

Roundtable discussion

Introduction

swissHEDGE regularly invites reputed hedge funds to join a roundtable discussion in which to share their views on a particular topic. This time, we have invited three leading European long/short equity hedge funds to share their views on investing in Europe.

Cambrian Capital Partners LLP

Fund: Incremental Fund Inc.

AUM: USD1b

Representative: Simon Connell, Fund Manager

Aster-X Capital Management B.V.

Fund: Aster-X Europe Fund.

AUM: USD150m

Representative: Marc Voncken, Fund Manager

Gradient Capital Partners

Fund: Gradient Europe Fund

AUM: USD600m

Representative: Scott Pagel, Fund Manager

Q: What is the most compelling aspect of the European equity space at the moment for long/short managers?

CAMBRIAN: The greater a share price deviates from the underlying fundamentals of the company, the more compelling the investment opportunity. This can manifest itself through wrong earnings forecasts or an inappropriate valuation attached to those earnings. Clearly, the greatest potential for an investment idea is when both occur. We currently feel that, on the short side (and in particular in technology), there are many ideas that satisfy both of these criteria.

ASTER-X: There are many interesting stock picks to play among all European countries we invest in, long as well as short. There are many themes to play, and different sector and country dynamics.

GRADIENT: We currently are finding the most compelling investment opportunities on the long side of the portfolio -

in the mid-market capitalisation space (USD1b - USD8b), where growth opportunities are above average, valuations are attractive and companies are less well researched and analysed by the investment community. We have been able to find a number of companies with solid business franchises and adept management teams trading on single-digit earnings multiples coupled with double-digit free cash flow yields. This combination provides significant upside potential with an underpinning of valuation support minimising downside risk.

Q: Has it been necessary to take on more risk to generate sufficient returns and how do you expect that to affect your strategy?

CAMBRIAN: It has been tempting at various times during the year to increase the risk profile of the fund as volatility continued to decline. However, it has been our belief for a while now that the implied risk of equities is unsustainably low, given the global macro-economic and geo-political backdrop. Increasing the fund's bets just as equity volatility may start to rise would be a bad strategy.

ASTER-X: We are very risk averse, and low volatility and capital protection are quite important to us. We prefer to miss out on opportunities rather than increase risk or change our strategy. Sticking to our strategy is core to our investment philosophy, and by the way: there have always been plenty of opportunities to implement our strategy.

GRADIENT: Our strategy, which deploys a research-intensive, fundamental, bottom-up approach to equity investing, tends to have volatility that is inversely correlated to market volatility, ranging from 6-14%. For instance, during periods of high uncertainty such as the middle of 2002 when market volatility spiked to over 40%, the fund had volatility at or even below the low end of our targeted range. At the time, the market was being driven by non-fundamental factors, and the difficult investment climate meant that capital preservation was of paramount importance. However, over the past 18 months we consciously have increased the fund's volatility to the upper end of our threshold as market volatility materially has decreased and as we saw numerous stock ideas trading at unjustified discounts to their intrinsic worth where we wanted to exploit the valuation anomalies and scope for alpha generation with large

position sizes given our high conviction in these names and comparatively lower risk emanating from market movements.

Q: How do you view the surge in funds and assets in European long/short hedge funds?

CAMBRIAN: It is right that hedge funds have seen significant inflows and clearly, capacity is limited. Therefore, our biggest concern would be that investors allocate to hedge funds for the right reasons but get the wrong risk/return profile through not being able to find sufficient managers of the right quality, who are still open.

Also, there has been plenty of discussion but very little analysis about whether the inflows into all hedge fund strategies have contributed to more modest investment returns. During the eighteen-month period to the middle of 2004, assets under management in European long short equity funds rose by around 30%. However, this total asset pool still represents less than 1% of the value of European equity markets. Whilst hedge fund assets are more likely to be leveraged and more actively traded than other investment strategies, it appears extremely unlikely that they alone are responsible for the 60% collapse in volatility during the same period.

ASTER-X: We just stick to what we have been doing for 15 years: stock picking. We do not see any capacity constraints to our strategy by this development.

GRADIENT: The increase in funds and assets in the European long/short equity area raises some minor competitive concerns; however, we believe that the space is not too crowded to prevent good risk-adjusted returns from being generated in the future given the depth and liquidity across European markets and the sizeable number of securities in the investment universe. European equity hedge funds still account for a nominal proportion of total equity assets managed; so capturing only basis points of traditional long-only performance «drag» results in percentage points of «alpha» generation for alternative investors.

