

Far-sighted foresight

Stenham has got key decisions right, at the right time in the past, about the future, so David Walker asked Harry Wulfsohn about what the future now holds for the FoHF group

Stenham has made quite a skill out of making decisive and far-sighted decisions at the right time. Back in 1987 when long-only markets headed south, Stenham's management decided to forego long-only completely in favour of multi-manager hedge fund portfolios.

When many still laid wreaths on the 'death-bed' of inflation, Stenham was preparing for the potential for inflation's resurrection, and noting the protective FoHF-linked measures investors could take to ward against it. (See Edwin Wulfsohn, Rael Berelowitz, Keeping it in the Family, *Hedge Funds Review*, March 2007.)

While other houses were beginning to rely on multi-strategy global funds of hedge funds, Stenham already had its Universal FoHF, launched in 1992, and was branching into single-strategy FoHFs, back in 2000.

And while peers are now launching into 'hot' areas such as energy/resources and gold, Stenham is already there, with eight focused funds of funds holding in aggregate around \$820m of the \$2.5bn Stenham overseas.

And as the industry is becoming more 'institutionally' focused, Harry Wulfsohn, director at Stenham, says the firm is moving to complement its family office and

UHNW roots to embrace institutional investors as well.

"Most of our growth in the last few years has come from institutional clients, initially the professional firms working with wealthy clients such as trust companies and private banks. For this market we are looking at the UK, Channel Isles, Western Europe and Latin America. More recently we are winning pure institutional mandates such as corporate pension schemes and county councils. You want as a business to have a diversified client base."

RISK AWARE

Stenham's major focus is on risk, and the company prefers to use the term 'hedged fund', than hedge fund. "We look to managers that use techniques to reduce risk," Wulfsohn says.

He cites notable exceptions, including Amaranth – in which Stenham was not invested – "which was a hedge fund that was more leveraged and directional than many long-only funds." He adds, "however there are whole strategies that are less risky and if you put them together in a fund of funds, and understand their correlations, you can construct something far less volatile."

Today's volatile markets Wulfsohn describes as a "good time to show you're doing what you said you do, because there are FoHFs that are more directional than people realised, so it's good if you can show you're not correlated to equities, and non-directional."

Stenham's FoHF stable is populated with a mixture of the globally diversified workhorses (in the form of Stenham Universal and Stenham Universal II and Stenham Multi-Strategy) and more focused thoroughbreds, such as Stenham Global Macro, Stenham Global Resources, Stenham Gold and Stenham Asia.

"The three multi-strategy funds are targeting Libor plus 5% on volatility of under 4%, to deliver returns uncorrelated to equities," Wulfsohn explains. His words

and Stenham's aims are supported by the facts. The non-directional multi-strategy products were up in November and December, and flat in January. More long term Stenham Universal and Universal II have returned investors 9.19% and 8.68% on a five-year compound annualised return basis (dollar classes) respectively. Their annualised volatility has been 2.95% and 2.78% respectively.

LEVERAGED DANGER

While many FoHF managers scrambled to get out of geared plays around last summer, Stenham has looked to do this for longer: "over the last two years we have materially reduced the risk in the portfolios, and by that we mean avoiding anything that's leveraged," Wulfsohn says. This has meant no CTAs and fixed income and convertible bond arbitrage in the portfolios.

"In fixed income as corporate spreads have narrowed managers have leveraged to deliver returns so we have had no money there for some time, nor to CDOs nor in sub-prime."

Wulfsohn then describes the 'wedding-cake' of leverage, which has all ended of course in tears and probably in court for some, of leveraged end-investors investing in a geared FoHF, investing in a geared hedge fund, in a leveraged CDO in mortgages, which of course are themselves borrowings geared to earnings. He adds by way of explanation, though, that Stenham has had some money in credit – short money. This has benefited Stenham's returns, as have its allocations to long volatility managers.

Allocating to long volatility also demonstrates Stenham's forward thinking. "About 18 months ago the VIX index was at unprecedented low levels and buying volatility was an asymmetric risk, a lot of upside, not much downside risk."

Redeeming money from the geared funds has allowed Stenham to allocate more to non-directional, flat-net strategies such as market-neutral, and net short managers, as well as out of momentum players and into "fundamental stock pickers." The equity portion of Stenham's multi-strategy FoHFs has been pared back from around 60% to 35%, and a broad geographic diversification

ensured, from the US, UK and Europe to Asia including Japan, where Stenham has been investing since 2001.

