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INFORMING THE HEDGE FUND COMMUNITY

SAIL Advisors

Hedge fund investing with an Asian perspective

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The rising importance of Asia's economies to the global economy is being matched with growth in private banking and hedge fund investing. It is not just Asia-based funds that are sprouting up. There is also expansion in the investor numbers from Asia that are allocating to hedge managers both in the region and around the world.

SAIL Advisors, a fund of hedge funds based in Hong Kong and managing around $2 billion, is one of the bigger investors among this new breed. Founded by Robert Miller, the co-founder of Duty Free Shoppers and ranked among the world's biggest hedge fund investors, SAIL has experience in hedge funds investing which dates back to the 1990's. It is running four primary funds (three that are global in scope and one that is Asian focused; see Table 1) and has over 40 employees in Hong Kong and New York.

Table 1 SAIL funds Source: SAIL

	GLOBAL STRATEGY (Total AUM: $1.8 billion)		SPECIALISED STRATEGIES (Total AUM: $157 million)	
	Topaz Fund	Flagship Fund	Asia Pacific Managers Fund	Emerging Managers Fund
Type of fund	Global multi-strategy, multi-manager	Global multi-strategy, multi-manager	Asia Pacific multi-strategy, multi-manager	Global multi-strategy, multi-manager
Inception	May 2001	January 1999	February 2007	February 2006
Size	$740 million	$1.1 billion	$150 million	$33 million
Return target	Libor + 400 - 500 bps	Libor + 600 bps	12%+	Libor + 600 - 800 bps
Risk target	4% - 6%	6% - 8%	8% - 12%	6% - 8%
Managers	50	50	25	20
2011 YTD	1.69%	1.59%	1.03%	1.76%
1-year return	5.27%	5.98%	4.78%	5.85%
5-year return (ann.)	5.00%	1.95%	N/A	N/A
Ann. return	5.87%	7.34%	5.72%	4.48%
Ann. volatility	4.68%	5.39%	5.50%	6.12%

In the aftermath of the post-Lehman collapse credit crunch, SAIL is faring better than many funds of funds. Its main multi-strategy products, the SAIL Flagship Fund and SAIL Topaz Fund, both suffered in 2008 but have bounced back. The lower volatility designed Topaz Fund which lost 13.6% in 2008 more than recouped its losses in the 2009 rebound with a performance of close to 19%. Meanwhile, the higher volatility designed Flagship Fund had a bigger drawdown in 2008, but shows a highly respectable annualised return of 7.34% with volatility of just 5.39% since inception (dating back to 1st January 1999).

Harold Yoon, managing director and chief investment officer with SAIL since 2009, visited London in May, taking time out to discuss hedge fund investing between sessions at a Mayfair investor conference. His approach to hedge fund portfolios is closely bound up with managing risk.

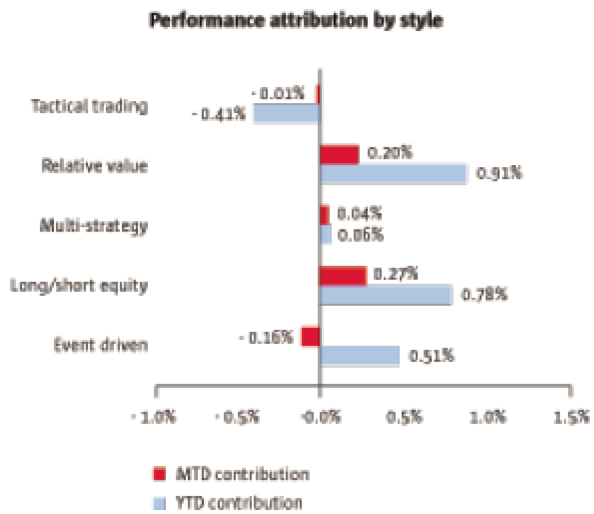
"Our philosophy is very much focused on alpha with beta being tightly controlled," Yoon says. "But as you know, there is no way to directly measure alpha so you need to be really good at risk management and being able to identify all the risks that are being taken. You then attribute returns to those betas or risks, and what's left over is the starting point for talking about alpha. It may just mean if you see a huge alpha number, that you have missed a risk factor."

