The Hedgeweek Interview: Brad Cole, CEO, Cole Asset Management: Focusing on managers with a sustainable edge

By *Anonymous*
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Brad Cole discusses the strategy and investment processes driving the Tellus Natural Resources Fund, focused on commodities and natural resources.

HW: What is the background to your firm?

BC: We have been active in the hedge fund and managed futures industry for more than eight years, primarily working through our sibling firm, Cole Partners, as a marketing agent for a variety of unique alternative investment products. We formed Cole Asset Management in 2004 as an investment adviser, in anticipation of developing our work on the asset management side of the business. We launched our first proprietary product, Tellus Natural Resources Fund, a fund of funds dedicated to the commodities and natural resources sector, in February 2005.

While our firm is the Investment Adviser to the Tellus portfolio, we share portfolio management responsibilities with a sub-advisor, Chicago-based AlphaMetrix Investment Advisers. AlphaMetrix was formed in 2005 as an alternative investment advisory firm that specializes in trading manager research, due diligence and developing technology for risk management and quantitative analysis purposes. They advise over USD 350MM in assets and have put together a really strong team of industry professionals and programmers. They have a managed account platform with real-time risk analysis and performance tracking capabilities, and they are contributing all of this industry experience and technological capability to co-manage the Tellus Fund.

While we have made legal distinction between the roles as investment adviser and sub-advisor to the Fund, the Tellus portfolio is managed very much as a collaborative partnership between the two firms, primarily through an investment committee of four people, two from each firm. On the Cole side, I have more than twenty years of industry experience, including 10 years on the floor of the CME trading futures and options, then as part of a successful Chicago based CTA. Developing and dissecting trading approaches has been at the heart of my investment career since 1980. I am joined by my COO, Rian Akey, who has been working with my firm for more than seven years, primarily in a research and due diligence capacity. From AlphaMetrix, Aleks Kins has asset management experience as a member of the alternatives group at Carr/Indosuez and Ramsey Quantitative Systems, Inc., where he helped to build the Emerging CTA Index, a multi-advisor product that focused on emerging commodity trading advisors. Jon Stein has previous tenure as the chairman of the investment committee for Efficient Capital Management, one of the largest multi-advisor CTA managers in the world, and before that was with Rotella Capital Management, a prominent CTA.

HW: Who are your key service providers?

BC: Our key service providers are all well-known, top tier industry participants. PriceWaterhouse Coopers is the auditor. Our administrator is Swiss Financial Services. Legal counsel is Winston & Strawn. We have a variety of managed account investments, and Calyon Financial is the FCM for these accounts. Our banking is handled by Northern Trust domestically, and by Bank of Butterfield offshore.

HW: Have there been any recent events such as launches or changes/additions to the management team?

BC: There have been no recent changes.

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HW: What is your investment process?

BC: From a top-down standpoint, we segregate the universe into five broad sectors: energy, metals & mining, agricultural, softs, and exotics & other. Within each sector we are looking for a combination of complementary exposures, including directional, relative value, and arbitrage; as well as a range of instruments, including securities, futures and options, and perhaps some physicals. The objective of our investment process is to identify the best manager or managers within each sector, while keeping complementary and balanced exposures at each sector and the portfolio level.

We find that we have a universe of about 200 managers that fit within our mandate of commodities and natural resources sector strategies. While that number is growing all the time, it is still a manageable and knowable universe. We identify areas of interest through our top-down assessment of what exposures we like and then look to evaluate managers within peer groups. This is done quantitatively, of course, when possible, but in many cases it can be difficult to make direct statistical comparisons: either the manager does not have direct peers or the strategies have only recently come to the marketplaces and you have limited quantities of data available.

In any case, we have developed a qualitative mapping procedure for each manager that we call a footprint. The idea is to create an impression of how the manager has performed or will perform based on its exposure profile or strategy. This helps to determine how the specific exposure of each manager will fit in with our existing portfolio, but also provides an outline of return and risk expectations for each manager. The core of our investment process involves understanding how a manager is achieving returns, how that exposure fits into the rest of the portfolio, and what risks that exposure introduces.

Along with the qualitative and quantitative assessments, we are also conducting thorough administrative and operational reviews. To make it into the portfolio, a manager must offer some kind of complementary exposure, compare favorably to peers (if they exist), and pass an operational risk assessment and due diligence process.

HW: How has your fund of hedge funds performed?

