensure that Income Partners can trade, even in stressed environments.

"With respect to currency risk, we will reduce CNH exposure if we expect the CNH to depreciate against the USD, and vice versa. We also adjust the tenor of our USD:CNH forward hedging to maximise the benefit from positive carry.

"In addition, we maintain a high level of diversification with strict concentration limits on country exposures (along with sector and issuer credit) to minimise risk brought on by any country's political instability," says Tan in conclusion.

At a time when the hunt for fixed income yield is more pronounced than ever, Asia clearly remains a treasure trove of possibilities. But it's not without its risks. As we've seen recently, the decision by China to devalue the RMB caught everyone by surprise.

In Seaman's view, this is a one-off adjustment designed to make the currency more market driven, which will bolster chances of the RMB being included in the SDR basket later this year.

"Fundamentally, with a current account surplus, and growth much stronger than in the rest of the world there is no justification for persistent RMB weakness. Without a stronger RMB, global imbalances have little chance of being corrected," offers Seaman in conclusion. ■

The new reformation

Robert White, partner, Oldfield Partners, examines corporate governance, shareholder return and the unlocking of Japanese value.

The attitude to investor returns and capital efficiency in Japan appears to have changed significantly in the last 12 months. Over the years there have been periods in which company managements have talked about raising dividend yields or targeting higher Return on Equity (ROE), but these objectives have either not materialised or been short lived. However, there are a number of reasons why we think that the current positive corporate trends in these areas should be more sustainable.

The Ito Review by the Ministry of Economy, Trade and Industry (METI), highlighted, *inter alia*, the low ROE of Japanese companies compared to those in other markets; and the creation of the new JPX Nikkei 400 index last year, which was launched in response to that report, and which evaluates, among other factors, ROE and shareholder return as important measures of selecting companies for inclusion in that index.

By way of background, it is important to remember that following the bursting of the 1980s' property and stock-market bubble, management efforts focused on repairing balance sheets burdened by high levels of debt. After the 2008 global financial crisis and in an environment of a punishingly strong yen, cash flow was allocated to the transfer of production facilities overseas and aggressive cost cutting was undertaken as a means of coping with international competition. With the election of Prime Minister Abe in late 2012 and the announcement of his 'Three Arrows Policy' for revitalising the Japanese economy, things changed.

The strength of the yen reversed rapidly and forced companies to reassess their priorities in terms of overseas production and capital expenditure. Whereas previously the focus had been on building new facilities overseas to be nearer to end markets and in order to reduce costs, managements have begun to look at renewing domestic production lines, many of which are decades old. In the past, change at Japanese companies often came about as the result of difficult operating conditions, but it seems that this time the pressure is of a different type.

Abe and his government are aiming to reform the corporate landscape of Japan in order to raise economic growth not just through a looser monetary policy (the 'First Arrow'), but through fiscal reforms (the 'Second Arrow') and regulatory change (the 'Third Arrow'). In this way, they are intent on raising the efficiency of domestic companies in order to spur corporate returns, thereby raising tax revenues and so helping the reduction of the fiscal deficit.

Moreover, it is clear that Abe is serious about corporate governance reform as a means of achieving improved shareholder returns for pension providers, thus placing less of a strain on welfare budgets. In this regard, the interests of everyone (government, investors and companies) are more closely aligned than in the past and, importantly, responsibility for much of this change has moved from METI to the Financial Services Authority, which has a much clearer focus on the interests of investors.

Key to the change in corporate governance has been three initiatives that are changing the attitudes of Japanese management, either directly or indirectly. This is happening through pressure applied by shareholders, most notably domestic institutions that have generally in the past taken a passive attitude to exercising their fiduciary duty to vote at company meetings and challenging managements on their policies.

The first of those initiatives was Japan's Stewardship Code which was drawn up in February 2014. As of the end of February 2015, 184 institutional investors and pension funds had signed up to that code, including the largest, the Government Pension and Investment Fund (GPIF). Both the Code and the involvement of the GPIF have had a major influence in changing investor attitudes in a number of areas, including raising significantly the percentage of assets that are committed to equities, as well as the use of voting power to effect corporate change.

Secondly, ISS (a leading global provider of corporate governance and proxy advice) in its Proxy Guidelines for 2015, which were issued in November 2014, introduced a benchmark for ROE. ISS recommended voting against the top executives of companies posting an ROE of less than 5 per cent in each of the previous five fiscal years or where managements could not show a clear strategy for improving lower returns.

"We recognise that the improvement is likely to happen slowly."

Robert White, Oldfield Partners

The third key factor has been the introduction of a new Corporate Governance Code (the Code), which came into effect on 1 June, 2015. The main aim of the Code is to stimulate 'growth-oriented governance' with particular emphasis on improving profitability and capital efficiency. It is expected to have a significant impact on Japanese companies in the following three areas: disclosure of ROE targets; increasing the number of outside directors and enhancing their authority; and the unwinding of cross-shareholdings, as well as the possible eventual removal of holdings by parent companies in listed subsidiaries.

