Navigating through difficult times

Stable returns through periods of exceptional market volatility…

Stenham has been managing assets on an absolute return investment mandate since 1988, through discretionary managed accounts and funds of funds. Our philosophy is to deliver consistent capital growth uncorrelated to equities and bonds and control the level of risk through diversification and our manager selection process. Over the last 20 years, we have successfully delivered stable returns through periods of exceptional market volatility, and in the process we have won and been short-listed for numerous awards.

The events of July and August have proved to be one of the most trying periods for hedge funds since the LTCM crisis in 1998. We will discuss the unexpected effects on certain hedge strategies, the outlook for the future and how we constructed our portfolios in anticipation of these events.Certain strategies rely on leverage to achieve returns. Once the indiscriminate selling started and assets were marked down, these leveraged strategies were forced to sell assets to meet margin calls, resulting in dislocations in asset prices. The worst affected were the quantitative equity strategies, which rely on models based on historical statistical relationships within equity markets to predict future trends. These strategies lost money in the initial sell-off but recovered towards the end of August as the statistical relationships normalised.

The withdrawal of liquidity led to dramatic increases in the correlations between many different strategies. Straightforward strategies such as long/short equity suffered as those stocks that were the most attractive and liquid were sold – either because there was liquidity or because of deleveraging taking place. This deleveraging led to a lot of short covering, which affected other strategies such as global macro when fundamental views on areas such as currencies (generally short the US dollar) reversed.

Any strategy that was invested in debt structures or areas linked to them lost money as credit spreads widened dramatically.

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The only strategies that made money were those that were either short credit or long volatility.

Outlook

When the financial markets experience such a dislocation it often happens that opportunities present themselves that then lead to above average returns in the ensuing 12 months. Those areas that suffered the most will present the best opportunities going forward. Some specific examples include value long/short equity strategies, distressed debt and global macro.

Our conservative positioning meant that through one of the most difficult periods for hedge funds over the past 10 years our drawdowns were modest at approximately -1.6%.

Our long-term track record and experience in navigating through difficult times stands us in good stead and we are optimistic that hedge funds remain a core component for diversifying risk in a portfolio.

Asset allocation

Increasingly, we see funds and even strategies becoming highly correlated – particularly at times of stress – and we have actively been searching for ways to mitigate this. Over the last 12 months, we have been repositioning the portfolios more defensively by increasing our allocations to strategies that will deliver performance uncorrelated to equities and bonds. Within these strategies we have been favouring defensive or contrarian style managers who will smooth performance positively irrespective of market volatility and avoiding those that use excessive leverage.

As an example, we have recently been increasing our allocation to long volatility and short bias credit. Concerns about an increase in equity volatility motivated a decision to allocate to strategies uncorrelated to equities and which act as insurance in the portfolio at times of stress. The exact weightings to these strategies are based on an analysis of the amount of net long equity exposure in the portfolio. We investigated a number of possibilities for insurance and concluded that these strategies were the most efficient options.

Despite, or probably because of, our risk-averse culture, we have consistently delivered returns above bonds with less volatility, with a 10 year compound average return of UK Libor plus 5-6% and a standard deviation of less than 4%.

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