EVENT REVIEW

Legends4Legends Amsterdam September 2017

Hedge fund managers & allocators opine on markets and fees

By HAMLIN LOVELL

The second annual Legends4Legends conference was organised by industry charity Alternatives 4 Children (A4C), of which Adamas Asset Management COO, Marc de Kloe, is a co-founder, in cooperation with local hedge fund allocator, Theta Capital, where partner and portfolio manager, Ruud Smets, was heavily involved. A4C's project selection criteria include sustainability (in both economic and ecological senses); local anchoring; independence, to foster longer term self-sufficiency; and transparency. The 2017 event raised EUR 100,000. A4C's projects have included funding schools and educational projects in Ghana, Tanzania, Kenya, India and the Netherlands. Theta Capital's Euronext-listed multi-manager offering, the Legends Fund, and their bespoke managed account capabilities, were profiled in Issue 118 of *The Hedge Fund Journal*.

Here we highlight views from those that spoke on the record.

Systematic and quantitative

Systematica's Leda Braga: Artificial intelligence, big data and alternative risk premia

"Every new day more new data gets recorded – 5 billion terabytes – than was recorded from the birth of the world up until 2003," says Systematica CEO, Leda Braga, who featured in *The Hedge Fund Journal's* 2013 and 2015 '50 Leading Women in Hedge Funds' surveys, in association with EY. Braga sees parallels between autonomous cars and autonomous investment processes: "Both use machine learning which needs enormous data sets, and multiple parameters, neural networks and multiple regressions to capture data complexity." However, "the sparse and noisy nature of financial data makes it more difficult to infer an investment thesis." To address these challenges, Systematica spends millions each year on data and is fortunate in having a large team of data scientists whose enthusiasm is demonstrated by attending the office for a hackathon challenge on a sunny Saturday. "We also train our staff incessantly in cybersecurity," she adds.

Geneva-headquartered Systematica, which has granted exclusive interviews to *The Hedge Fund Journal* in 2015 and 2016, is "a white box not a black box," says Braga. In practice, this means the firm is transparent in articulating its approach, but does not publish its code. One example of a tradable signal is that large share price moves backed by institutional investors are more persistent than those

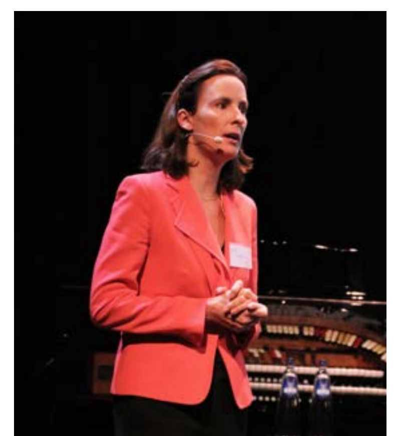

Robert Gibbins
Autonomy Capital


Gijs van Thiel
747 Capital


Thomas Heidstra
Unilever/Univest Cy


Emmanuel Gavaudan
Boussard & Gavaudan AM


Joseph Naggar
GoldenTree AM


Anne-Sophie d'Andlau
CIAM


Cyrus Amaria
Lyxor AM


Remko van der Erf
Kempen Capital Mgt


Alex Roepers
Atlantic Investment Mgt

driven by retail investors. But turning this idea into an actionable model entails collecting, cleaning and filtering vast amounts of data from multiple sources. Another useful finding is that "natural language processing (NLP) techniques can cluster companies into sector groupings that have better predictive power than traditional GICS sector definitions," says Braga. One example – classifying Facebook partly as a media company rather than simply a technology company – seems very logical, given its advertising revenues. However, "the alpha from this signal is already decaying, so a richer model will be needed in future," foresees Braga.

Innovation at Systematica takes many forms, including customised mandates and ESG initiatives; fee netting across multi-strategy offerings, and lower fees for alternative risk premia (ARP) products (which can also be dubbed style premia or alternative beta). Braga views ARP as "replication of commoditised hedge fund styles that can replace funds of funds". Braga argues that ARP fees work out much cheaper than what it would cost retail investors to synthetically replicate typical ARP strategies. Using baskets of ETFs and some leverage to reverse engineer a generic ARP equity market neutral strategy would result in a total management fee loading of between 1.6% and 3%, which is much higher than many ARP strategy fees, according to Systematica's calculations – not to mention additional financing costs for leverage.