Inevitably, the impact of these guidelines and regulations should mean a significantly improved landscape for the investor in Japanese equities as capital efficiency is improved, excessive cash balances reduced, cross-shareholdings unwound and under-utilised assets either developed or disposed of. One example of a change in attitude to investor returns came earlier this year from robotics company Fanuc, which announced a surprisingly big increase in its dividend, a large share buy-back and the cancellation of treasury shares. This was a significant change from their previous stance.

We recognise that the improvement is likely to happen slowly. Change tends to take time in Japan, but when a strong consensus has built, as seems to be happening now with regard to shareholder returns and capital allocation, it tends to endure. It seems unlikely that the large number of companies that are increasing the percentage of independent outside directors on their boards will reverse that trend in future; and that companies such as industrial machinery group Hitachi and automobile parts company Denso, both of which have global businesses and which have added foreign external directors, will return to the previous wholly domestic structure.

It has been interesting for us how in our meetings with Japanese company managements this year, their focus has changed slightly away from shareholder return and corporate governance, towards greater balance sheet efficiency. In particular, since the introduction of the Code there has been a greater willingness on the part of company representatives to give a clearer explanation of their reasons for holdings of listed equities- interesting progress. Recent discussions with general trading company Mitsubishi Corp, for example, have highlighted the group's intention to rationalise their equity holdings, as well as focusing on share buy backs and dividend increases.

There is enormous scope for change and we continue to research carefully those companies with promising businesses, which also have strong balance sheets that can be streamlined to provide better shareholder returns and we are looking also at the scope for the unwinding of operationally unimportant equity holdings and other un-utilised assets as another means of achieving improved capital efficiency. ■

The infrastructure platform

James Williams reports that the Pensions Infrastructure Platform (PiP) has reached GBP1 billion in commitments.

The UK government's national infrastructure plan details GBP466 billion of investment needed over the next five years. For UK institutional investors, this presents a significant opportunity to invest in core infrastructure projects such as HS2 – the high-speed rail link which will account for GBP16 billion of the government's GBP70 billion transport spend by 2021. The de-carbonisation of the energy industry will also require significant investment.

Unfortunately, many UK pension plans lack the scale and resources needed to invest directly in this asset class. To address this issue, the National Association of Pension Funds (NAPF) established the Pensions Infrastructure Platform (PiP) at the end of 2011.

By signing a Memorandum of Understanding with HM Treasury and the Pension Protection Fund, the ultimate objective for PiP is to become the go-to investment platform to help UK pension schemes invest in infrastructure projects.

So far, that objective appears to be well on track as, a few weeks ago, PiP announced that it had secured over GBP1 billion of commitments.

"Back in 2011, Canadian and Australian pension funds were coming over and buying UK infrastructure, but UK pension funds weren't doing that much," says Michael Weston, chief executive of PiP. "The feeling was: 'Wouldn't it be a good idea for UK pension funds to more actively allocate to this asset class given that long-term core infrastructure is low risk and an effective substitute for UK index-linked gilts?'"

The first phase in the platform's development – which, along with NAPF, has nine other UK pension plans supporting the initiative – was to work with external fund managers to set up a series of funds as per PiP's specific criteria;

Key features of the PiP

- Target size of GBP2 billion
- Low fees: 50bps
- Low risk: PiP is expected to invest at the low-risk end of the infrastructure asset spectrum
- Long-term cash returns of RPI+2-5 per cent (i.e. as a liability match)
- No minimum commitment – open to all pension schemes
- Profits will be reinvested for the benefit of all PiP investors

"The focus right now is to establish PiP as a direct investor in UK infrastructure assets and build the team to do that."

Michael Weston, PiP

namely, brownfield infrastructure projects with a 20-25 year time horizon, and inflation-linked cash flows and a 50 basis point annual fee. The first fund was the Dalmore PPP Equity PiP Fund, which closed in February 2014 with approximately GBP510 million.

A second fund, Aviva Investors PiP Solar Photovoltaics (PV) Fund, has raised GBP132 million, whilst some of PiP's founding investors have co-invested GBP380 million in a GBP440 million fund to invest in the Thames Tideway Tunnel (TTT) project, with Dalmore Capital acting as a core member of the winning consortium.

"We raised assets among a group of 11 UK and European investors specifically for this project," says Michael Ryan, CEO of Dalmore Capital. "Many might have expected the project to be acquired by overseas sovereign wealth funds or the big core infrastructure funds. We see this project as a major step forward in demonstrating the capacity of pension funds to take part in complex infrastructure projects."

