

HEDGE FUNDS

THE VOICE OF THE ALTERNATIVE INVESTMENT INDUSTRY FOR 10 YEARS **REVIEW**

Asian commonsense

A real understanding of where alpha is being generated, coupled with deep risk analysis, is the key to the success of Hong Kong-based SAIL Advisors' funds of hedge funds, discovers Margie Lindsay.

Hedge fund investing is just about using common sense, says Harold Yoon (pictured right), the chief investment officer of SAIL Advisors, one of Asia's leading fund of hedge funds (FoHF) managers. That may be easy for Yoon to say but in execution it is something that seems to have stymied many other FoHFs.

Yoon's rules for manager selection are to stick with managers that produce alpha, stay with only liquid instruments and keep a close eye on risk.

This philosophy, with some embellishments, has worked well for SAIL since Yoon joined in 2009. SAIL was set up in 2003 as part of the Search Investment Group created in the 1970s as the family office of Robert Miller, co-founder of the Duty Free Shoppers chain.

The family has a track record of investing in hedge funds. In 2003, buoyed by strong performance, Miller decided to open the family office to outside investors. While the family is still a significant investor, Yoon believes the FoHFs should be attractive to investors in the US and Europe.

In mid-2009 SAIL took over ING's four FoHFs, when Yoon first came in. Before joining SAIL in July 2009, Yoon was the chief investment officer and head of the ING FoHFs. He joined ING in 2002 and was based in New York.

One of his pre-conditions when joining SAIL, he reveals, was to have an office in New York. SAIL has always had a strong presence in Hong Kong with analysts, risk management, finance and operational due diligence handled from there. Yoon is also setting up a London presence. He is a "big believer" in having offices where investors are located.

Since joining SAIL he has concentrated on building the investment team and

rebuilding the team in Hong Kong with a number of former ING people joining there.

"We are very strong now," declares Yoon. This is important because the way his team analyses and assesses managers in the flagship Topaz fund as well as the two smaller emerging managers and Asia-Pacific funds is at the heart of his investment philosophy.

Yoon is dismissive of FoHFs that do not show investors how they add value. Unless a FoHF can clearly give something extra, Yoon believes it has not earned its fees. "The biggest trend seen since the financial crisis," says Yoon, "is that investors were very disappointed with FoHFs." That loss of faith has pushed more into direct investment but Yoon believes many investors still need an advisor in order to make the right choice.

He says FoHFs that played safe and only put money into big-name funds do not add value. Hedge funds find it harder to generate alpha once they hit the \$10 billion to \$20 billion mark, he says. "The value a hedge fund can add is alpha, not chasing beta," he notes. For him the role of the FoHF is to find out who is actually producing that alpha and make investments in those funds.

Yoon is confident he has the skills to make those decision calls. From 1994 until 2000 he headed risk management for ING in the Americas. He worked on the 350-man trading floor overseeing 10 risk managers with offices in New York as well as Brazil, Mexico and Argentina. At the time ING was one of the biggest proprietary traders in Eastern Europe.

"This experience of working with prop desk traders was how I learnt about hedge funds. We worked with hedge funds as counterparties since 1994. I've

been through the crisis. All the good traders that I knew at ING are now working at or running hedge funds," he says.

This background in risk management is what Yoon believes gives him an edge. "The average person has a really tough time differentiating between alpha and beta. Every hedge fund tells you they are a massive alpha generator and how they perform against the S&P 500. That may not reflect the risk at all."

Yoon's technique is to model every investment made by a manager to find all the beta. Once this is attributed, "what's left over is a starting point for us to really assess whether or not it really is alpha. We make sure we fully understand the strategy and all the risk taken."

The focus is on alpha generation to drive returns while controlling and minimising risk. The only way to understand alpha is if he can properly manage all the beta and liquidity risk SAIL is taking with the investment. An important part of the process for every investment is quantitative modelling for alpha and beta. These are not just regression-based models.

Every month as part of the risk management monitoring process, SAIL sends out a risk template to each hedge fund. This lays out what SAIL believes is the key information required in order to perform the kind of analysis needed. Analysts phone the hedge fund managers to help them fill out the forms and to get additional information that many may not want to put on paper. "Hedge funds have to be careful about regulatory rules and about treating investors equally and fairly," notes Yoon.

So newsletters, risk reports and other documents sent to investors will be the same. "But in terms of meeting with and



talking with managers on the phone, we think the relationship is critical. That's why the emerging managers are very important for us as we develop that relationship," Yoon explains.

All the risk information is collected. The big equity positions, shorts, sector information, geographic information and more are then put into SAIL's databases. "We use that information to build a bottom-up exposure model for the fund." Using different models, both alpha and beta components are taken into consideration.

Position information from the fund is given to SAIL and from this it constructs a model. In addition SAIL runs a weekly bottom-up model to compare the returns the models produce with the estimates received from the funds on a weekly basis. Often SAIL's analysis picks up a deviation.

This is where alpha kicks in, he says. For example, the fund may have a position in a stock that is being taken over or has a big earnings surprise. The stock might be up 30% but if the fund has a high conviction position of 5% or 10%, that one position could have a 2%-3% impact on the returns.

"That's going to be hard to compute in

the model. We compare our model return estimates against the estimates from the fund and then the analyst can explain any deviations, as he knows what's causing it, or we're going to follow it up to have a better understanding of what's driven the returns."

In addition Yoon builds left tail-risk hedges into the portfolio. "We look at the distribution of returns." He believes that the market is now experiencing five and ten standard deviation events. "These are unpredictable. We recognise that these once in a lifetime events are happening much more frequently, especially in this environment."

By building in the hedges, SAIL tries to control some of the losses it will inevitably sustain. "It's not perfect. We're not going to recover full losses but it will keep losses to levels we and our investors expect."