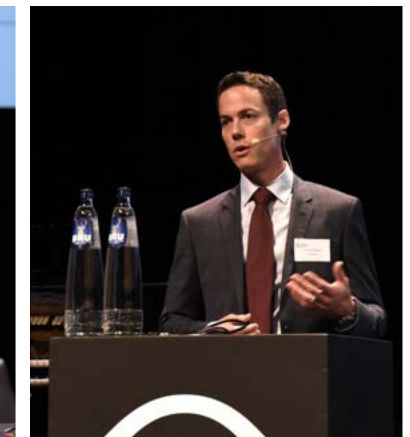
The remarks above came from Leda Braga's speech to the audience at the conference, and not from an interview with *The Hedge Fund Journal*.

Equity long/short

Horseman: Long inflation and commodities, short expensive defensives

Horseman Capital Investment Manager and Partner, Russell Clark, uses equities to express macro views, which Horseman publishes in freely available market commentary. Clark sees Asia, rather than the US or Europe, as the centre of the global economy. Having lived in Japan in the 1990s and learnt the language, Clark viewed Japan – then the world's second largest economy and largest net creditor – as key. Now, Clark reckons China is pivotal, and he got the short China and commodities versus long bonds trade right in 2011-2012. Clark has now become a bull of oil and commodities, as he expects "long term undersupply of iron core, coal and copper will become more severe as China cuts capacity in coal, steel and shipbuilding." Clark also thinks "the pools of cheap labour in China and Eastern Europe are tapped out". Noting output warnings from two US shale producers, Clark sees oil rising to 80 USD and expects inflation. Clark "finds it strange that people do not talk about China raising rates" but expects other countries could follow suit and thinks China may cease buying Treasuries. Rate rises could then cause a stagflation style recession, as seen in early 2008. Clark is short of stocks perceived to be 'expensive defensives' and 'bond proxies', such as tobacco, REITS, and equity income stocks. Clark owns commodity producers and industrial firms that have significant commodity inputs. More idiosyncratic shorts include Google, where Clark expects "growth of digital advertising will mean revert to structural levels, based on WPP results, questions about the effectiveness of digital ads, and advertising fraud." This positioning is clearly contrarian. Clark took the helm of Horseman's Global Strategy when John Horseman stepped down in 2009.


Russell Clark
Horseman Capital Mgt


Christoph Englisch
EnTrustPermal


Loic Fery
Chenavari Investment Managers


Bruce Richards
Marathon AM


Leda Braga
Systematica Investments Ltd


Ruud Smets
Theta Capital


Paul Gleize
TIG Advisors


Marc de Kloe
Adamas AM

Atlantic Investment Management: Long value, including select auto parts stocks, short Tesla

Atlantic Investment Management Founder & CIO, Alex Roepers, runs a concentrated, bottom-up, value portfolio. He argues that "megacap technology stocks are overbought and dangerous. The FANGMAN stocks (Facebook, Amazon, Netflix, Google/Alphabet, Microsoft, Apple, and Nvidia) account for most of the market's rise, propped up by a surge in ETF buying. We expect a rotation to value." Most of the value stock picks that Roepers presented at the 2016 Legends event have performed well. Harman International was acquired by Samsung (and Atlantic obtained a higher price by perfecting appraisal rights). Owens-Illinois and Atos have also appreciated. Atlantic is "averaging down" on German auto drivetrain supplier, Schaeffler Group, which has a 4% dividend and currently trades on below 7 times 2020 earnings. Atlantic is the largest non-family shareholder and Schaeffler is a good example of how Atlantic engages constructively with management and boards. Atlantic does not seek proxy fights or board seats.

Roepers thinks that auto-related stock valuations have become excessively bifurcated between traditional manufacturers and those (namely Tesla and Nvidia) narrated as plays on electrification and autonomous driving. The dichotomy is false as there are still many hurdles to the adoption of fully electric as well as autonomous drive vehicles. Roepers sees underappreciated growth for auto suppliers in hybrid-drive vehicles, those that combine internal combustion and battery technology, which are a key reason why internal combustion cars will be around for decades to come. "OEMs can reinvent themselves and VW for instance spends $15 billion a year on R&D compared to less than $1 billion for Tesla," says Roepers. Atlantic is short Tesla partly based on its valuation being 50 times that of GM or VW based on Enterprise Value per car. Roepers is also critical of Tesla's investor communications.