Ryan says that the objective of the PPP Fund is to invest in long-term, low-risk investments with inflation correlation, confirming that "at least 85 per cent of the investments must be in operational UK PPP". PPP stands for "public private partnership" and is the most common model used by governments to finance national infrastructure projects.

"These assets are yielding and offer low volatility as the income streams are predominantly based on availability of the asset rather than usage or demand," confirms Ryan.

The second phase of evolution for PiP is to become an investment manager in its own right, thus allowing it to become a consortium member and effectively get one step closer to the action. Once PiP becomes an FCA-authorised AIFM, it will be able to invest directly on behalf of the ten supporting pension schemes.

"The focus right now is to establish PiP as a direct investor in UK infrastructure assets and build the team to do that. We expect, ultimately, to have a team of ten to 15 people in place to become an efficient and credible investor in UK infrastructure. One of the new hires will be COO and head of risk, and one will be Investment Director who will run the origination and execution side of things. We will then recruit resources as and when we need them in terms of raising capital and being involved in direct deals," explains Weston.

Once authorised, the PiP team will aim to roll out its first internally managed fund: the PiP Multi-Strategy Infrastructure Fund.

Weston says that this will initially be supported by PiP's founding pension plans, who will commit enough capital to take the fund to first close.

"At that point, we will then start to acquire real assets directly and talk to other UK pension schemes about joining and committing capital to the Fund. It will be the same long-term low risk buy-and-hold strategy into UK infrastructure projects, with a targeted annualised return of 2 to 5 per cent, no performance fees, no carried interest and a 50 basis point annual cost," confirms Weston.

Now that PiP has reached GBP1 billion in commitments, the next milestone will be to raise another GBP1 billion to manage internally. According to Weston, the platform's philosophy, going forward, is to ensure that the revenue generated from asset management covers operating costs, and all necessary regulatory capital requirements.

"Any additional surplus capital will be given back to our investors through lower ongoing management fees. PiP has been created for UK pension schemes, directed by UK pension schemes and will be operated such that they derive most of the benefits of investing in this asset class as economically as possible," confirms Weston.

The founding pension schemes were very clear that they didn't want to create a fund of funds vehicle with PiP. The fact that Dalmore and Aviva are on the platform is merely a stage in the development process.

The platform's priority will be to make direct asset acquisitions for the PiP Multi-Strategy Infrastructure Fund, as well as engage in co-investment schemes with other asset managers. "We will only look to bring on additional external managers where we feel that that is the best way to access niche areas of the market," adds Weston.

With two thirds of the Dalmore PPP Equity PiP Fund's capital now committed to investments, Ryan states there is "good deal flow" in operational PPP to allow the remainder of the fund to be invested.

"In the longer term, there will be continued deal flow in operational PPP but probably at a reduced volume as there has been a transition of ownership from short-term investors to long-term investors such as pension funds. Dalmore believes that the yield and overall investment returns of operational PPP are compelling given the risk and investment characteristics of such investments," concludes Ryan. ■

New market

Advent's Jad Fares explains Saudi's new market initiative will take its time evolving.

June saw Saudi Arabia's Tadawul stock market open to qualified foreign investors (QFI) for the first time in a bid to increase the involvement of international investors on the Exchange. The Exchange says that overall stability of the market over the medium term is expected to increase with the introduction, in a measured manner, of direct investment by foreign institutions. This will come alongside moves to encourage a rebalancing of current stock market participants from individual investors – who account for approximately 34 per cent of market ownership and 90 per cent of monthly trading activity – to institutional investors.

Jad Fares, Regional Sales Manager, Advent Software comments that in this most traditional of countries, the long wait is over but there have so far been no dramatic changes. "Saudi Arabia likes to take its time to move and make change," he says, "while the markets are open, whoever was stepping into Saudi Arabia continues to do so today but with a more accessible market it will take some time for a very big change to appear."

Saudi Arabia has the largest stock market in the Middle East, with a market capitalisation of USD570 billion, and it enjoys strong performance with the Saudi Arabia All-Share index, the TASI, up 15 per cent since the start of 2015, outperforming the MSCI emerging markets index, which is up 2.4 per cent over the same period.

Inflows could also see a further massive hike if the market's opening results in an upgrade from frontier status to inclusion in the MSCI emerging markets index, as has been widely predicted.

"Opening the gates to direct foreign investment – even though certain limitations will still apply – is expected to lead to a surge of inflows."

Jad Fares, Advent Software

Fares says: "Things are going to be different now as people get access to more diversified areas of the market across the board and all companies."

Advent has been operating in Saudi for some years, giving it a footprint that no other asset management solution provider has, and signed up the largest bank this year and five asset managers last year.

"Until now, foreign investors have been restricted to indirect ownership of Saudi stocks through exchange-traded funds and swap agreements with authorised intermediaries," Fares says. "But as long-time operatives in the region, we've seen significant pent up demand for more. No surprise then that opening the gates to direct foreign investment – even though certain limitations will still apply – is expected to lead to a surge of inflows."