BC: We have been pleased with how the portfolio has performed. Since February 2005 the total return is 29.16% net; for 2006 year to date the total return is 15.90%. These returns have come with annualized volatility since inception of 8.00%. We have been particularly pleased with performance during months like April and October 2005, as well as February 2006. These are periods when commodity markets have had dramatic pullbacks, even in the midst of a secular bull market. Some of the commodity indexes were down 10% or more in these months, while the most we lost in any of these periods was 1.09%, so the portfolio defended really well in some tough markets. So, in reality, most of the volatility we have seen has been to the upside. Over the long term we do expect to see volatility increase; our target is about 10% annualized volatility. With that kind of volatility we are targeting a rolling Sharpe ratio of 1.0.

Our performance since inception has been consistent with our pro forma expectations of what we could achieve in this space. Rolling 12-month returns have been in the top quartile of expectations, while volatility and lack of correlation to commodity benchmarks has been consistent with expectations.

HW: How many funds are in your portfolio?

BC: There are currently 16 managers in the portfolio. Over time we expect to maintain core holdings in 16-20 managers, and perhaps have a smaller number of non-core holdings in strategies or markets that are especially niche in nature. We think many of those niche holdings are where some real alpha opportunities will be going forward.

HW: Are you linked to any hedge fund indices or have you launched products linked to hedge fund indices or do you have plans to do so? If so, please provide details.

BC: We do not link to any of the commodity indexes, or even benchmark to them really. However,

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we keep very aware of how these indexes, like the GSCI or the Dow Jones-AIG Index, are performing, because so many investors look to these as a bellwether for commodity returns, but also for risk. This helps us keep aware of what investor risk and return expectations are for a commodity themed product.

HW: What makes a manager/strategy special enough for you to select him?

BC: We are looking for a manager with some kind of uniqueness or edge that we think is sustainable. The edge can be any number of things: unique or lengthy tenure, an information base or flow that that is exceptional, a strategy that is multi-faceted, or coverage of a market segment that is not widely followed. For example, there are a lot of energy managers that have emerged over the last couple of years. We are not particularly excited by a manager who is profiting from a static long position in mid- to large-cap energy companies. While these guys have made money in the last couple of years, it's generally clear what exposure and risk they add to the portfolio, and that pure directional exposure is not something we want to pay for. We want to pay for risk management; for tactical approaches to these markets. The commodity space is an interesting one because there are a lot of really unique and compelling stories out there so we think we have had a lot to choose from.

HW: What are your criteria for removing managers from the fund?

BC: We talked about our footprint process earlier, where we map out the exposure expectations for each particular manager. While we do set things like drawdown levels and volatility targets for each individual manager, the footprint allows us to think about things more qualitatively. We have performance expectations for individual managers when gold trends up, or when crude oil consolidates. We align and consider manager performance in light of these expectations. Material deviation from footprint expectations is cause for dismissal from the portfolio - maybe even if there is reason for it - because that is a deviation from some type of exposure we were building into the portfolio. The managers are not stand-alone investments and need to be viewed always in the context of the whole portfolio. Other criteria can include personnel changes, more quantitatively construed under-performance, or in some cases our own top-down tilting away from a particular type of exposure.

HW: How many managers do you have on the substitutes bench?

BC: You know, everyone in the commodities space talks about limited capacity as if there are not any managers out there. It's true that there is a fairly defined universe of managers, but there is actually a large number of interesting, compelling stories and strategies covering a wide range of markets. We have nearly as many managers on the 'bench,' so to speak, as we have in the portfolio. If you are not afraid of the nooks and crannies, these markets are a great place to be looking for traders.

HW: What events do you expect to see in your sector in the year ahead?

BC: We are long term bullish on the commodities arena as a whole and expect to see high volatility continue. The main drivers here are long term shifts in supply and demand to accommodate Asian mobilization into global capitalism, increase corporate activity both in terms of re-investment into R&D and increased production capacity, but also in terms of an increase in M&A activity as valuations rise in the sector. Lastly is the idiosyncratic nature of commodity distribution means more structural inefficiencies as opposed to the deeper capital markets. These fundamentals feed into our multi strategy approach quite nicely.

As far as commodity prices, we don't see copper going up 50%/year forever, or gold, or sugar for that matter. We expect to see more range trading as far as individual commodity markets go, even if the range is fairly wide, but still with plenty of volatility for traders to find opportunities. Outright exposure to copper right now is a concern, especially with the anecdotal stories about some of the recent short squeezes. It will be interesting to see how some of the emerging interest in bio-fuels affects the relationship between corn, sugar, and the energy sector.

