InvestHedge

A HedgeFund Intelligence publication

Volume 8 Issue 3 December/January 2008/9

The only publication that focuses on investors in hedge funds

# Refocused Ermitage ready to capitalise on improved fund of funds model

After a busy few years of restructuring, Ermitage has positioned itself to take advantage of what it sees as a 'broken' fund of funds model by providing large institutional investors with customised hedge fund portfolios

By Claire Makin

Ian Cadby

Jonathan Wauton

Caught between rollercoaster markets and fearful investors, most fund of hedge fund managers see very few reasons to be cheerful. But Ermitage's chief executive officer Ian Cadby and chief investment officer Jonathan Wauton are startlingly optimistic about the prospects for their $2.4 billion business.

They say that current markets play to Ermitage's strengths (both men have trading backgrounds), while future industry trends point in their favour. They are positioning Ermitage as a provider of customised solutions for institutional investors, drawing on sophisticated investment systems that the team has developed over the past four years. "It's an important service that is more and more in demand from clients, particularly with the chaos in the market," Cadby says.

The past few years have been busy for Ermitage. The product line-up has been overhauled, new hires made and funds launched. A buyout of the business from Liberty Group in 2006 saw Caledonia Investments taking a 60% stake. The same year, Ermitage made an important strategic hire in Nick Macleod, who joined from rival Financial Risk Management to build up quant, risk measurement and portfolio construction. OPTICS, Ermitage's customised portfolio system, was rolled out in 2007.

The company increased its pace of expansion in 2008, while many competitors focused on damage control. Two new funds, the Directional Fund, and the multi-strategy Opportunities Fund were rolled out, as well as a bespoke fund for a major Dutch pension fund.

A New York office opened in June, and Daniel Eichner joined from Lighthouse Partners as head of relative value, one of Ermitage's core strategies.

At the same time, Ermitage hired John Rushen from BlackRock as head of European institutional business, with an eye on the notoriously difficult UK pensions market (Rushen was a partner at William M. Mercer). The consultants who act as gatekeepers to UK pension funds have so far favoured large fund of funds groups, but Cadby suspects that they will have more time for smaller, better performers given the carnage in the industry.

Ermitage already has a strong foothold in the US market, where CalPERS is a client, a fact that is well-known in the hedge fund community. Ermitage won a $100 million mandate to run a European multi-strategy portfolio for the giant California fund in 2006.

Cadby is unwilling to talk about CalPERS, except to say that the mandate highlights the strength of Ermitage's investment and risk management processes. Ermitage also runs money for several US endowments.

Performance results seem to vindicate the effort that Cadby, Wauton and their colleagues have put into reorganising the business and product range over the past four years.

Although they regret any investor losses, these have been relatively small compared with industry averages, and two of Ermitage's 13 funds of funds are in positive territory this year.

Both of these are thematic. The new Directional Fund (CTA and macro strategies) is up 2.71% since launch in March 2008. The older Resources Fund is up 1.4% for the year after gaining 3.5% October.

Among the older and larger funds with the broadest mandates, Ermitage's best performer has been the $126 million European

Absolute Fund, a long/short equity fund that has dipped 1.5% in euro terms (2.62% in dollar terms) this year through October, against -4.44% for the InvestHedge European Equity average. The $95 million European Multi-Strategy Fund, launched in February 2007, is down just 44 basis points for the year.

Even so, Ermitage's solid results and refocused business have yet to be reflected in overall asset growth. Assets under management have remained around the $2 billion mark for a couple of years (excluding $516 million in money market funds). This partly reflects shrinkage in some of Ermitage's legacy funds, such as its six-year old Japan fund, which has suffered despite strong relative returns as investors have pulled out of Japan. A listed seeding vehicle, Strategic Partners Fund, launched in 2003 with the backing of some big name US investors, is nearing the end of its life as managers in the portfolio have become established. Ermitage is planning to launch a successor when conditions improve.

But Ermitage sees its biggest growth potential in providing customised hedge fund portfolios for large institutional investors. Cadby and Wauton say that the standard fund of funds model no longer works. Institutions now want a more transparent process and a tailored approach for their money.

According to Wauton, it is no longer enough for fund of hedge fund managers to combine "20 icons of the hedge fund world" in a portfolio and market it to investors as a diversified product.

Many top managers have shocked investors with the size of their losses this year, and fund of hedge fund clients who thought they were buying diversification have been disillusioned. "With many of our competitors, clients are not getting what they thought they were getting," Cadby adds.