Other stock picks include GKN, which Atlantic views as "a powerhouse of manufacturing and high technology, ranked top three in most of its markets – and a potential bid target for a Berkshire Hathaway or, facilitated by a break-up, for strategic buyers in aerospace and automotive." ATM maker and servicer, Diebold Nixdorf, "can cut $240 million of costs, further penetrate the US retail solutions market and expand earnings to near $3.50 per share by 2020," Roepers expects. Though electronic payments are growing market share, Roepers still sees cash usage growing globally. Cell-tower infrastructure supplier Commscope is another growth story, geared to rising demand for network bandwith as well as the rollout of AT&T's large first responder network, FirstNet.

Fees and co-investments

Unilever: Investing direct and negotiating fees

Among several allocators speaking was Unilever's Head of Hedge Funds, Thomas Heidstra. When he joined Unilever's Univest from Theta Capital in 2012, Heidstra was charged with streamlining the portfolio and cutting costs. He has shifted from several funds of hedge funds, indirectly exposed to over 100 managers, to directly investing in 21 managers. The hedge fund portfolio is intended to be a diversifier, which should have zero correlation to equities and bonds. Unilever aims to negotiate lower fees and costs and, to this end, is seeking greater transparency around costs from managers. Heidstra seeks fees appropriate for each strategy, pointing out that "ten basis points might be too much for a sovereign bond fund running tens of billions in a similar strategy whereas a 1% management fee might be very appropriate for a capacity constrained strategy."

Theta Capital
Co-investments are one way in which allocators may obtain more aligned and negotiated fee structures. Theta Capital Portfolio Manager, Ruud Smets, closely monitors co-investment opportunities, such as one offered by Glenview.

Glenview
Glenview offered its existing investors a 'sidecar' limited-life long-only vehicle at zero fees to take advantage of the significant dislocation in security prices that had occurred in the autumn of 2015. This vehicle has appreciated 35.7% since inception (through 9/30/17).

Glenview finds value in selected healthcare stocks. "Shire Pharmaceuticals trades on 8.5 times our forecast of its 2019 earnings, as people are too worried about a binary patent cliff. Our worst-case scenario DCF (Discounted Cash Flow) model still results in a valuation that is 30% higher," says Robbins.

EnTrustPermal
EnTrustPermal espouses "a private approach to public securities" and finds that co-investments can be good vehicles for running a concentrated book of deals "where the manager can influence outcomes, such as activists getting board seats or distressed debt managers sitting on restructuring committees". Entrust Permal's Senior Vice President, Christoph Englisch, sees two to five-year deals as the sweet spot for picking up illiquidity premia around corporate events and catalysts, and sovereign restructurings in Argentina, Venezuela or Puerto Rico.

Credit managers

GoldenTree and Kempen: Structured credit – the 'Cinderella' credit segment
GoldenTree, whose Global Head of Business Development, Kathy Sutherland, featured in *The Hedge Fund Journal's* 2017 50 Leading Women in Hedge Funds survey, in association with EY, has recently opened an office in Australia. GoldenTree manages over $25 billion and its credit strategies are a core holding for Kempen's multi-manager vehicles, including its Diversified Structured Credit Pool (KDSCP) product launched this year. Kempen's co-head of hedge funds, Remko van der Erf, was "impressed by GoldenTree's fundamental credit expertise and state of the art technology for CLOs and RMBS". Van der Erf interviewed GoldenTree's Senior PM, Partner and Executive Committee member, Joseph Naggar, who explained why he views structured credit valuations as anomalous: "In most parts of the credit markets, valuations are at post-crisis tights, but in structured credit, a 'BBB'-rated CLO tranche offers a spread of 400, which is still above pre-crisis levels." One explanation could be memories of sub-prime NINJA loans inside pre-crisis RMBS structures: structured credit was at the epicentre of the GFC. "But the next crisis or recession will not be the same as the last one," says Naggar.

