

Top hedge funds that defied the trend

The global financial slump divided the pretenders from the professionals, writes Jane Searle.

Hedge fund managers earned a reputation as cowboys in the global financial crisis with those who borrowed to invest. But this generalisation fails to recognise those fund managers who survived the meltdown to prove their prowess. The downturn divided the pretenders from true hedge fund managers, who preserved capital and offered real diversification from shares. Several recorded gains in the past two calendar years and are optimistic about the 2010 outlook.

For investors seeking a respite from volatility, they might offer the chance to profit from a recovery while hedging against ongoing weakness. The complexity of some hedge fund strategies means some advisers argue these funds are better suited to sophisticated rather than retail investors with only small amounts to invest. When comparing funds, investors should look beyond the short term. High returns in a single year are not necessarily an indicator of an ability to control the risk of capital loss over a long period.

A large variation in returns from year to year or a high standard deviation as a measure of the volatility of returns are pointers to a higher-risk fund.

The easiest hedge fund strategies for small investors to understand include so-called long/short and market-neutral strategies. Long/short funds use short-selling, which enables them to profit from the fall in a stock price or index.

Market-neutral funds balance their long and short positions so they in theory have no overall market exposure. For example, they may have half of their portfolio in equities and short-sell the remaining half, so their share exposure balances out to zero.

Morningstar co-head of fund research Tim Murphy notes that average hedge fund performance in 2009 was solid, though investors were still behind on a two-year basis. "In 2009, we saw returns in the high single digits or low teens but there were several double-digit losses in 2008."

Murphy says several funds, particularly those that invest in a number of other funds, are still operating with limited opportunity for withdrawals following redemption freezes in late 2008.

"The redemption freezes gave hedge funds a bad name and a lot of people were burnt by the promise of funds delivering absolute returns," he says. "Now there's a trend towards people launching more liquid vehicles."

Here are five hedge funds which have stayed true to form, showing solid long-term returns through the crisis and delivering diversification from shares.

APEIRON GLOBAL MACRO FUND

The Apeiron Global Macro Fund offers diversification from



individual asset classes as it profits by taking views on economic or market imbalances – such as the prices of commodities or the outlook for equity markets.

Returns rely on the manager's ability to pick trends correctly. Managing director David Hobart works with two colleagues to monitor the fund, and has worked on the proprietary trading desks of BT Foreign Exchange, Macquarie Bank and ABN Amro over the past 15 years.

Hobart says Apeiron's first objective is to preserve capital and, second, to generate returns – aiming for 15 per cent annually over three years. The fund was set up in 2006 and has generated double-digit returns for each of the years since. The exception was 2009, when it shed 1.46 per cent after short-selling the roaring ASX200 index due to concern about the US consumer sector.

At the height of the credit crisis in 2008, Apeiron returned 18.83 per cent after posting 20.79 per cent a year earlier and 14.91 per cent in 2006.

Hobart is optimistic about opportunities for the coming year.

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"Last year there weren't many strong imbalances as equity markets recovered, but this year there are more."

Apeiron is backing trends such as a rise in grain prices as developing markets like China lift meat consumption. It is also selectively short-selling long-dated bonds as it predicts fallout from government debt. Self-managed super fund investors comprise the bulk of its investor base.

FORTITUDE CAPITAL

Fortitude has a strong focus on hedging against the risk of losses and aims to return 5 to 10 per cent above the cash rate for its Absolute Return Trust.

The portfolio has low variation in returns. Its volatility of 2.95 per cent means its returns can vary by 2.95 per cent from one year to the next. The Australian stockmarket, by comparison, has a volatility level of around 12 per cent.

The fund has had just five months of losses from 58 months since inception in 2005, with its lowest annual return at 5.93 per cent last year, as the manager remained sceptical on the sharemarket recovery. It posted a 12.29 per cent return for calendar 2008 at the height of the crisis.

Managing director John Corr says the fund should be able to post returns in the mid to high teens this year. "We were too conservative after the rally in the second quarter last year but expect to do quite well this year [with the opportunity to profit] from takeover and other corporate activity."

Fortitude's Absolute Return Trust is a market-neutral fund, which means it balances its long and short positions through the use of derivatives so it has no overall market exposure.

Despite Fortitude's solid performance, funds under management have dived from \$190 million in the 2008 third quarter to around \$80 million as some large offshore investors withdrew money after suffering losses elsewhere. It is now diversifying its investor base and aims to make the Absolute Return Fund available to retail investors such as self-managed superannuation funds this year.

BLACKROCK ASSET ALLOCATION ALPHA

This \$380 million hedge fund uses derivatives to reflect the manager's view on how economies, markets and sectors are likely to perform. For example, in 2008 it took the position that interest rates were likely to be cut, sharemarkets would fall and there would be a flight to major currencies. All three predictions were correct and saw the manager return 41.18 per cent that calendar year.

But it held most of these defensive positions when markets rallied last year, resulting in an annual loss of 0.14 per cent.

The fund's director, Vincent Lo Blanco, says the portfolio is positioned to profit from the recovery. "We think interest rates will rise in Australia, Canada and the UK and are long on gold, and currencies such as the Australian dollar – but short the yen, euro and the US dollar," he says. He suggests an allocation of 5 to 10 per cent to alternative assets in a

well-diversified portfolio – though some financial planners would suggest this range is way high.

The fund is available to retail investors and has an average annualised return of 19.01 per cent since inception in mid-2006. There is a 1 per cent management fee and a 20 per cent performance fee.

PLATINUM ASSET NT

Australia's largest hedge fund manager impressed through the slump, notching gains for several of its funds as global indices suffered double-digit losses.

Platinum shuns the hedge fund label due to its negative connotations with higher risk and it mainly buys stocks then short-sells stocks or market indices.

Platinum has also held its ground through the recovery – its flagship International fund posting 19.7 per cent for the year to December against 4.4 per cent for the MSCI World Index. The fund has average annualised returns of 9.7 per cent over 10 years against a loss of 2.7 per cent for the index.

Its investment philosophy centres on the contrarian views of founder Kerr Nielson.

Chairman Michael Cole told investors recently that Platinum's business model had strong exposure to the resurgence in global equity markets and was winning new business.

The manager was not entirely immune from the downturn as investors pulled money out to cushion their other losses. But funds under management have recovered, reaching \$17 billion at the end of December.

NAOS SMALL COMPANIES FUND

This fund profits from backing under-researched small stocks and leverage-increased exposure to the stockmarket – to magnify returns. So far, the strategy has paid dividends, with average annualised returns of 14.84 per cent since inception in 2005.

Unlike the more conservative Apeiron and Fortitude funds, portfolio manager Sebastian Evans cautions this fund has "very high" volatility and sits among its higher-risk peers. Its performance over the past two calendar years illustrates this – it posted a loss of nearly 64 per cent in 2008 as small caps nosedived and a return of almost 175 per cent in 2009 when small caps rebounded.

Evans has restructured the portfolio since his arrival in late 2008, reducing the number of stocks held from 30-40 to 10-20, a change which has the potential both to magnify returns and lift volatility. The fund typically holds 80 per cent in small or microcap stocks and gears this to exposure of around 150 per cent. Over the past year it short-sold the Australian Securities Exchange top 50 stocks to comprise the remaining 20 per cent of portfolio returns.

Evans says: "Several small companies are still trading at a huge discount and are under-researched, with the potential to return up to 300 per cent over the next one to three years."

The fund has an investment minimum of \$25,000, a management fee of 1.5 per cent and a performance fee of 20 per cent over the cash rate once it beats the level at which it last charged a performance fee.