He believes that 2008 will be a defining year for fund of hedge fund managers because it will highlight those that offer the most robust portfolios. "A bull market hides a lot of sins," he points out.

According to Wauton, a recurring theme played by large institutional investors has been that funds of funds mean an unnecessary layer of fees, and that the institutions' high profiles enable them to carve out capacity with whichever managers they favour. But this trend to direct investing in hedge funds is now rightly being questioned, he says. "Once you take beta out of the equation you've got to work a lot harder," he notes.

By contrast, Ermitage takes the view that combining strategies in a properly structured portfolio is far more important than securing capacity with top managers, or even allocating to the best performers. "In some cases we are firing managers who are up 3% this year because we expected them to be up 15% in this particular environment," Wauton says.

Central to Ermitage's philosophy is a view of hedge funds as building blocks to deliver investment solutions. Funds of funds, or variations on the model, are intermediaries. "We take primary return streams and combine them in a way that delivers a return stream that the client wants. That's what we get paid for," Macleod says.

To this end, Ermitage has spent a lot of time and money deconstructing funds, analysing their sources of risk and how they generate performance, and integrating this with return forecasts across a range of market environments. The result is a portfolio system named OPTICS, which was developed by a team led by Macleod, and rolled out in 2007.

This system identifies a portfolio that is most likely to meet a client's objectives, not only in terms of risk and return, but also geographic specialisation, focus on (or avoidance of) certain strategies, and other constraints or preferences, such as position concentration, number of managers in the portfolio, and even views on the market. "If you don't know what you are trying to do, you don't know how to achieve it. If you start with the objectives, everything else falls into place," Macleod points out.

OPTICS is integrated with Ermitage's four-year old manager database, LEWIS, which contains due diligence on some 600 researched managers and statistics on 5,500 more.

Ermitage invests with 117 managers across its portfolios. Positions are quite concentrated among 20 or so underlying funds, with 10 core managers typically accounting for 50% of assets. Most are mid-sized or smaller managers. "We are not a $50 billion fund. We don't want to have to write a $200 million ticket to make a difference in our funds," Wauton says.

Macleod notes that hedge funds are not a static, non-correlated asset class, which is how they are often presented to institutions. Instead, hedge funds are dynamic strategies, whose defining characteristic is their ability to adapt as market conditions change. Tracking a group of CTAs against the S&P 500 Index, for instance, shows that they were uncorrelated in the 2001-3 bear market, became positively correlated in rising markets through 2007, and have since become uncorrelated again. Cadby was a registered CTA and options trader for several years, and Ermitage is very comfortable with the strategy, unlike some of its competitors.

This forward-looking view means that Ermitage tries to pick the right manager for the environment and portfolio objectives, rather than the best manager in a particular asset class based on historic data. "Basically we are saying that we don't extrapolate the past into the future," Macleod says.

This is not the only belief that sets Ermitage apart from many of its competitors. "We don't think volatility captures risk, we don't think diversification depends on correlations, and we don't use VaR with a normal distribution in the

### ERMITAGE: A CORPORATE HISTORY

Ermitage made its first hedge fund investment in 1984 and launched its first fund of hedge funds in 1997. The following year, Liberty International bought 40% of Ermitage, and ownership then passed to parent Liberty Group (formerly Liberty Life Association of Africa) which bought 100% of the company in 2001. The same year, Ian Cadby and Jonathan Wauton joined. Cadby and Wauton had previously worked together on the OTC options desk at Citicorp and subsequently ran an Asia hedge fund together. Cadby also worked as head of hedge fund trading at Regent Pacific Group and Cresvale. He became Ermitage's CEO in 2004.

In 2006, Cadby led a management buyout of Ermitage, in which Caledonia Investments took a 60% stake. Caledonia has holdings in a portfolio of companies including Close Brothers, Rathbone Brothers and Polar Capital. Paul Myners, former chief executive of Gartmore, who has a long association with Caledonia, became Ermitage chairman, but resigned when he was appointed City Minister in October 2008. He remains a shareholder of Ermitage.

tails because that doesn't work," Macleod says.

Ermitage is also impatient with debates about alpha versus beta returns. "You can't separate alpha from beta. People who tell you that you can have got it wrong," Macleod says. Most returns attributed to alpha include a beta element, he notes.

The importance of quant models and algorithms to Ermitage does not blind the team to the value of old-fashioned common sense. "We are very pragmatic," Macleod says. He advocates using models as guides, not pushing them beyond their limits of applicability, and not accepting theories that conflict with real-world experience. "It would be a mistake to strain everything to get an optimal portfolio, because in the real world, there is no such thing" he adds.