And Naggar views the yield pickup as a 'complexity premium': "ETFs and liquid mutual funds cannot access structured credit, which requires knowledge and technology to analyse unusual features such as structural amortisation." With multiple tranches, sometimes millions of underlying borrowers, and constantly changing deal and call dates, powerful computers are required. "We were one of the first and are still one of the largest clients of Amazon's AWS cloud computing division," says Naggar.

Certain niches in structured credit, "such trust preferred CDOs, backed by junior debt of US regional banks, trade at the lowest levels in the whole world," he points out. GoldenTree recently acquired mezzanine paper at 50 cents, which has appreciated to 65, and offers a substantial safety cushion: "Defaults of 24% two years in a row would be needed for the instrument to start losing money. The peak level of defaults in the global financial crisis was 7%," explains Naggar. Consumer credit card receivables also offer a high margin of safety: "Certain mezzanine tranches could withstand defaults of 19% per year, without losing money; current default rates are running at 3-4% and they peaked at 17%," says Naggar.

Split or non-existent credit ratings may be one reason for yield pickup in structured credit. Ratings agencies have different opinions on the trust preferred CDOs, and some structured credit, such as the aforementioned mezzanine credit card paper, is unrated. Credit ratings are the last thing GoldenTree looks at.

The trust preferred CDO also offers optionality in terms of gearing to higher prepayments, which Naggar expects could arise from regulatory changes that do not require congressional approval.
A shrinking supply of some types of structured credit bodes well for the technical outlook. Despite this, GoldenTree finds adequate liquidity in structured credit, "at GoldenTree we trade $2-5 billion in the asset class per year and sometimes $100 million in a day," Naggar says. In addition, Naggar said "while new issue in structured products are down by 60% from pre-crisis levels, the new issue market in ABS, CLOs, and other structured credit creates $300-500bn of new product per year."

Marathon: Late in the cycle but too early for distressed
Credit manager Marathon marks its 20th year and has 150 professionals. A stake in the firm has been sold to Blackstone without any change of control. Manager Bruce Richards starts each week with an early morning macro meeting on Mondays at 7am. Marathon's outlook is that quantitative tightening of $10 billion a month this year can probably be digested by the markets – but Marathon will be closely watching the markets in 2018 when the QE unwind ramps up to $50 billion. The firm also expects Venezuela to default in 2018.

Marathon judges that credit markets are in a late cycle phase, with slightly deteriorating credit quality, higher leverage ratios, and declining profitability at least for the Russell 3000 companies outside the S&P 500. Against this backdrop, Marathon prefer leveraged loans, to high yield for several reasons.

"A flat yield curve is one: loans are priced off LIBOR whereas bonds are priced off Treasuries; loan yields of 550 basis points are slightly higher than high yield bonds at 520; and loans are more senior, meaning recovery rates have historically been around 80% rather than the 30-40% seen in high yield bonds. Moreover, default rates at 1.4% in loans are below the 2.6% seen in high yield, partly because the high yield market is amenable to riskier and more leveraged capital structures," explains Richards.

Marathon finds structured credit offers relatively good value and makes good use of their expertise in understanding cashflows, ratings, and legal language. Marathon also picks up illiquidity premia from private lending strategies, including royalties, receivables, aircraft leasing, and direct real estate. Marathon "has invested $2 billion in Non-Performing Loans (NPLs) in Europe, with much higher face values, initially in Northern Europe, and we are now close to completing deals in Italy, Portugal and Spain," says Richards.

Marathon reckons that $100 billion of dry powder is seeking distressed opportunities but is in no rush to launch its own distressed fund. "The supply of paper is much sparser than it was in the Great Recession of 2008, or the early 1990s recessions, both of which saw default rates hit 10%," observes Richards. "Distressed paper in 2017 is more often associated with industries such as retail, old media, or fixed line telecoms, that are in secular decline," he adds. Richards expects better opportunities will appear in distressed, but not any time soon, given the economy and corporate earnings are accelerating for now. But Marathon is active in one area of distressed: Puerto Rico. "It is a beautiful place with beautiful people and we are invested in the utility PREPA, where we find the restructuring story is interesting. It may be based on the Long Island Power Authority (LIPA) model. We expect PREPA could have a BBB- rating when it exits securitisation," says Richards.

