Risk management at heart of outperformance through the crisis

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Appreciation of the importance of risk management before it was brutally brought home to the industry in 2007 and 2008 was central to the ability of many of those hedge fund and fund of funds managers who outperformed their peers during the market turbulence of the past couple of years – and whose success was rewarded at this year's inaugural Hedgeweek awards, which were presented in London last month.

Greenwich, Connecticut-based Centaur Performance Group won the award for Best Credit Fund thanks to the votes of Hedgeweek readers impressed by the outstanding performance of the Centaur Credit Select Fund, which returned more than 45 per cent in 2009. "The risk management function is key for us," says chief investment officer Henry Pizzutello. "Our investment process was probably responsible for most of the outperformance."

Central to that process is identifying the primary risk factors to the fund's strategies. "Most people manage the risk – we try to keep it out of the portfolio before we have to manage it," Pizzutello says. "Early in 2009, the primary risk we identified in the US market was not credit quality but access to liquidity in the capital markets. Every investment we made at the beginning of the year was designed to negate that risk.

"Issuers in a distressed financial state or with significant leverage, or credits that were at the bottom of the capital structure, were taken out of the portfolio. Even though these assets gained the most in value for the year, it gave us a runway, and allowed us to invest knowing that we would not be subject to events beyond our control."

The basic risk profile of the Centaur Credit Select Fund is focused on capital preservation, low correlation to down markets and moderate upside. According to Pizzutello, the 2009 returns reflected unique market conditions. "Last year was exceptional for a number of reasons," he says. "We target annual returns of 10 to 15 per cent, but we had three successive cycles that earned 15 per cent each."

Centaur invested in secured high-yield paper early in the year, then convertibles and relative value as capital markets thawed, and toward the latter part of the year the firm made money in distressed assets. "Those cycles would normally occur over a period of three to five years," says Pizzutello, "but all three happened to be compressed into 12 months."

According to Pizzutello, investors were impressed that the fund has made outsized returns without shedding its risk-averse philosophy. "One of the things that really resonated with investors was our performance in 2008, because it's more gratifying when you outperform on the downside," he says. "Throughout the crisis, we have been flexible enough to capture alpha while being conservative and disciplined enough to stay out of trouble."

Some managers may have changed their investment approach because of the crisis, but Pizzutello is not one of them; on the contrary, he believes it has allowed the virtues he has espoused for years to shine. "My investment philosophy has been fairly consistent over the years," he says. "More than anything else, the crisis has provided a way for me to address how our process is different from other strategies. We sometimes lose that opportunity in bull markets."

He believes that the current market environment will allow skilled managers to demonstrate how they stand out from their peers even more. "This year is going to be much more of an opportunity for differentiation, because last year almost every asset class was moving up in concert," he says. "Unless you really got behind the numbers and understood how people were achieving their returns, you might as well have put your money into the S&P 500. This year we really expect to see differentiation among asset classes as well as fund managers."

For many managers caught up in the savage downturn of 2008, the crucial issue was whether they could recover, and carry the confidence of investors with them. One who did was Michael Petry, chief portfolio manager with Copenhagen-based Danske Capital, whose Danske Invest Hedge Fixed Income Strategies Fund received the Hedgeweek Award for Best Fixed-Income Fund after achieving a return of more than 40 per cent for its investors over the course of the financial crisis.

Petry says that in the wake of the downturn he and his team have been even more focused on their downside risk lest the market should run into a fresh period of extreme turbulence. "At the beginning of the crisis, when Lehman collapsed, we lost 20 per cent, and we would very much like to avoid it happening again," he says. "We are very focused on whether the same things should happen again and how much we would lose or gain. But apart from being more focused on risk, we are doing more or less the same as we did before.

The fund invests in the euroland, US and Scandinavian fixed-income markets, eschewing corporate bonds, and using techniques such as short selling, derivatives and leverage to generate high absolute returns. Petry says investors have mostly been very satisfied with the way the fund has been run – "Of course they did not like the drawdown after the Lehman collapse, but no-one really blamed us, they fully understood that the Scandinavian market was one of those hardest hit at that time" – but the fund did face redemptions later, ironically, after it had started making money again.

"We had most redemptions after we really started giving investors a good return," he says. "Perhaps it was because when people looked at their various investments, they could see they had a 40 per cent return from our fund, whereas they might have lost 20, 50 or 80 per cent of many of their other investments. They were taking a profit from one of the few investments where that was possible."

Petry acknowledges that many managers who were able to maintain liquidity through the crisis were punished because they were among the few places investors could go to raise cash, but he is confident that the fact his fund was able to maintain liquidity will ultimately yield benefits as investors come back into the market. "We are starting to see that now," he says. "We are getting more and more enquiries from different kinds of client who are interested in our fund because of its returns during the crisis."

Daniel Farrell, director of marketing and investor relations at Phalanx Capital Management, which is based in Chicago with an office in Hong Kong, argues that being a "truly hedged" hedge fund – being genuinely capable of making money whether markets are rising or falling – was central to the Phalanx Japan Australasia Multi-Strategy Fund winning the Hedgeweek Award for the Best Relative Value Fund.

"If you look at our returns from 2008, that was a very difficult year for a lot of investors, but we were able to make money," Farrell says. "Market conditions changed throughout that year. And in 2009 we were able to make money as well. We endeavour to make money in all market cycles."

He notes that volatility in the markets in which the fund invests – Japan, the rest of Asia and Australia – tends to be far greater than in Europe and other Western markets. "The market movements are a lot larger, and we are able to capitalise on that through the asset classes we use, including convertible bonds, volatility, OTC or listed equity options, swaps and merger arbitrage," he says.

According to Farrell, the fund's managers are positioned for a hiccup in its targeted markets. "While it's difficult for us to predict what the market is going to do overall, our personal feeling is that there will be a correction at some point," he says. "The premise of our business is to be able to protect against fat tail events and to profit from them. We will always have a bias toward the downside wherever we're able to make money, and we feel there will be some type of correction coming up."

During the crisis, he argues, Phalanx and its investors benefited from its principals' experience of extreme market events. "Our chief investment officer, Chris McGuire, has been around since the late 1990s and has been through Long Term Capital Management and the Asian debt crisis," Farrell says.

"One of the things we did that was unique among most convertible funds was to use asset swaps, which are much cleaner than using credit default swaps. We used that experience to navigate through the markets with a rational mind. There was a lot that we had already learned from the experience of the past."

The fund's success over the past two years enabled it to win mandates from investors at a time when other managers were experiencing capital outflows. "We've always had strong performance with good numbers, and our target return is 15 to 20 per cent every year," Farrell says. "We've seen tremendous opportunities in this space and have been able to capitalise on them to make oversize returns over the past couple of years.

"Investors have responded to that very enthusiastically. We started 2008 with a much lower level of assets under management, but having gained a tremendous amount of momentum we've been able to attract fresh capital over the past year while most investment managers were losing assets. A lot of our competitors have shrunk, but we've had very few redemptions and we've been able to bring in new money."

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