Q: Have you seen any noticeable changes in the trading environment over the last three years?

CAMBRIAN: The past three years have seen extremes on both sides in terms of market volatility and investor sentiment. During the eighteen months post September 11th, fear was clearly the dominant factor driving investor decision-making. This pushed equity prices significantly below any measure of fair value. Over the last eighteen months, to a certain

extent, the opposite has been true. Whilst liquidity during the entire period has been adequate for large caps, in the former period there was clearly a greater risk with entering a long position too early but in the latter period short entry points have become more risky.

ASTER-X: Not that much over the last three years. But over the last fifteen years market, participants have become more short term/trading oriented in general.

GRADIENT: The most noticeable change in the trading environment over the past few years relates to a trend toward more momentum-based, technical trading with a short time horizon at the expense of fundamental-oriented trading with a longer-term investment focus. Trading also has migrated to more direct market access channels with electronic links to stock exchanges, bypassing or reducing the importance of brokerage houses for trading functionality. These trends have been driven principally by the proliferation of hedge funds, proprietary trading desks and large program trades which are accounting for an increasing proportion of volumes.

Q: Have the barriers to entry fallen in the European long/short space?

CAMBRIAN: No, not really. Certainly, there is more competition for prime brokerage business and there are more institutions ready to invest early in hedge funds than when we launched our fund just over 4 years ago. However, barriers to entry have never been that high. The reason for more funds entering the space is simple: there is sufficient demand as the industry has reached a level of maturity that is attractive to the risk profile of the bulk of institutional money.

ASTER-X: No. Especially in the UK, it has already been quite easy for many years to set up a fund.

GRADIENT: The barriers to entry in European long/short equities have not dramatically changed over the past couple of years, and in fact the pace of new long/short European equity hedge funds launching recently has slowed down. The difficult aspect of the business is not in establishing a hedge fund, but in attaining critical mass, generating consistent risk-adjusted performance that meets client objectives, and building up a favourable reputation within the industry.

Q: What have been the hardest challenges this year?

CAMBRIAN: Coping with the surprising lack of equity

volatility has been the hardest challenge this year. When one looks at the various economic imbalances that currently exist in the world, and at the associated fragility of global growth, then the fact that measures of implied volatility are at eight year lows suggests a high level of investor complacency.

ASTER-X: Fighting the beta-exposure and uptrend in the market. We are fundamental and very prudent investors, and markets have been driven up by liquidity more than fundamentals.

GRADIENT: As fundamental, bottom-up investors, one of the hardest challenges in 2004 was routinely dealing with all the noise and misinformation surrounding structural, top-down concerns that masked to a large extent the material improvement in corporate growth and profitability. Also, as was the case in the previous year, 2004 proved to be a difficult time for making a significant contribution to performance from the short side of the portfolio.

Q: What do you believe will be the most important skills to have to be successful in the European Long/ Short space?

CAMBRIAN: It still seems to us, both anecdotally and empirically, that most European long/short hedge funds do not use both sides of the portfolio for alpha generation. Many funds have a long bias and employ futures on the short side as a hedging tool. This leads to an asymmetry of returns (funds perform better in up markets), and also to a higher correlation of returns amongst long/short funds than one might expect. Should markets prove to be tough going forward, as we expect, then the ability to generate sufficient alpha on the short side will be a manager's biggest differentiating factor.

ASTER-X: Sticking to our investment philosophy and investment framework, as well as having talented people on board with superior stock selection skills.

GRADIENT: We believe that the most important skills to have for success in the European long/short area are the ability to combine good security selection with robust portfolio construction/risk control methodologies. The ability to excel in both areas of the investment process is critical for achieving consistent, above-average returns under a risk-controlled framework. On the stock selection side, a hedge fund manager must be innovative and creative in seeking out investment ideas that are poorly covered by research analysts, and have the ability to take advantage of improper interpretation of corporate news by the market as well as appropriately applying specific company information

to other securities in the same or complementary industries. On the portfolio construction side, a hedge fund manager must be able to ascertain the different types of risks embedded in the portfolio from many different perspectives such as risk from single issue concentration, diversification across industries and countries and biases due to beta, style and market capitalisation.

Q: Has it been more rewarding to time the market or focus on fundamental stock picks in recent markets?