The Tadawul has strong liquidity and despite its oil dependence and the impact of plunging oil prices, the country also boasts strong corporates and enormous fiscal reserves that the government can draw on to sustain economic growth, Fares says.

"For asset managers, the anticipated capital inflows and allocations offer mouth-watering opportunities. But not everyone's boat will float on the rising tide."

Fares warns that foreign investors bring strict due diligence requirements and high service standard expectations which will put pressure on firms' existing operational platforms. "For instance, expanding the available distribution channels may help investment funds reach a wider audience – but only if you can compete effectively against rival funds, and satisfy distributors' operational and performance due diligence requirements."

Using independent custodians requires automated interfaces and reconciliation tools to efficiently exchange and reconcile the data flows. "Promoting the Sukuk and debt markets means funds will need sophisticated trading and portfolio management systems able to support multiple instrument types," Fares says. "Meanwhile, enhancing investor protection – with its heightened focus on regulatory compliance and disclosure – increases the onus on robust data collection, management and reporting capabilities." ■

Checking the strategies

Do all alternatives behave as alternatives during a market crisis, asks James Williams.

When it comes to investment management, investors want to know which strategies perform best during bear markets, just as much as they want to know those that lead the way in a roaring bull market.

To convey this, RCM Alternatives recently produced an interesting infographic to detail which strategies held up the best (and worst) during five crisis periods over the last 20 years. Fourteen strategies were considered: seven traditional (equities, bonds, REITs) and seven alternatives (hedge funds, commodities etc,).

The five crisis periods included:

- 1994 surprise US Federal Reserve rate hike;
- Implosion of Long Term Capital Management;
- Burst of the Dot com bubble;
- 9/11 tragedy;
- Global credit crash.

This has been one of the longest, biggest bull markets in the history of US equities. Not only that, but the US bond market has been going north for 30 years straight. What this infographic attempts to do is show investors which strategies have performed well in different periods of stress, so that they can

"What seems like diversification during good times can become highly correlated during a market crisis ."

Jeff Malec, RCM Alternatives

prepare themselves for when the inevitable bear market returns.

"One objective was to help wealth advisors and their clients start having the right conversation about diversification and protecting the downside," says Jeff Malec, a partner and managing director of RCM Alternatives. "We kept hearing of so called 'Alternative Investments' in things like commodities, hedge funds and gold, and really wanted to illustrate that some of those aren't all that alternative during times of stock market stress."

Indeed, if one uses the bursting of the Internet bubble at the start of the century as an example, RCM Alternatives' research finds that international stocks recorded losses of -46.53 per cent during 2000 and 2002.

Yet at the same time, long/short equity hedge funds lost -14.59 per cent while commodities lost -12.10 per cent. The real "alternatives" during that period proved to be global macro and managed futures, making gains of 44 per cent and 21 per cent respectively.

"Also, in 2008, we saw hedge funds and real estate down right alongside the stock market. The clear stand out was managed futures, which showed a tendency to act very differently during such periods," notes Malec.

The infographic is packed with figures. Of particular interest is that if one considers the median performance of all 14 strategies during the five crisis periods, long/short equities have averaged double-digit losses; -10.89 per cent to be precise. That, says Malec, was the "most surprising statistic. For most investors' 'go-to' alternative investment strategy, that's not a great number."

Small-cap stocks are the worst performers, which is perhaps not surprising. What is clear, is that for investors who want the most effective hedging against major market dislocations, managed futures are an order of magnitude better than any other strategy, proving just how important this strategy can be over the long-term.

The findings show that managed futures returned an average of 14.34 per cent over the five crisis periods, the next best strategy being global macro, returning 1.17 per cent.

But as Malec comments: "We think it's important that people think about their investment portfolios holistically and that no single asset class – traditional or alternative – is a panacea in any market. Furthermore, we think the tendency for many asset classes to fall together in a crisis is an important message. What seems like diversification during good times can become highly correlated during a market crisis as return drivers such as access to credit, a growing economy, and others, are seen stretching across asset classes."

One of the key takeaways, in Malec's opinion, is that long-only commodity investing is not only the worst performing but also the most volatile strategy in the marketplace.

"I think another key takeaway should be that despite being correlated and falling in tandem, hedge funds and private equity did better on a risk adjusted basis; making them candidates for replacing stock market exposure – not just diversification. Finally, it's worth noting that managed futures held up across the whole period. This shows that they aren't just a pure hedge, designed to perform during a crisis whilst costing money the rest of the time. They can stand on their own, even when there isn't a crisis," concludes Malec. ■

To refer to the infographic in full, please click on the following link: http://managed-futures-blog.attaincapital.com/2015/07/07/infographic-7-traditional-vs-7-alternative-assets-in-5-bear-markets/

Looking for alpha in Vietnam

Vietnam's stockmarket prepares to raise foreign ownership limits, reports James Williams.

