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HEDGE FUNDS REVIEW

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Risk management at heart of Prima Capital FoHF success

Fundana's manager selection for the long/short equity FoHF Prima Capital emphasises control of downside risk with the focus firmly on managing risk rather than returns

As the father of value investing, Benjamin Graham, once said: "The essence of investment management is the management of risk, not the management of returns." Or, in the words of Dariush Aryeh, who manages the $718 million equity long/short Prima Capital Fund: "There is always someone ahead of us but our goal is to manage risk, not return."

Management of the fund of hedge funds (FoHF) firmly focuses on downside protection. "This is especially important in long/short equity where, if the drawdowns are too big, funds struggle to get back up," Aryeh says.

"Our focus for the last 20 years has been on selecting managers who are exceptional at managing drawdowns. This approach enabled Prima Capital to get through June and August 2013 unscathed."

Aryeh is also CEO of Trocadero Asset Management, the $1.026 billion management company for the FoHF.

The $1.1 billion Fundana, investment adviser to the Prima Capital Fund, was founded in 1993, the same year the fund was launched.

"A lot of people get risk management wrong," he says. "They focus on risk measurement, not management. We manage what we can control and limit what we cannot."

The Prima Capital Fund's objective is to outperform the S&P 500 with half the volatility and drawdowns over a cycle. Since inception, the FoHF

Dariush Aryeh, chief executive officer, Trocadero Asset Management (left) and Michael Gerber, head of research, Fundana

has produced annualised returns of 7.2% with 8.1% volatility and a maximum drawdown of 20%. The fund was up 13.8% by November 30.

"June and August [2013] were important months for us," Aryeh says. "We are subsequently considerably up, which is a textbook case for our defensive approach to equity investing."

As a long/short equity strategy, Prima Capital has a natural long equity bias. Around 35% of performance is attributable to the net market exposure. "The rest comes from managers' stock-picking capabilities," Aryeh says. However, he admits it is not easy to find the right underlying managers for the fund.

The dispersion between the best and worst long/short managers (26.9%) is almost twice that of US small-cap long-only managers (15.6%), according to Fundana analysis. "As a result, if you select the wrong manager in this strategy you could have a negative performance while indexes finish up in a given year," says Michael Gerber, head of research at Fundana.

"We look for what we call 'boring managers'," Aryeh adds. This, he explains, means finding managers with repeatable performance and proven abilities to manage drawdowns and add value on their long and short portfolios versus appropriate indexes.

"While in a given year none of our top fund convictions are likely to be one of the best industry performers, over the years they achieve exceptional compounded returns," he says.

A manager's ability to manage drawdowns can only be truly identified after they have

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Fund facts

Fund name:	Prima Capital Fund
Fund adviser:	Fundana
Management company:	Trocadero Asset Management
Inception date:	April 1, 1993
Strategy:	equity long/short
Assets under management:	$718 million
Performance year-to-date:	13.8% (November 30, 2013)
Performance (annualised):	7.16% (October 31, 2013)
Sharpe ratio (annualised):	0.5 (October 31, 2013)
Custodian:	Credit Suisse (Luxembourg) S.A.
Fund administrator:	Credit Suisse Fund Services (Luxembourg) S.A. (CSFS)
Auditor:	Ernst & Young Accountants LLP
Domicile:	British Virgin Islands
Liquidity:	monthly
Redemption:	monthly with weekly net asset value estimate

lived through several market corrections, which presents a conundrum for those trying to identify emerging talent.

"We may like a manager who has come from a firm we know, understand and like, who doesn't yet have a track record of their own. They can tell us they will behave a certain way if drawdowns occur, but you don't know if they will until they go through one," Gerber explains.

"We start with very small positions in new managers – about $1 million to $2 million or around 10 basis points for the flagship fund. If they go through one or two market corrections and do what they say they will and perform, we increase our allocation. We do all the due diligence and reference checking but it is impossible to pinpoint the psychology of the manager as they become an entrepreneur."

The qualitative side of due diligence can be the most problematic when selecting emerging talent, especially in regard to reference checking. Unsurprisingly, the references provided by managers are seldom negative about those managers.

One of the most important factors in Fundana's selection process is leveraging its network of industry contacts to gather a range of independent views. Over the last 20 years, the team has built a proprietary contact database called HedgedIn.

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>
> **Dariush Aryeh, CEO, Trocadero Asset Management**

"We store the details of every analyst or portfolio manager we meet so we can always call a person who has worked with a new manager or knows them in another capacity, and who is not on the list of references," Gerber explains.

"We try to find informed opinions so we can drill down into what exactly it means to be a portfolio manager at a certain house so we really know who we are dealing with and can avoid mistakes. We also do this for managers who we have known for a long time as it can add interesting insights on the qualitative side."

The importance of Fundana's network underpins its selection of managers based primarily in North America and Europe. "Fundana will never be a company with 50 people based in five different locations. We couldn't run an Asia long/short fund, for example, because we don't have the network," Aryeh says.

"Our goal is to remain a boutique with a nimble approach to how we select managers, run the portfolio and communicate. This is a very different philosophy to many of our competitors and requires a different mindset. The real success of our firm has been our ability to not succumb to temptations."

The continued focus on selecting managers who demonstrate a clear ability to manage drawdowns remains important. Although the landscape for equity long/short may look promising going into 2014, Fundana expects some bumps along the road.

Correlations between S&P 500 stocks are returning to historical levels of around 30% from nearly double that during the financial crisis. While the key question in 2008 was when to buy or sell, knowing what to buy and sell has once again become paramount.

"There is a much bigger differentiation between good and bad stocks in the current environment as the market has put macro issues to the side," Aryeh says. "Managers have been able to capitalise both on the long and short side, provided they are good shorters. Going forward, we believe the environment for equity long/short will be one of the best of the last 15 years. This is not to say markets will go up or down, but the market dynamics will favour equity long/short managers."

As long as deleveraging continues in Western equity markets, Fundana expects one or two corrections of roughly 5% to 7% a year, even if it ends a year in positive territory.

"To generate performance, managers will have to know how to short, which is where many long/short managers fail. It is not just the opposite of long. Managers have to react differently and fight more," Gerber says.

"There is a difference between those that can short stocks and those that just short a market. Managers may have 'safe' shorts that are defensive stocks, which don't fall as far as the market if it corrects. They may also have crowded longs so they get really penalised as the longs go down more than the market and the shorts don't go down as much."

To identify which managers have genuine stock-picking skills, the team at Fundana analyses the position data managers are required to post with the Securities and Exchange Commission to ensure they remain true to their mandate and liquidity parameters and show where performance is coming from on a weekly basis.

"The key to long-term performance is compounding returns, which means avoiding big losses," Aryeh concludes. "Fortunately, searching for these asymmetric returns is our passion as well as the core of our investment philosophy." ■