Global multi-strategy funds

The Topaz and Flagship global multi-strategy funds invest in around 50 managers around the world in different strategies (see Fig.1). Typically 70% of allocations are to long/short equity and credit or event driven managers where SAIL is looking to find the biggest return generators and sources of alpha. The rest is allocated to relative value and macro funds, which are used for diversification and risk control purposes in the portfolio.

Fig.1 SAIL Flagship Fund - style allocation

Source: SAIL



Style allocation

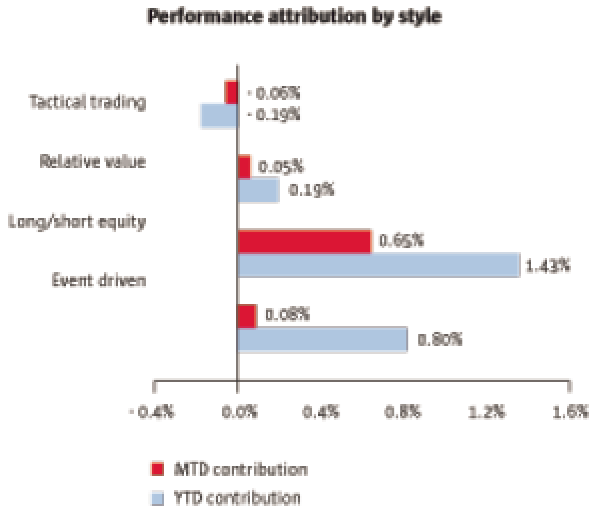
Event driven	**27%**
Long/short credit	8.1%
Credit driven	7.9%
Other event driven	11.1%
Long/short equity	**31%**
Long/short equity	31.4%
Relative value	**16%**
Convertible bond arbitrage	6.8%
Fixed income arbitrage	3.9%
Other relative value	5.6%
Tactical trading	**25%**
Global macro	13.0%
Emerging market	7.4%
Other tactical trading	4.7%
Total	**100%**

SAIL also runs two specialist strategies that provide additional diversification, but with only 20 or so managers and seek higher returns on a risk adjusted basis. One is the SAIL Asia Pacific Managers Fund which seeks to capitalise on growth in the region through investments in unique Asia managers. It has a return target of in excess of 12% and target volatility of 8-12%. The higher concentration is a product of there being fewer high quality Asian-based hedge fund managers to choose from than in the global multi-strategy funds.

The second specialist vehicle is the SAIL Emerging Managers Fund, which invests in smaller, younger hedge fund managers that typically have assets of $50-100 million (see Fig.2). About one quarter of investments are day one; another quarter within six months of the fund's launch and another quarter within the first 12 months. The fund has $33 million committed. The research mandate of the fund is borne out by the fact that about half the managers in the Topaz fund were first sourced through Emerging Managers. Though the fund was set up in 2006, SAIL is only beginning to market it and hopes to raise assets to $100 million by the end of 2011.

Fig.2 SAIL Emerging Managers Fund - style allocation

Source: SAIL



Style allocation

Event driven	**34%**
Long/short credit	9.8%
Special situations	9.0%
Other event driven	15.1%
Long/short equity	**41%**
Long/short equity	41.2%
Relative value	**9%**
Fixed income arbitrage	4.7%
Statistical arbitrage	3.9%
Other relative value	0.1%
Tactical trading	**16%**
Global macro	8.8%
Emerging market	4.8%
Other tactical trading	2.6%
Total	**100.0%**

Finding new talent

"Emerging managers is a really important fund for us," says Yoon. "We are not big believers in investing in big brand named funds, especially multi-strategy funds that have $10-20 billion. The question is how do you generate alpha from that? Typically, for long/short equity managers the sweet spot is funds in the $400-600 million range." As funds grow towards $1 billion and returns tail off (showing the profile of many bigger funds) SAIL will likely be beginning to redeem from them.