As of September 2015, overseas investors will be able to hold a 100 per cent stake in certain industries in Vietnam. This development comes on the back of a recent imprimatur by the Vietnamese government to raise the limit from its current level of 49 per cent, and is a sign that the communist-ruled country is prepared to further open up its capital markets. However, in sectors of national interest, such as banks, certain limits will remain in place for now.

By opening up its markets, attracting more institutional inflows – which total USD243 million through July 2015 compared to USD280 million for the first half of 2014 – and deepening the liquidity pool, Vietnam hopes to satisfy MSCI Inc's criteria and receive an upgrade in status from frontier market to emerging market.

One fund management company that welcomes the decision is Ho Chi Minh City-based Saigon Asset Management, which runs the Cayman-domiciled Vietnam Equity Holdings fund. Since its inception in 2007, the fund has returned 62 per cent (in EUR) by running an equity long strategy that takes a bottom-up fundamental approach to selecting small- and mid-cap stocks.

"Given that we are based here on the ground, the relaxation of foreign ownership limits are welcomed as they should increase market cap, liquidity, constituents, each creating a wealth of opportunities across small-, mid- and large-caps, with locally based overseas-domiciled funds best placed to identify value early ahead of other foreign investors that lack a local presence," comments Steve Mantle, Investor Relations, Saigon Asset Management.

Much like China, Vietnam's authorities take a slow and steady approach to market reform. The government has its own targets (292 to be precise) for 2015, regarding the equitisation of state-owned companies; that number, YTD, is just 40. Indeed, the number of listed companies has grown by just 5 per cent in the last four years.

One of the reasons for the apparent tardiness, and lack of success, of public listings, is the shallow depth of liquidity in Vietnam's stock market. Average daily volumes on the VN Index have grown to USD100 million but back in 2013 they were just USD40-45 million.

Hopefully, the decision to raise foreign ownership limits will act as a catalyst for private companies to use public markets to raise equity: as foreign investors allocate more capital, market volatility will dampen down and increase liquidity, further encouraging more private companies to IPO in what could, potentially, become a virtuous circle. Mantle certainly believes it will benefit the VEH fund.

"The companies we invest in are often undervalued as they don't have or have only little sell-side analyst coverage from securities firms. It is up to funds to sniff them out and run valuation models, it isn't as widely covered as some bigger markets," says Mantle, who refers to a couple of the fund's recent winning trades:

- Dien Quang Joint Stock Company (DQC): one of the country's top three lamp manufacturers, the fund bought in August 2013 and exited in April 2015 with a gross return (including dividends) of 169 per cent.
- OPC Pharmaceutical: the fund entered a trade in November 2011 and exited in April 2014, making a gross return (including dividends) of 119 per cent.

Once publicly listed companies reach the 49 per cent foreign ownership limit, which has been in place since 2006, these stocks trade off market with premiums of anything between 7 and 20 per cent.

Fund managers who know which stocks represent value and growth opportunities – and which stand a good chance of reaching the 49 per cent threshold – have the ability to steer a twin-turbo alpha generation engine.

"We've been able to pick companies and allocate to them at an early stage, when their FO has still been relatively small, thereby getting ahead of other funds that operate in this market.

It's about being able to identify these opportunities early on and benefiting from the premiums at the point of divestment – that's the skill set; the alpha component. We're getting both share price appreciation plus the premium on top," explains Mantle, adding: "Even when the FO limits are removed in September, it will still provide plenty of opportunities for actively managed funds like ours on a more open and hopefully bigger market."

One example is FPT, Vietnam's leading technology company which VEH started buying in April 2009 when foreign ownership stood at 28 per cent. The share price has increased 2.6x and the fund has made strategic divestments including premiums of up to 16 per cent.

The premiums that arise when stocks are traded off market lead to reported P/E ratios being slightly artificial; a form of price arbitrage whereby the P/E ratio for the listed stock differs slightly when the foreign ownership stake is factored in, partly explaining why Vietnam's average P/E of 13 is considerably lower than ratios of 17 in Indonesia, 19 in Thailand and 23 in the Philippines.

"The relaxation of foreign ownership limits are welcomed."

Steve Mantle, Saigon Asset Management

FPT is one of the most sought after stocks. It is trading at Vietnam Dong (VND) 47k (about USD2.15) with earnings per share (EPS) at 4.3k and a P/E ratio of 10.9. The local representation caused by FOL, and the reluctance of these retail investors to pay the same price as foreign institutional investors, restricts open market prices. Due to the premium, the price when traded off-market could be, say VND53k, which relative to EPS produces a P/E ratio closer to 12.3.

This is what leads to higher premiums when companies reach their FO limits and move off exchange. Currently, there are some 30 companies within Vietnam who have reached the 49 per cent limit.

