New York Trip Report

The Equity Market Year of the Central Banks

October, 2019

Executive Summary

The change of course of the US central bank FED with several interest rate cuts in contrast to the planned interest rate hikes has fueled the equity markets to new all-time highs

Hedge funds have been cautious as expensive markets have become even more expensive, but hedges were very costly in 2019

Interest rates seem to have bottomed and it is difficult to imagine how they could go even lower, especially when the central bank purchase programs will have to stop one day

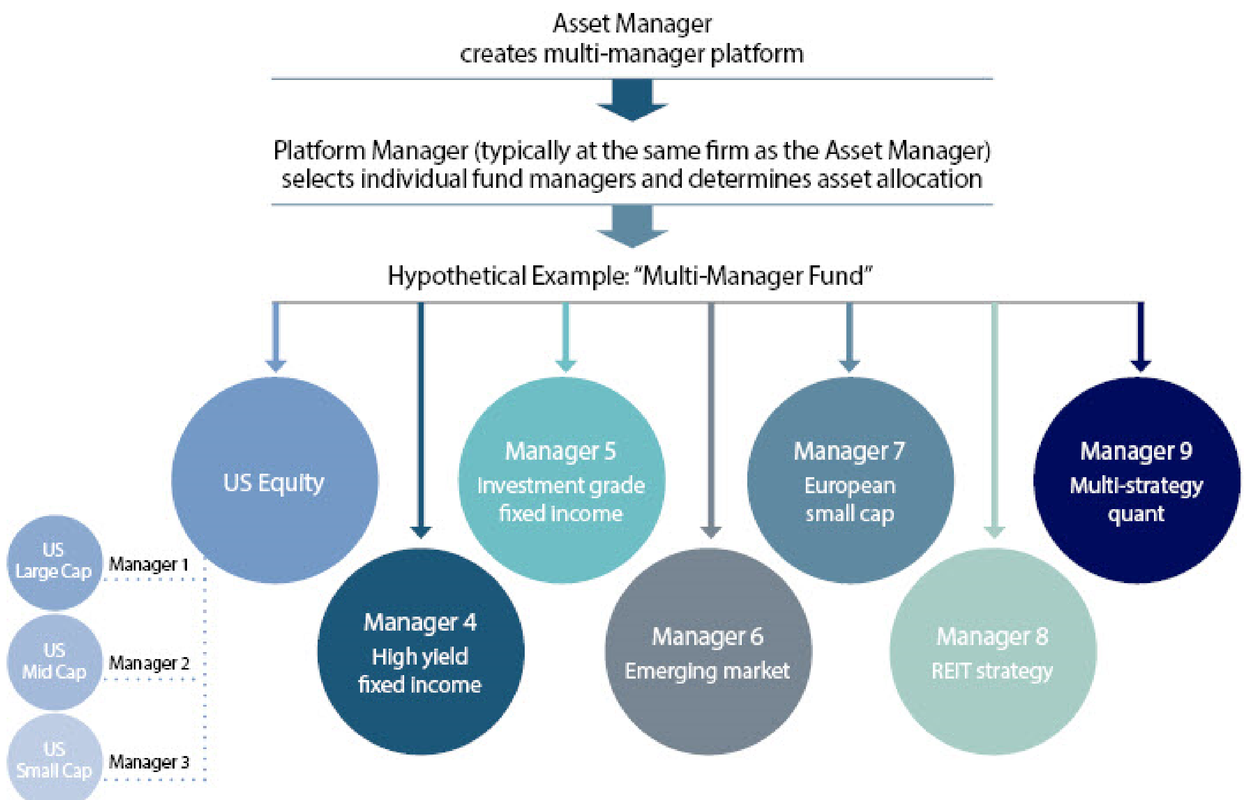
The government debt in the US, and elsewhere, is ballooning and the FED has to inject overnight liquidity as the financial system shows first signs of a confidence problem?

The trade war is far from being over and after a minimal achievements with China the focus is turning to Europe?

Multi-Manager Platforms

In recent years, multi-manager platforms have grown in importance as an efficient way of getting diversified exposure to hedge fund returns. Due to their above average risk-return numbers, the demand for such multi-manager platforms was quite strong.

Multi-manager platforms are a collection of different portfolio managers (who specialize in different asset classes), organized by one overarching manager (the asset manager). The asset manager establishes an umbrella vehicle with sub-funds that invest in specific asset classes and strategies (e.g. L/S equity, fixed income arb, macro, etc.), and is responsible for the selection and allocation of capital to the underlying managers within the portfolio. The asset manager can select the best portfolio managers in a given category, eliminating the need to build in-house capabilities across any of the asset classes it invests in.



Source: Brown Brothers Harriman & Co.

Main advantages of multi-manager platforms often are seen in the diversification, similar as traditional fund of hedge funds, not putting all your eggs into one basket. Further in setup-defined freedom of the portfolio managers to focus on their core responsibility of portfolio management, while still receiving the benefits of a relatively captive flow of assets via the asset manager. Another benefit lays in the dynamic allocation of capital (compared to the more static traditional fund of hedge funds approach) and more efficient use of capital, mainly through application of leverage on their quite diversified and sometime even factor neutral hedged portfolios.

But even in the multi-manager space not all that glitters is gold. There have been more wind downs in the past than one would expect. A few of them have been related simply to performance. It seems not so easy to attract always the best talents in the industry to join a multi-manager platform. Quality managers sometimes prefer the freedom of trading within their independent funds over the potential limitations (often driven by risk considerations) which they have to accept within the multi-manager approach. Another liquidation was based on an insider trading case of one portfolio manager, putting at risk the entire structure. Other cases are hard to judge, but probably mainly related to missing economic success. Setting up and running a multi-manager platform requires decent investments into infrastructure and head counts. Lack of income through missing performance fee can lead to the termination of the structure.