To handle such analysis, Yoon needs a team of hedge specialists "with the appropriate backgrounds" and quantitative skills. One of these is Allen Sing, executive director and portfolio manager responsible for CTA strategies.

With over 15 years of experience in the hedge fund and investment banking

industries, Sing joined SAIL in February 2002 from a US equity long/short fund where he was a research analyst.

Yoon emphasises the need to avoid the larger funds where alpha generation is dropping and that may have organisational issues, particularly as they add more staff. "Where we really add a lot of value is identifying the smaller managers. We have an emerging manager FoHF. We will make day-one investments, including up to a quarter of the portfolio," Yoon says.

Yoon believes investing with managers early gives several benefits. One is access to the manager. "If you try to talk with him when they are \$1 billion, it's hard to get his time. You'll probably be doing a lot of talking with the investor relations man. So we like to go in before or close to the launch and get full access to the portfolio manager."

Yoon also demands full transparency. He thinks this is important, too, in order to judge how much skill and how much luck is helping to generate the alpha. Looking at funds with one or two-year track records can mask someone just being lucky. "If you invest early and follow the money, you'll have confidence

that the track record reflects the strategy he is running today.”

These skills at picking new managers are particularly apparent in the two specialised FoHFs: Asia Pacific Managers Fund and the Emerging Managers Fund. When SAIL bought the ING portfolios the Emerging Managers Fund had been liquidated and Yoon had to start the portfolio up again. He is hoping to have \$100 million in the Emerging Managers Fund by the end of the year.

“We focus research on emerging managers. Over half the hedge funds in our global funds were sourced through the emerging managers strategy. This has been very successful, sourcing managers early. For that, however, we want premium for the extra risk we are taking,” he says.

The other area where Yoon believes SAIL adds value is in its knowledge and coverage of the Asia-Pacific area. This is unsurprising. Not only does SAIL have a local presence, there are Mandarin, Japanese, Thai and other Asian language speakers on the team. “That’s super-important,” confirms Yoon.

This is because he believes most alpha is being generated by Chinese long/short equity funds. Although these managers are based in Hong Kong, the research is typically done in Shanghai or Beijing. “You need to go out and talk to the analysts as part of your due diligence. If you don’t have a Mandarin speaker, it’s difficult.”

Yoon is grateful to be in Hong Kong. While at ING he was trying to cover Asia-Pacific from New York. “Now I can see the different perspective when you have all the people in Hong Kong with the satellite office in New York. It’s very, very different. I think that’s a real edge for us.”

But just being in Asia is not everything. There are not many big-name \$1 billion funds. Most of the managers, says Yoon, are \$200 million or even under \$100 million. “You need to go and do on the ground research. We see very few people resourced up in order to do that hands on research.”

Yoon also believes in the Chinese story. He believes there is going to be a lot of potential upside which China long/short managers are going to be able to capture. “Those are our highest alpha managers. This is what is interesting for us.”

To give some idea of why he has confidence in his managers to perform, Yoon points to the fact that even though the local China market is flat this year, on average the China managers in his portfolio

are up 6%-7%. “It’s really showing the alpha generation.”

Yoon also believes the Chinese government will be able to engineer a soft landing. “If they are able to keep inflation under control and economic growth at 7%-8%, potentially you can have a lot of upside on the China equity markets and that is something our long/short managers can catch.”

While Yoon’s optimism on China may be questionable, he believes it is the right view and is in line with the managers in his underlying funds. He also thinks China will be the dominant story in the future as there is enough liquidity on the equity side to support managers compared with India or some of the other South-East Asian markets where there is not as much liquidity.

Yoon is so confident that he expects to launch a purely Asian long/short equity FoHF in August. “One other thing that influences our views is the conversations we’re having with hedge fund managers in London and New York. What I found was



Harold Yoon

that they are starting to allocate to Chinese equities. So that’s a good signal.”

Despite all the theories and analysis, Yoon says the investment philosophy of SAIL boils down to avoiding funds that are too big and assessing how returns are generated. He steers clear of funds with poor liquidity terms. During the financial crisis Yoon admits Topaz, the flagship FoHF, lost close to 14%.

The reason, however, was not a lack of liquidity but “because everyone was selling and marking to market”. Having suffered a loss in 2008, however, SAIL was able to capture the alpha opportunities in 2009 because its managers maintained liquid portfolios were able to run strategies as normal.

One other thing Yoon avoids is investing in funds where he does not understand the source of risk/return. “I’m not saying we won’t invest in quant funds but we have to have an understanding of how the fund’s models work and verification that we’re not investing in a set of returns only,” says Yoon.

This, he adds, is where having strategists is important. His own background, originally in engineering, as well as a team strong on quantitative experience, helps. “The rule of thumb we use is if it is too difficult for me to understand, it’s probably too complex for our investors.”

For the future Yoon expects to continue doing the same thing. With marketing efforts picking up, particularly in the US and UK, he hopes to increase AUM, particularly in the two smaller FoHFs. He also plans to launch a new product and continue providing investors with solid performance, capitalising on the expertise of the Asian managers as well as a local presence. ■

SAIL ADVISORS FOHFS

Total assets under management (AUM): \$2 billion

Topaz Fund: flagship global multi-strategy, multi-manager

Inception: May 2001

Size: \$740 million

Return target: Libor plus 400-500bp

Risk target: 4%-6%

Asia Pacific Managers Fund AUM: around \$150 million

Strategy: Asia-Pacific, multi-strategy, multi-manager

Inception: February 2007

Return target: 12% plus

Risk target: 8%-12%

Emerging Managers Fund: global, multi-strategy, multi-manager

Inception: August 2006

Size: \$33 million

Return target: Libor plus 600-800bp

Risk target: 6%-8%