Chenavari: European specialty finance sweet spot
Chenavari has grown assets from $40 million to c.$5.5 billion over ten years since it was started by Loic Fery. Chenavari is quasi exclusively invested in credit, structured finance and private debt markets in Europe with almost two thirds in private debt markets. Fery is constructive on European credit, pointing to "strong and sustainable fundamentals and a delinquency rate that keeps on improving, especially on consumer assets". Chenavari finds most plain vanilla European high yield is not even worthy of the name 'high yield'. Chenavari "has a significant short position in liquid corporate credit, where spreads are artificially tight". While Chenavari sees remaining pockets of value in European ABS and Financials, Fery is primarily seeking value in areas with higher barriers to entry, such as specialty finance private credit, especially in receivables, trade finance and leasing but also in real asset finance, such as shipping finance or other transportation assets such as railcars or logistics. "Some of these deals are sourced from European banks, which are now disposing of performing loans that do not meet their return on increased regulatory capital constraints," says Fery. Sometimes consumer finance activities are spun out into new firms, and Chenavari has several strategic investments in European speciality finance firms, with a total of 730 professionals across Europe. Chenavari's exposure includes Irish speciality mortgages, French equipment leases, Spanish corporate receivables, UK auto loans, and Dutch and Belgian personal loans.

Additionally, "Chenavari benefit from being a full credit house with capabilities to securitise whole loans and turn them into public ABS/CUSIPS, a process that is generative of alpha for our LPs," says Fery. Even as headline yields on European consumer debt have fallen moderately, loss rates and costs of refinancing senior debt have fallen much faster, meaning that net IRRs implied by specialty finance private credit strategies have actually risen to high teens or more.

You can find more detail in Issue 123 of *The Hedge Fund Journal's* profile of Chenavari titled 'Scouring Europe for Value'.

Event driven managers

Lyxor Asset Management and Tiedemann: Defensive merger arbitrage
Lyxor Asset Management's Head of Northern Europe Sales, Cyrus Amaria, argues that "for those who view equity market valuations as elevated and are concerned with market risk, merger arbitrage can be an uncorrelated strategy over the long term. For instance, Tiedemann's merger arbitrage strategy [Tiedemann Arbitrage], has been a managed account on the Lyxor platform for 16 years and a Lyxor UCITS fund for nearly 5 years. The reference fund has not had a losing calendar year for the past 23 years, which is remarkable."

Tiedemann Managing Director, Paul Gleize, explained how "risk is mispriced in complex merger transactions. The investment team employs deep research within complex, hostile, up-for-sale situations where we believe our primary research work can drive uncorrelated alpha." Tiedemann is a global event-driven strategy focused on near-dated (0-30 days) events within a merger process.

You can find more detail on Tiedemann's approach in Issue 112 of *The Hedge Fund Journal* titled 'Lyxor Tiedemann's Merger Arbitrage Sweet Spot'.

CIAM: Championing the interests of minority shareholders
Hot on the heels of their success with Euro Disney, London and Paris-based activist CIAM has secured another victory for minority shareholders, in SFR versus Altice. For the second time in ten years the French regulator has blocked a deal. "Altice tried to squeeze out France's number two mobile operator, SFR, at a cheap price. We disputed Altice's fair value opinion on several grounds: it excluded two valuation methods (comparables and past transactions) and it used the lowest metric for SFR combined with the highest for Altice," explains CIAM co-founder and managing partner, Anne Sophie d'Andlau. "Altice threatened minority shareholders with the highly unusual tactic of charging them a management fee of about 3% of revenues. We wrote to Altice board members reminding them of their duty to minority shareholders; one board member resigned," she adds.

CIAM also filed a complaint alleging misuse of corporate assets around, amongst other matters, a related party property deal. Eventually this year Altice's offer of EUR 34.5 per share was 38% above its initial tender of EUR 24.7. CIAM's strategy has annualised at around 11% over the past four years, and is up 21% in 2017 to September, with single digit volatility and low equity beta. CIAM donates 25% of their performance fee to charities. THFJ

"For those who view equity market valuations as elevated and are concerned with market risk, merger arbitrage can be an uncorrelated strategy over the long term."
— CYRUS AMARIA, LYXOR