Reflecting Stenham's macro views – which play a significant role in allocation – all the US equity managers in its multi-strategy FoHFs are either net short or defensive.

"In the arbitrage portion there are event-driven managers and merger arbitrage and distressed managers delivering returns uncorrelated to equities."

ASIAN PROMISE

Asia is one area catching Stenham's eyes presently. It is also taking up sizeable portions of time of Stenham's CIO Kevin Arenson, who visits there four times a year and Asia analyst Lynda Stoelker, who is there six times a year. Stenham also enlists the expertise of Albourne Partners as part of their manager research process and to help source new leads in Asia, "a second pair of eyes there for us."

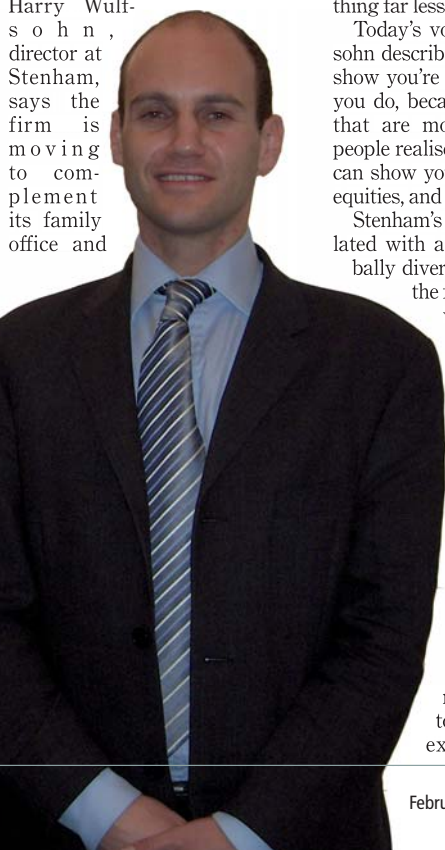
The firm also has a independent consultant in Beijing.

"We find Asia very similar to Europe's position in the early 1990s. When you get in early you can negotiate fees and agree capacity with high quality managers, as we did in Europe when we started investing there in 1994–1995," Wulfsohn says.

Asia is also geographically distant from present troubles plaguing Europe and the US. While Wulfsohn does not discount China being impacted by global slowdown, for example, he describes Stenham's macro concerns thus: "We are worried about the US and UK and fundamental risk of the financial sector. We believe there is much more unquantifiable leverage out there and the whole credit derivative business has spread risk around in a way that is hard to quantify."

"The US may already be in recession, the financial sector is in worse shape than they are disclosing and the credit crunch and housing crisis is hammering the US consumer. People say corporate US has low leverage and good stock levels but it is reliant on the consumer."

"When it comes to the debate about the decoupling of Asia from the US, although China has gone through massive growth



for 10 years in absolute terms its economic share of global GDP is small," he says.

"People talk about the next six months – I think the next year or two are a concern. The last few years have been driven by massive liquidity creating imbalances in the system which have to unravel somehow."

A general economic gloom that arguably pervades much of the US and European hedge fund community, and engenders a defensiveness among some, is countered in Asia by a general bullishness about prospects. Wulfsohn says Stenham's allocation to underlying managers will be tempered by its own macro economic view, as an example it has redeemed from one top performing equity long/short manager for being too concentrated and too directional.

OPERATIONAL ISSUES

Wulfsohn adds, Stenham is increasingly very mindful of extra operational risks especially posed by funds with shorter track records, such as many that may be found in Asia, and he emphasises Stenham requires a track record of at least two years to invest in a manager.

"Operational risk is a big issue and we will also do much more reference checking and we will look at the portfolios in detail to understand a manager's ability to manage risk.

"People say you can't short there and the markets are not as liquid, so you have to understand how the managers hedge out their risk.

"With the funds we will spend a lot of time looking at their process and their IT and infrastructure and systems, and conduct reference checks.

"Also you need to ask whether a manager has been through a bear market, because they can look great on paper, but not have that experience, and you need to ask whether they are really adding value or simply benefiting from a strong equity market."

For those managers with shorter track records, but promise, Stenham can invest via its Emerging Stars portfolio, a proprietary product not open to external investors. Stenham's other operational questions may revolve around whether underlying managers are buying their research from large investment banks, or conducting it themselves.

The company's Asian FoHF, Stenham Asia, has returned 14.8% since its February 2005 inception on volatility of just 5.44% and 16.61% in the last 12 months. Wulfsohn says its current \$130m could double

on present allocation styles.