There are a few important differences between various multi-manager platforms that are key for a potential investor to analyze carefully before a potential investment.

Different handling of netting risk: Netting risk arises from the fact that payouts for portfolio managers on platforms are typically based solely on the performance of individual manager books, with little, if any, regard to the performance of the overall fund. It refers to the cost of having to compensate performing managers in situations in which other managers on the platform, and the overall fund potentially, do not generate returns. Netting risk is borne by platforms in the case of platforms that charge fixed management fees, and by investors in the case of platforms that charge 'pass through' costs for manager payouts.

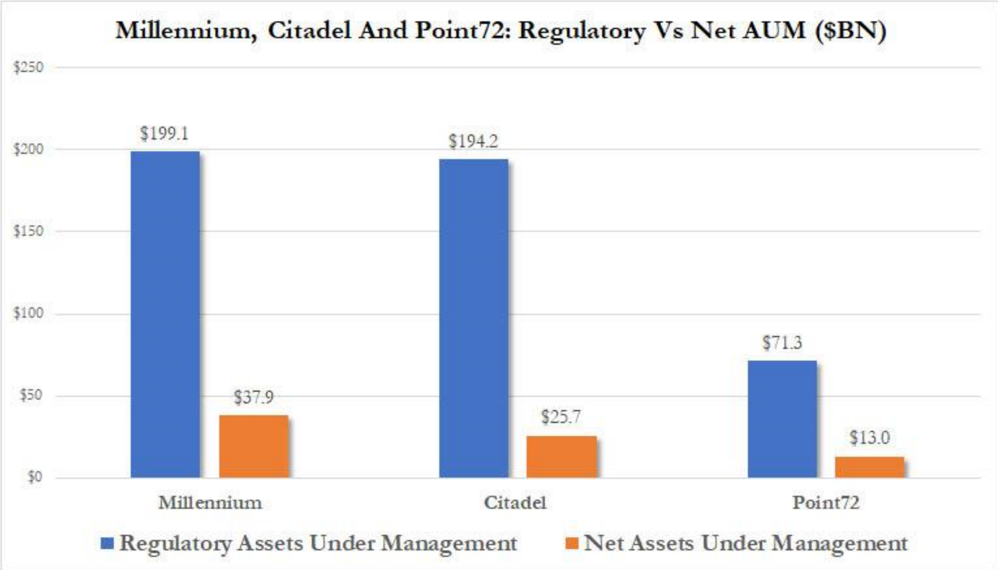
As an example, Millennium International which is probably the largest and most well-known manager platform fund charges no management fee on the fund level, but all management and performance fees on the individual managers are charged to the fund as a cost. In other words, the entire compensation of the managers is passed through to the fund. Well performing portfolio managers are passing through a lot as they earn performance fee on their pool of money while negatively performing managers also pass through some fixed costs. The total amount of costs is based on each underlying manager - similar to a FoF set-up - and therefore can be very considerable, even if the overall fund did not perform. This is the case when the negative contribution from the poorly performing managers compensates or over-compensates the positive returns from the performing managers. In contrast, AB Arya which is the former Visium Global manager platform charges a performance fee of 2% and pays any netting risk above this 2% out of its own pocket. This is a big difference as the pass-through costs of Millennium were about 8% per annum in average over the past 10 years!

First loss platforms: A first loss platform is essentially a collection of managed accounts where each portfolio manager absorbs the losses up to a defined amount. The loss is absorbed by the portfolio manager posting an amount, typically 10% of their allocated trading capital, which can be thought of as collateral. In other words, if a PM wants a USD 100 mn account from a platform then they are responsible for allocating USD 10 mn with the remaining USD 90mn being allocated by the platform. This USD 10 mn first loss tranche, in theory, protects the investors from losses of up to 10%, as negative P&L is allocated to the manager's capital first. Investors' capital is only negatively impacted if losses exceed the manager's USD 10 mn buffer. The managed account structure gives the platform the flexibility to pull accounts before losses of more than 10% are experienced, theoretically protecting investors. In return for absorbing losses, managers are typically very well compensated, with 50% performance fees not uncommon.

Such multi-manager funds offer increased downside protection as a good portion of the losses are absorbed by the portfolio managers, but the upside is also limited through the 50/50 split of potential returns between the managers and the platform. Less than 50% ends up in the pocket of the end investors.

One of the main risks the bull market during the last decade probably facilitated to hide: **leverage.** The following chart shows the leverage (regulatory to net assets) of three of the largest multi-manager funds in the world.

While Izzy Englander's Millennium had regulatory leverage of 5.25 times over net assets according to SEC filings, Ken Griffin's Citadel is running a "buying power" of 7.5 times and Point72 of Steve Cohen applies a leverage of 5.5 times.



Source: Tyler Durden

Michael Gelband, who quit Millennium in 2017 after realizing he would not take over from Englander any time soon, is disclosing USD 82.3 bn of regulatory assets as end of 2018, while the firm had USD 8.4 bn of investor capital under management, resulting in a roughly 10 times leverage according the fund's Form ADV.

Conclusion:

Recognizing some of the advantages that multi-manager platforms provide, particularly the efficient application of the invested capital, it is important to look at more than just the net returns. The netting risk can be very expensive and has a direct impact on the total expense ratio of a fund. Leverage works often well, especially in a low interest rate environment such as now, but can also hurt tremendously in market shocks as experienced with Citadel in 2008. Ken Griffin's fund lost 55% in 2008 or a total of USD 8 bn of client's assets!