Aside from its strong Asian heritage, several factors helped put SAIL on the map. Paramount was the foundation capital allocated by Miller. His understanding of hedge fund investing and the need to allocate long term capital provided a cornerstone at a time when funds of funds weren't yet institutionalised. SAIL also incorporated strict adherence to fiduciary responsibilities that had characterised the Miller family office.

Prior to SAIL, Yoon had run ING's fund of funds business for eight years. A background in risk management and trade execution at ING Barings Americas in the 1990s and a brief stint running a long/short equity fund in 2000-02 gave Yoon the capital markets expertise to under stand investment strategies, the related risks and sources of alpha. These skills became increasingly important as funds of funds became more process oriented and less about relationships with key funds like Tudor and Caxton. A double MIT grad (electrical engineering then management) also gave Yoon the necessary quant skills.

"It is a combination of having the quantitative side and risk management and blending that with understanding of managers' strategies," says Yoon, describing what a fund of funds manger needs to deliver to investors. "It is difficult to get good statistics of how liquid some instrument is. In good periods there can be plenty of liquidity but when you really need the liquidity – when people are selling – the market gaps. Those are the types of things you can't teach people in a text book or through a model. You have to have hands on experience."

Managing risk, generating alpha

Fund of fund portfolio managers work at the intersection of strategy allocation and risk management with the latter function devoted to keeping losses under control in difficult market periods. The corollary is that when there are good opportunities on the alpha side, appropriate risk is taken to generate alpha returns.

SAIL uses beta and alpha models. With its long/short equity book, it forecasts base, bear and bull market scenarios. Models are used to estimate the level of market (or beta) exposure that each investment would have in each scenario.

"Hedge fund managers don't run static portfolios so you have to know them well enough to be able to know how they will react to changes in the market," says Yoon. "That is where the analysts' experience really kicks in."

Say a long/short equity manager is typically 30% net long. In a base case scenario of the market going up 10%, the exposure should bring about a 3% return. If the alpha models show that the manager is generating 600 basis points of alpha per year the combined return (beta plus alpha) will be a 9% return. Take a bear market scenario where the market is projected to fall 20%. The same manager would lose around 6% due to beta, but would be expected to generate about the same 6% alpha leaving the portfolio flat.

"For any one month this type of modelling isn't going to work very well," says Yoon. "But over a 12 month time frame it does work quite well. We have this model for every type of investment. We roll it up for funds within a strategy and then we have a strategy alpha and beta forecasts. We then extrapolate for each of the strategies so we have the portfolio alphas and betas." The system typically gives a result that is within 1% either positive or negative of the portfolio's actual performance.

Using stress scenarios

With risk management, the use of stress scenarios is the most important tool for SAIL. Right now, for example, it has two main stress scenarios: a Euro zone sovereign debt debacle and a double dip recession in the US. With Topaz, the low volatility global multi-strategy fund, volatility is targeted to be less than 5% with an aim to cap maximum losses at 2.5% in any given month. Since launch in 2001, the fund has delivered that consistency save for September and October 2008.

"Those scenarios were a big problem," says Yoon. "You have to go through historic scenarios, but no crisis is a repeat of the past. So you have to be forward thinking and come up with risk scenarios that you think are relevant for the current time period, and not just use historical risk analysis. For us the stress scenario is typically the most important factor in controlling the risk – to make sure in a stress scenario that the losses are controlled to the levels that our investors are expecting."

The litmus test for how portfolio analysts at SAIL are evaluated is whether funds perform within the forecasts in terms of downside or negative performance. Each fund has a forecast return and a range of outcomes. Whether the returns correspond with the range is the most important criteria SAIL uses to evaluate the success of its manager selection.

"The amount of beta exposure that we take is tightly controlled," says Yoon. "We are not investing with any significant allocation to managers that have 70% net long positions. Most of our managers have from 20% to 50% net exposure. But overall the portfolio will still have a net long bias. That is where portfolio construction is very important. The relative value and macro parts of the portfolio are used to balance off the risk-taking in the net long exposure we have in credit and equities. The other thing we have done is put in tail risk hedges so there is a percentage of the portfolio, particularly in the macro part, where we know that in any type of positive market environment we are going to lose money. If the markets fall off very hard or there is a crisis these tail risk managers will kick in with significant gains to offset some of the losses that we are taking on the equity part of the portfolio."