Teamwork is important; Ermitage wants to avoid fiefdoms, where people jealously guard information and refuse to share it with other teams. In the early days, each analyst had responsibility for a portfolio. But because of the key man risk, this system was dropped in favour of decision-making by a central committee. This disenfranchised the analysts, so Ermitage set up a hybrid system, with three strategy heads of long/short equity, relative value and directional (CTA and macro) strategies reporting to Wauton.

A separate portfolio construction team works with the strategy heads to apply the models, while the investment committee, headed by Wauton, implements strategic decisions.

Operational due diligence reports to chief operating officer David Morrissey. The team focuses on all aspects of operational risk, and has absolute power of veto. They have exercised it on roughly one in every 10 managers that have been evaluated.

With its people and systems in place, Ermitage is now ready to expand further in the US and European pension markets. The ultimate goal is to manage money for several more large institutional clients, with whom Ermitage can develop a long-term relationship based on an understanding of their needs and objectives, Cadby says.

Ermitage is aware of the demands this will place on people and systems. Ongoing support is crucial because pension funds are accountable to trustee boards and must be able to explain performance.

Portfolio transparency is a vital part of this equation. Ermitage would like to invest more of its clients' money via separately managed accounts rather than in funds. Wauton says that in the current environment managers are proving far less resistant to the idea than in the past.

Unlike many other groups, who are sitting tight until the fog clears from the markets, Ermitage began adjusting its portfolios for increased volatility in June 2007. "It is a new environment. Like weather systems, when a new one comes in, it stays for some time," Macleod notes.

The team responded by building up allocations to short-term trading strategies across all portfolio styles. Ermitage's multi-strategy funds already had nearly a third of their money in these strategies; by early 2008, Wauton insisted that each portfolio should have at least a 10% allocation as protection. "By March we were saying 'The shorter the trade duration, the better'," Macleod says.

Among funds receiving allocations is Ermitage's Global Dynamic Trading Fund, a high conviction futures trading fund run by Ermitage technical analyst Elliot Refson, a strategy which has returned 65% since October 2007. The $100 million fund sits within Ermitage's Global Wealth Management subsidiary business, but has attracted investors from outside the group.

At the same time, Ermitage shed managers with insecure credit lines (including some larger managers), illiquid positions, counterparty risk and those that were too small to survive.

The $250 million Asset Selection Fund, which invests in relative value strategies, received a major overhaul in early 2008. As a result, Ermitage was able to redeem from managers who have since made it very difficult for investors to withdraw their money, Wauton says. The fund's niche mandate contributed to it being down 16% this year through October, having suffered in the distorted markets like others in the sector.

**"It is a new environment. Like weather systems, when a new one comes in, it stays for some time"**
***Nick Macleod***

Ermitage remains on high alert, anticipating further redemptions from underlying managers regardless of performance, and wary of asset risk lurking in credit portfolios. The team is also watching for 'scope creep', with managers tempted away from their core competence by other opportunities.

New opportunities are also appearing on the horizon. Ermitage is flagging early 2009 as a possible re-entry point for private direct lending, US corporate credit and asset-backed securities.

Ermitage is not looking to fix its systems because there is nothing wrong with them, Wauton says. The pace and scale of events has been surprising, but no strategy has behaved differently from what Ermitage expected, given the conditions.

"The biggest surprise has been counterparty risk. It became a new variable," he notes. The wild card was rehypothecation, where prime brokers reinvest hedge fund collateral. This practice hit the headlines only when some hedge funds failed to get their collateral back after the Lehman collapse. Ermitage's operational due diligence department have been working all hours to ensure that its managers are not affected.

Only a handful of clients have redeemed from Ermitage's funds of funds, Cadby says, and even fewer have pulled out completely. Some have needed cash, while others have reduced their hedge fund allocations.

When the market crisis is over, Ermitage partners foresee a lot of soul-searching across the industry. "The fund of funds model will be quite damaged when it comes out of this. Managers will have to be much more creative, much more dynamic," Wauton says.

Cadby is convinced that Ermitage has a clear edge in providing investment solutions to global pension funds, based on its combination of systems and human talent. "We think 2008 will only go to channel clients towards our style of investing, as they realise the traditional fund of hedge funds model is broken," he says. As a result, he is looking to build up the New York business, and perhaps find a strategic partner.