"The Asia fund is much more directional, and has smaller managers, who are more aggressive, and it has managers in China and India. It is there to capture Asia's upside because we believe that is where opportunity is going to be in the future, but through diversification of countries and manager styles we have reduced the fund's volatility.

"So you're getting MSCI Equity Asia-type returns with much less volatility." The fund of hedge funds includes China, India, Australian and pan-Asian hedge funds among its 14 underlying constituent funds.

"We have a very forward-looking perspective on the macro

they are increasingly long equities and following themes like commodity equities," he says.

To mitigate such risks, Stenham has added two contrarian macro managers in the last six months to its three global macro funds, Stenham Quadrant, Stenham Trading and Stenham Global Macro.

While macro managers may be viewed as a diversifier in a multi-strategy portfolio especially at times of market dislocation and stress, Wulfsohn notes a risk fund of hedge funds managers such as Stenham have been conscious of of late: "Over the last few years there has been so much cash everything has gone up and people

explains. This FoHF also holds two water-focused managers and a timber fund. "There is such a strong macro story around softs and alternative energy driven by classic supply and demand, such as water shortages and changing diets in Asia," he says.

The FoHF has eight managers now, which Stenham expects to grow to 10, absorbing the 50% of its assets presently not invested. It aims for Libor plus 6%–8%, and has achieved 9.7% on standard deviation of 3.8%.

LIQUID MARKETS, LIQUID STRATEGIES

Stenham has a general predilection for liquid strategies, and will mostly not invest in funds with redemption terms less favourable than 12 months, although it has allocated to distressed managers. All Stenham's investee funds currently have quarterly or monthly redemption terms at worst.

"We are very mindful of lock-ups and liquidity and will negotiate early redemption penalties if necessary," Wulfsohn says.

Wulfsohn says a key development at Stenham has been the separation of due diligence of underlying managers into three teams, each with a veto over investment. The teams cover operational issues; investment performance; and quantitative analysis.

"Our operational team will undertake a detailed analysis of liquidity terms of the managers and liquidity terms of the underlying instruments of those managers," Wulfsohn explains, as well as examining the aforementioned operational issues.

Stenham's quant team analyses performance, and breaks down performance cycles based on key risk events, as well as stress testing the portfolio.

As Stenham takes in more institutional money, will this change its focus and processes, away from what some may see as the traditional needs of family office and UHNWs? No, says Wulfsohn, and he draws on Stenham's heritage attracting both UHNW and now institutional allocators alike as justification.

"Our philosophy has not changed and we are still very mindful of managing risk focused on non-correlation to equity markets. It is our long track record at delivering that is attracting clients."

In regard to Stenham's activities in the future, he adds: "All we have is our track record.

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HARRY WULFSOHN, STENHAM

environment and we look at it from a qualitative, top-down approach." Wulfsohn says. "Over the last few years we have been concerned about risk and imbalances building up, but it's important to say, it doesn't matter if the event you're concerned about doesn't happen, the key thing is to be able to deliver returns without taking on too much risk and it's all about understanding the risk a strategy or manager is taking on to deliver the returns."

This sentiment, also voiced by Wulfsohn in *Hedge Funds Review* back in December 2005, was a driver behind the January 2006 launch of its Stenham Global Macro FoHF, which has since produced annualised returns of 9.14% on annualised volatility of 4.36%. (Stenham has been investing in macro as a strategy via its multi-strategy products since the 1980s.)

Wulfsohn says, while the world's large global macro management houses – many of which Stenham has been invested in for some time – continue to produce returns, Stenham's analysts are mindful of some macro managers following similar themes, so concentrating risk. "You need to be aware of correlation risk where

have taken on leverage.

"When things go wrong people panic and assets you expect to be uncorrelated become correlated." Wulfsohn cites in this regard gold: "people have been getting out due to general investor nerves."

A PRECIOUS RESOURCE

Stenham's gold-focused FoHF is a mixture of equity long/short funds, long only funds and gold bullion.

It was launched in 2003 as a prescient hedge against inflation and dollar devaluation. By combining manager styles and territories Stenham Gold has delivered returns in excess of gold equities with a two thirds of the volatility at 19.27% since its September 2003 launch, producing an annualised return of 18.16%.

The gold product is complemented by Stenham's Global Resources FoHF, launched in 2006 with internal money, subsequently opened to external allocators in 2007, and now with \$35m.

"Its themes are softs and alternative energy, so it is not playing managers investing in the traditional energy or hard commodities. It is directional, and has long-short equities with some relative-value but no CTAs," Wulfsohn