Tail risk protectors

The extreme volatility of recent years occasioned SAIL to look closely at funds that could function in a portfolio as tail risk protectors. It is now looking at setting up a managed accounts-based solution for a client to do just that, using up to seven such funds – including specialist volatility traders, CTAs and macro managers. A broad group of managers is needed to cover different asset classes, geographies and strategies and to avoid the risk that any one tail risk manager may call the market wrong.

"The aim is to get protection from a global crisis that swings through equity markets," says Yoon. "When we look at these managers some have spread type positions on yield curve-Libor-OIS type spreads. Others have equity put positions – some just have a bearish view on the macro environment for Europe and the US – those are more medium and long term but then others are trend followers and one is a tactical approach which adds value though shifting positions. With the managers we can identify alpha generation and evaluate how much down side capture is there vs. losses if the markets rally."

The aim is capture the entire downside of a market crash in return for giving up some of the upside of a rally. The skew to returns in a bull market is one way SAIL aims to add value and generate alpha for investors.

Core-satellite structure

Given the inherent difficulty in forecasting economic conditions 6-12 months ahead SAIL uses a core set of managers, particularly in long/short equity. The core managers, in whom SAIL has high conviction about generating consistent alpha returns, account for 70-75% of the portfolio. Many of the core managers may have slightly lower returns since their net long exposure is circumscribed in market upturns.

The remaining satellite managers are adapted to market conditions. Top down asset allocation is deployed. In 2010, the prevalence of ‘risk on/risk off’ trades sapped returns from fundamental stock picking. But the high level of M&A and corporate event activity led Yoon and his team to skew the satellite allocation towards event driven managers to benefit from that market activity.

“What we do is adapt the portfolio depending on the market environment,” says Yoon. “So for the last couple of quarters we have added more of these equity-type strategies. This year alpha generation is stronger so as we are moving into mid-year we have neutralised that risk a bit but we haven’t eliminated it. We are more aggressively positioned than we were in 2010 – but compared with 2006, it is lower now since there is a much bigger risk of a macro driven crisis.”

Credit exposure reined in

Credit is an important alpha generator and portfolio diversifier. In the second half of 2010 SAIL’s portfolio managers began reducing outright credit exposure and started putting on more hedges as spreads tightened. Now the credit portfolio is flat to slightly short. Typically, the global multi-strategy funds have more of a long bias as portfolio managers pick specific companies where they want to go long the debt. The trimmed exposure to credit is designed to protect the portfolio from managers whose company research is strong, but who may get side-swiped by economic or macro volatility.

As SAIL has a broad coterie of investors in Europe and Asia, it has looked closely at developing a UCITS fund. The research SAIL did showed that the UCITS liquidity terms were too onerous and too limiting for mainstream hedge funds to run their strategies and produce significant alpha returns. It is noteworthy in rejecting a UCITS product at this point of time that three of SAIL’s funds are dealt quarterly (Topaz offers monthly liquidity with 45 days notice).

“The industry is still pretty young,” says Yoon. “Most people didn’t invest in hedge funds until the mid-2000s so have about five years or so experience in investing. The regulatory environment is going to continue to evolve and will need to adapt. When investors see UCITS are underperforming even though they have all this comfort through transparency and liquidity, they are probably going to want to adapt.”

A distinct investor proposition

Positioned as a market specialist and knowledgeable hedge fund allocator globally and in Asia, SAIL offers a proposition in terms of manager selection and research that is quite distinct from that of an investment consultant or adviser. What’s more, it has proprietary capital invested in the funds alongside investors.

“I tend to think the advisors recommend well known funds,” Yoon says. “We don’t think that this is where the greatest alpha is going to be. Money is starting to move back into funds of funds but the due diligence is more severe. That is probably what we note the most. Several years ago we had investors making allocations after one meeting; you don’t see that anymore. Now a number of our investors want us to take them to see the hedge fund managers we are actually investing with to get a better understanding of what we do and the type of exposure we are taking.”