Analysts expect consumer stocks such as Vietnam Dairy Products JSC to benefit from the 100 per cent ownership rules come September.

Managers thrive on volatility. It's where they demonstrate their edge, their skill. And in that sense, Vietnam is no different. Much of the volatility there is due to the fact that it is dominated by retail investors with shorter-term investment horizons; they typically account for 80 to 90 per cent of daily trade flow. Far from being perturbed by the expectations of more institutional money flowing into Vietnam's market, Mantle welcomes the prospect of increased competition.

"Extra liquidity and increased overseas participation in particular will provide great opportunities for our locally based investment team to achieve further market outperformance," says Mantle.

To give some idea of the volatility, the VN Index last year finished up 8.1 per cent. 2014 was one of just four years in the last 11 where the index didn't grow more than 17 per cent. Last September, it was trading at 641, up 27 per cent YTD. By December, the index had fallen to 518, largely due to the then heavy weighting of commodity stocks. It has since recovered, and is up 11 per cent on a YTD basis (608 at the time of writing). But Mantle doesn't expect the same thing to happen again.

"If the removal of foreign ownership limits and wider capital market reforms are implemented effectively, the index has the potential to reach over 700 in the initial period following this. There is also the added spice of the Trans-Pacific Partnership (TPP), where Vietnam is expected to be the big winner, plus Asian (RCEP) and EU free-trade agreements reaching advanced talks. A very conservative estimate would be a minimum of 670 by year end, which given the market was hovering around 630 throughout July, would imply that the effects of the FO removal have been priced in early.

"If Vietnam is included in the MSCI Emerging Markets Index, the valuation gap to other ASEAN stock markets will be closed or at least reduced substantially meaning that the market could rally 30 to 50 per cent," adds Mantle in conclusion. ■

Past performance indicators

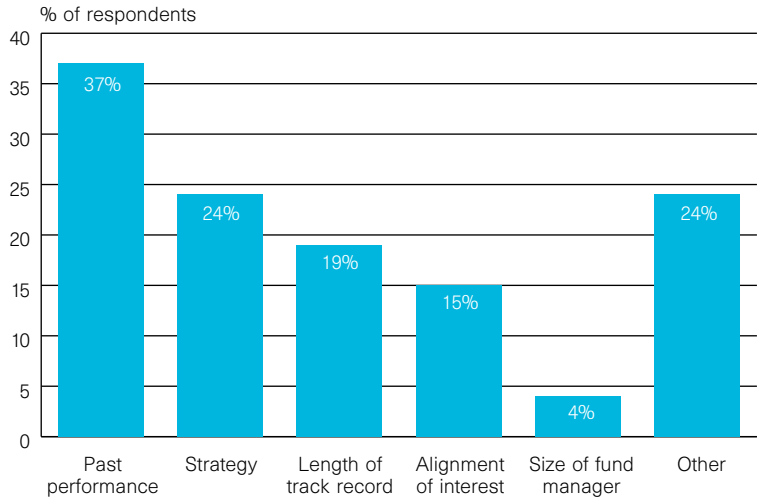
In this issue's Preqin Perspective, the firm looks at the performance of sector-specific vs. generalist buyout funds.

One of the main attractions of private equity for investors is the potential for outperformance over public equities over the longer term and the prospect of high yields. Offering insight into the sentiment of the LP community, Preqin's latest global study of LPs revealed that 37 per cent of investors surveyed indicated that a GP's past performance is the most important factor assessed when looking to partner with a new private equity fund manager (Fig. 1).

Looking at Preqin's performance database to compare the horizon IRRs of public indices, private equity and, more specifically, buyout and venture capital, as shown in Fig. 2, over the ten year period to June 2014, buyout and private equity as a whole outperform all listed indices shown by a significant margin, with buyout posting annualised returns of 21 per cent, compared to 7 per cent for the S&P 500.

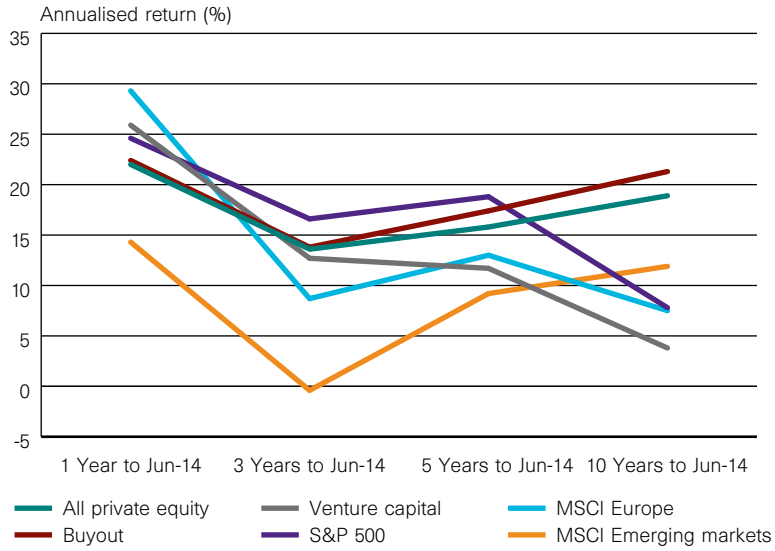
Fundraising data shows that the majority of buyout funds through the years have been diversified in investment focus, both in terms of the number of funds raised and the aggregate capital secured. Yet for many investors, a manager's ability to demonstrate deep expertise in a focused field is a key differentiator, with the belief that a deep knowledge of specific industries will lead to more well-informed investment decisions. Is there a difference between the performance of funds that are diversified and those that specifically target investments in one sector?