HW: How will these changes/future events impact on your own portfolios?

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BC: Shorter term, our views vary by sub-sector (Energy, Metals, Foods and Basic Materials). So the near term degree of long versus short or how much volatility exposure is going to be the individual manager's tactical call. Weather we are bullish or bearish, we allocate to managers on a sub-sector basis with the objective of creating an asymmetric payoff: capturing directional moves up or down, but then manage the volatility when the markets turn around.

For example, we see widespread fundamental bearishness in the grain sector in the wake of record crops in 2004 and 2005. But with continual index buying, sustained moves to the downside have been fleeting and thus difficult to maintain a high degree of profitability based on fundamentals. As a result, volatility is lower and there may be no clear direction on prices until the 2006 crops start to come in. So, we don't abandon the space by any means, but we have modestly lowered our allocation to the sector until either the fundamentals change or we find another war to play the food market.

On a broader basis, if the directionality of the markets starts to cool down, the biggest impact will be on investors who start thinking about some of the limits of passive investment in commodities. There is more than $80 billion in passive commodity products; we think that was a first step for many investors and that some of that money will find its way to the active side. A slowdown in the run-up will be a catalyst for that.

HW: What differentiates you from other managers in your sector?

BC: There are a variety of things that we think make our fund different from others in the space.

The first is coverage. We are not an energy fund. That particular sector is well-known and well-covered. There are a handful of well-known, pedigreed groups and they are not a mystery to anyone in the space. We do not think we are setting ourselves apart in the energy sector (nor is anyone else). We have sector limits that mandate a diversified portfolio of broad commodities exposure. That limits the amount of assets we can ultimately manage, but it increases our focus on the other sectors in a commodity portfolio - and these are places where we feel we can get a real edge: finding good, solid, professional grain traders, softs traders, metals groups, and managers covering peripheral markets. These are the managers who are not always widely known or accessible.

We don't have asset level minimums in terms of a manager has to have a certain amount of assets to be considered - you just can't do that here when you are looking at a trading only in the livestock or grains. The managed account platform that AlphaMetrix brings to the table is a huge advantage in terms of mitigating much of the business risk of looking at these smaller managers. Also, everyone on our investment committee has substantial experience looking at small and emerging managers, so that is a clear specialty for us.
We also consider ourselves a natural resources fund, as opposed to commodity only in terms of futures-only. There are other managers in the space who won't go into managers in the securities markets. We know that adding long/short managers into the portfolio can add some equity exposure, but feel that the trade-off in terms of an expanded opportunity set is worth that relatively small amount of exposure. We can get involved in peripheral markets like water, forestry products, utilities, shipping, infrastructure - there are all kinds of additional ways to get involved in resources that aren't really available in a futures-only strategy.

HW: Some funds of funds have complained that managers are not taking enough risks in the current environment - what are your views on this, and on risk in general?

BC: Well, we probably have a higher appetite for risk than many strategies; that just comes with the space we are in and our expectations. We talk a lot about whether we are taking enough risk - when you have a commodities portfolio with single digit annual volatility that is something you have to ask yourself - but we are certainly not having a problem with finding adequate risk-taking on an individual manager level. When you assemble them into a portfolio, you see that the building blocks you're given in commodities are non-correlated and quite nice for smoothing out a return stream, but individually there has not been a problem with taking enough risk.

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More traditional, broad fund of funds may be asking that question, but we might turn it on them as the fund of funds manager: Are you taking enough risk at the portfolio level? Or are you saddled into only finding large, institutional money managers and strategies, the whole three year track record and USD100 million phenomenon. Is that what investors are paying fund of fund fees for;

HW: Are investors' expectations moving upwards and how do you deal with this?

BC: Well, first and foremost, we are an investor. And our own expectations are moving upward. So we deal with this by being demanding and expecting transparency that is meaningful and fair. And expecting liquidity terms that are fair for a given strategy and not just some kind of lock-in for the manager's convenience. Because if we are demanding of that kind of thing, then we are in a position to pass more information, and more meaningful information, on to our own investors.

HW: Are you planning any further launches this year?

BC: We are focused on the Tellus portfolio at this time, and do not have any specific plans for additional products at this time. There are some interesting possibilities down the road, but for now we are committed to the success of this product.

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