CAMBRIAN: European equity markets moved in their narrowest range for a quarter of a century during the first half of 2004. Whilst the second half has seen a slightly broader range, there has been little to go for as far as market timing is concerned. All of our return this year has come from fundamental stock picking (alpha) and this is where we continue to see the bulk of our opportunity.

ASTER-X: We are fundamental stock pickers, and have added substantial alpha since the start of the fund and in our previous careers (independently of each other).

GRADIENT: In 2004, it was much more rewarding to focus on corporate fundamentals as share price drivers for individual securities rather than correctly timing the market. During the year, equity markets moved in a narrowly defined trading range, and volatility was at a 10-year low, resulting in significantly smaller than normal opportunities to capture returns from beta. While the overall market had a high single-digit return in 2004 in a low volatility environment, the dispersion of returns among stocks across Europe still was very high, providing the opportunity for strong alpha creation.

Q: How do you see the outlook for long/short Managers going forward, and what is your market outlook for the immediate future?

CAMBRIAN: We are strong believers in the structural shift of plan assets out of traditional investment vehicles into hedge funds. Market indices have beaten European long/short returns for the second year running and it is easy to forget the experience of 2002 when essentially flat returns for hedge funds beat equities by 30%. Given the precarious state of pension funding across Europe, no plan allocator can afford the experience of 2002 again. Whilst in the context of historic hedge fund returns, the current return/risk profile offered by long short managers is unexciting, when compared with long term returns from

equities the mix is still very attractive.

For the immediate future, we are pretty bearish on equities and such an environment would remind any doubters of the obvious advantages hedge funds have over traditional investment vehicles.

ASTER-X: Markets will become more difficult, and the wheat will be separated from the chaff. We expect sub-par investment returns for the market overall over the next 2-3 years.

GRADIENT: We are relatively optimistic about the prospects for European equities at the beginning of 2005. The fundamental backdrop for stocks is constructive both from a growth and valuation perspective. Global economic growth this year, while likely decelerating from the pace witnessed in 2004, should be robust and at long-term trend levels, supporting organic revenue growth and nearly a 10% improvement in earnings. Despite the market's advance in the past two years, European equities actually are cheaper now, trading at 12 times current earnings as profit growth has outpaced equity asset appreciation. Dividend yields coupled with share repurchase programs offer a 4% return in 2005 at a point in the economic cycle when European equity valuations are very attractive and at a 20% discount to their historical average. While we are aware of the potentially negative macroeconomic and structural issues such as global growth and trade imbalances, euro strength eroding export competitiveness, waning fiscal stimulus, tighter monetary policy, higher input costs and inflation risks, the positive corporate fundamentals should outweigh these concerns in our opinion.

Q: What factors or sectors do you think will dominate return generation in 2005?

CAMBRIAN: Because of the current lack of visibility, only an extremely brave or foolish investor would attempt to look into the future further than a few months. As we are

neither, we prefer to keep our views restricted to the short term. We enter 2005 with corporate profitability at cyclical peaks and equity investors prepared to attach high valuations to these earnings due to a renewed level of enthusiasm for stocks. This is an extremely dangerous mix. For this reason, as well as the negative outlook for the US consumer, we are cautious on equities. In this environment, we would expect some of the more defensive and relatively depressed areas of the markets such as food & beverage or pharmaceutical stocks to hold up better than most, but we would expect to make most of our alpha on the short side. As technology stocks return to more normal levels of earnings growth, we would expect them to suffer significant de-ratings.

ASTER-X: Global growth is poised to slow down, due to a US slowdown and economic imbalances in the world. Many companies in US and Europe will suffer from deflationary pressures in several manufacturing and consumption related sectors caused by China. Unemployment will remain relatively high.

GRADIENT: We believe that the market is neither fully appreciating nor rewarding genuine growth companies exhibiting highly visible revenue growth with margin enhancement potential. Therefore, stocks with these characteristics should perform very well in 2005. From a sector perspective, we are optimistic on selected telecommunications operators principally based on compelling absolute and relative valuations, positive earnings momentum, scope for increased cash returns to shareholders and significant value transference to equity holders as strong free cash flow generation reduces net debt levels. We also have discovered some interesting long ideas in the industrial space due to the pent-up demand for capital expenditures after years of below-trend corporate spending, incredibly strong balance sheets and attractive valuations with further earnings growth potential despite the market's unwarranted concerns about the industry already reaching peak earnings during the current cycle.

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