Figure 1: Most important factors LPs take into account when looking for a new private equity fund manager



Source: Preqin

Figure 2: Private equity horizon IRRs vs. public indices (as of 30 June 2014)

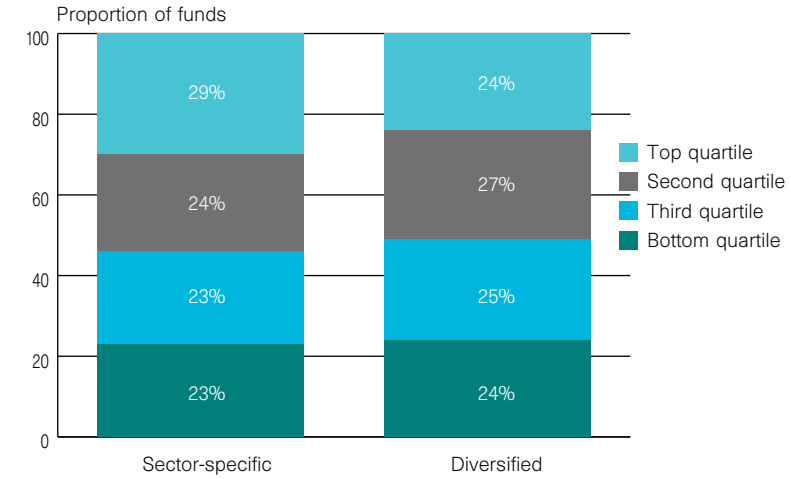


Source: Preqin

Top-quartile performers

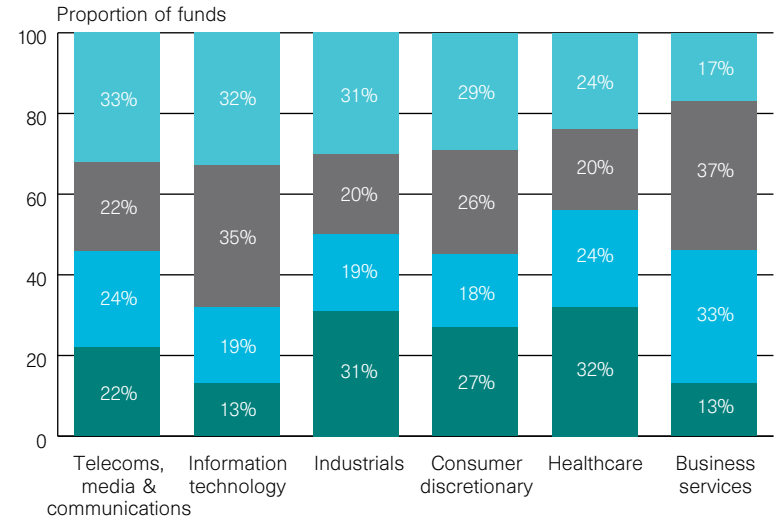
Using Preqin's performance metrics for 1,552 buyout funds, with vintages ranging from 1982 to 2012, we can compare the performance of sector-specific and diversified funds (Fig. 3). What instantly stands out is the greater proportion of sector-specific funds that rank as

Figure 3: Performance quartile breakdown of sector-specific buyout funds vs. diversified buyout funds



Source: Preqin

Figure 4: Performance quartile breakdown of sector-specific buyout funds



Source: Preqin

top-quartile performers: 29 per cent compared to 24 per cent of diversified buyout funds. While no guarantee of future performance, this analysis shows that those fund managers that exclusively target one industry have historically been more likely to achieve top-quartile returns.

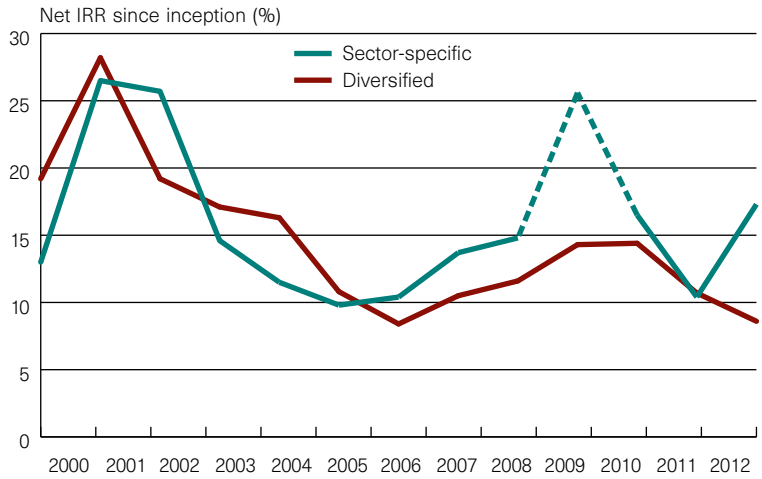
Variable performance within sectors

However, returns can also range quite significantly within individual industries. Fig. 4 illustrates the mixed fortunes of sector-specific funds, with some industries attaining excellent track records as significant proportions of funds become top performers and/or see only a small minority of funds falling into the bottom quartile. The most remarkable of the industries shown, in terms of relative levels of success, are the telecoms, media and communications (TMC), and information technology (IT) sectors. A third of vehicles exclusively focused on the TMC sector, and a similar proportion (32 per cent) of solely IT-focused funds, qualify as top-quartile performers. Only 13 per cent of buyout funds focused solely on investing in the IT industry became bottom-quartile funds – a significantly smaller proportion than that of all other sectors shown in Fig. 4, with the exception of buyout funds targeting business services.

The last decade has been an age of consumer-led technological change, with astronomic growth in the use of smartphones, tablets and mobile apps. Technological innovation in conjunction with economic and social trends across the world has driven this change, leading to a wealth of private equity investment opportunities. Rapid rates of infrastructure development, especially in emerging market regions, burgeoning middle-class populations and increased levels of disposable income are all factors that will have contributed to the continued flow of capital into the consumer market and heightened the appetite for advances in the TMC and IT sectors.

Conversely, almost a third (32 per cent) of buyout funds exclusively focused on the healthcare industry rank as bottom-quartile performers. The healthcare sector has traditionally been associated with innovation and significant growth, encompassing several sub-industries including pharmaceuticals, medical devices, hospitals, biotechnology and

Figure 5: Median net IRR by vintage year and industry strategy



Source: Preqin

more. Investments in the industry often serve as defensive holdings in bear markets owing to the constant global demand for healthcare services, but Preqin's data highlights the range in quartile rankings of healthcare-focused buyout funds and therefore the importance of fund selection for investors.

Median IRR comparisons

The median net IRR chart (Fig. 5) shows the performance of buyout funds by vintage year and highlights the extent of the discrepancy between diversified and sector-specific vehicles over time. For earlier vintages, diversified funds showed a higher median net IRR; however, in 2005 the trend reversed. In certain years, the difference is quite significant: for vintage 2009, diversified funds had a median net IRR of 14.3 per cent compared with 25.6 per cent for sector-specific vehicles. However, it is worth noting that the spike in the chart for vintage 2009 sector-specific funds comprises data points for just four vehicles compared with 48 diversified funds for the same year. All four of these sector-specific funds achieved top-quartile returns when compared to buyout funds of the same vintage and geographic focus, with individual net IRRs ranging from 24.0 per cent to 41.5 per cent.

Preqin's latest data for vintage 2012 funds shows that the difference between the two fund categories is considerable, and despite the gap narrowing in the years in between, sector-specific buyout funds appear to maintain the edge in terms of performance.

Outlook

Statistics for the current buyout fundraising landscape reveal the continued bias for diversified funds. There are currently 277 funds seeking $202bn in aggregate capital; in terms of the split between sector-specific funds and those funds diversified in industry approach, only 39 per cent of buyout vehicles will invest exclusively in one industry, accounting for just over a quarter (26 per cent) of all capital sought.

Another method of targeting specific industry sectors is via customised investment products; separate account vehicles have become increasingly prominent in recent years as the private equity asset class evolves and LP appetite for these structures increases. This year, an INR 60mn fund of funds focused on the agro-industry was established under India-based firm SIDBI, and New Jersey Division of Investment committed $150mn in the NJ/HitecVision co-investment vehicle, which explores opportunities in the oil & gas industry. Hewlett Packard Ventures is another example of a vintage 2015 fund exclusively targeting one sector; the $500mn separate account provides expansion-stage capital to technology start-ups.

Preqin's database shows that for the majority of LPs currently looking to make a commitment to new private equity vehicles, a diversified industry approach is on the agenda. Among the 18 per cent that are specifically looking at just one sector, there are a handful of industries that have attracted notable interest, namely the energy, technology and healthcare sectors. ■