

ALTERNATIVE MANAGEMENT

Hedge fund selection: an end to anarchy

State-run pension institutions and central banks have a great taste for structure and, whenever possible, standardised structure. EIM, the Nyon-based financial-services group, has well understood that requirement and obtained not only ISO, but also GIPS certification. Sound performance requires a solid structure: armed with this motto, EIM's CEO Patrick Susse is ready to take on the markets.

An interview by Véronique BÜHLMANN

Banque & Finance: EIM is a wholly independent company that ranks among the world's leading specialists in hedge-fund selection and monitoring. In which specific areas can it claim absolute leadership?

Patrick Susse: Firstly in the fact of its very early involvement in hedge-fund investment. We have conducted an in-depth informative and educational campaign with asset-management banks and Swiss pension funds. We have also been actively in contact with regulatory authorities in Switzerland and overseas. In France, for example, we have worked very closely with the AMF (the former COB) on the management of risk and illiquidity.

B&F: How do you rank EIM in terms of market share?

P.S.: In Switzerland, this market share is very low because we have been keen to avoid a geographical concentration of our client base, which would not have been a healthy approach for us as a single-product enterprise. Hence we have started prospecting abroad at a very early stage.

B&F: 60 percent of EIM's customers are based in Europe. Which Europe?

P.S.: We are particularly active in northern Europe, where the approach to asset management is traditionally quite modern and where investor interest in the hedge-fund industry has arisen early. France has also become a very important market for us, particularly since our installation. The share of our activities in southern Europe remains

low, whereas Germany is a promising market that will only develop when its current fiscal and regulatory problems are solved.

B&F: Why do you ignore the UK?

P.S.: The British pension fund market is traditionally equities-oriented. A change of mentality in this respect is underway, but it is taking place slowly.

B&F: Could this phenomenon be related to the FSA's extreme circumspection regarding the hedge-fund industry?

P.S.: I cannot say whether the FSA is extremely circumspect. On the other hand, I do observe that after having regained some composure following the losses incurred in recent market corrections, many UK pension funds now wonder whether they wish to remain hostages to equity markets.

B&F: Could you give us a rough idea of your market share in Europe?

P.S.: It is rather substantial in France, at least among that market's leading institutional investors. We also have some very large clients in northern Europe. However, I am not certain that reasoning in terms of market penetration has much relevance. What matters more importantly is the specific segment in which we are involved, that of large institutional investors. Among them, for example, the Seventh National Swedish Pension Fund (AP7) belongs to our clients. It is my belief that we occupy a leading position among institutionals such as pension funds and

state-run institutions like various monetary authorities.

B&F: Defenders of alternative management have shifted from the promise of two-digit rates of return to that of absolute returns as well as, according to your recent brochure, that of reducing the market's directional risk. How would you explain this trend?

P.S.: You will have to agree with me on one point: we cannot be blamed for lacking imagination. That said, what I keep telling my clients is that I do not believe that hedge funds are designed to generate annual performances of 25 to 30%. Their aim is to reduce a portfolio's risk and ensure a long-term performance far superior to the requirements of a pension institution.

B&F: You say so today. But were you defending the same argument ten years ago?

P.S.: Yes. In my view, believing that hedge funds must earn 30% a year is a mistake. They have acquired this reputation because at the time, the industry was dominated by macro managers. Yet by and large, hedge funds are not at all designed to offer this kind of performance. On the other hand, what can be recurrently pointed out is that a hedge-fund portfolio is characterised by a low risk exposure and a very strong resilience in the face of falling markets.

B&F: Certain private clients still think in terms of two-digit rates of return. Yet it is true that your clients are almost exclusively institutions. Why is the share of your private customer base so minimal?

P.S.: Simply because we have not developed it. Private clients are essentially banking customers. As such, they require a specific organisational structure that we are not necessarily capable of providing. In my view, private banking is a different industry altogether.

B&F: You joined EIM in May 1995. Prior to that date, you worked with UOB, where you were in charge of private banking. Today you are CEO of the EIM Group and managing director of EIM SA. How would you describe your current functions?

P.S.: My role is to design the company's global strategy for the coming years. In this context, we will for example emphasise long-only and absolute-returns strategies. The

idea is to apply hedge-fund methodology to the selection and composition of long-only managers' portfolios. With this in mind, we do not aim for a market-oriented management but propose to select a certain number of strategies to meet specific objectives: currently, these are to ensure good protection against market falls and to take better advantage of bull runs.

B&F: What are your other strategic orientations?

P.S.: We must for example think of ways to ensure optimal selection and tracking of managers whose numbers are on a constant, steep rise. Therefore, the current process needs to be transformed. Increasing numbers of managers also require that we need to forecast the future trend in account creations.

B&F: Do you have any ideas?

P.S.: Thank goodness we do. But they are still at an exploratory stage. Nevertheless, I believe that we will see more specialisation in the future, as much at the level of manager selection as in the area of manager aggregation.

B&F: Does that mean that in future, we will see the emergence of companies specialised, for example, in the universe of long/short managers?

P.S.: Yes. This trend is due to the fact that the period of time during which underlying managers remain open to new capital is gradually becoming shorter. When I started working in this industry ten years ago, a panel of thirty managers was sufficient to meet the requirements of your whole client base. These times are over. Today, when you invest in a manager and funds continue to flow in, you need to select another manager when the first one closes. This second manager's approach will certainly be very similar to his predecessor's, but nonetheless, you will have had to select and monitor him with particular attention. This trend has a very strong influence on our industry as the monitoring of new managers can no longer be ensured by a small team. To excel at this profession today, a company needs to be endowed with considerable size.

B&F: When you mention managers' life spans, you mean asset-management capacities. Others, however, claim that a manager's "efficient", i.e. high-performance lifespan also tends to

become shorter. What is your view on the issue?

P.S.: This does not match my personal observations.

B&F: What are your challenges in 2006?

P.S.: This year will probably be pivotal on financial markets. Given the time it takes to redefine an account's profile, preparations for 2006 should have been made in 2005. At EIM, we have begun these preparations in mid-August of last year, for we anticipated substantial changes. We therefore needed to review our strategies and reduce our exposure to long/short strategies, notably those characterised by a long bias. We also needed to increase the share of macro strategies, which are easily adaptable to sudden trend reversals in the market. It is my belief that in 2006, the impact of strategic allocations within accounts will be clearly measurable.

B&F: Do you anticipate important capacity problems?

P.S.: We have a very rigorous approach to capacity management. This enables us to have a very clear idea of the capacities we need in every type of style or sub-style, including those that must be available in the event of marked change at the level of strategic allocation. When you have 8 billion under management and must reallocate 20% of your portfolios, it means that you have 1.8 billion to allocate to other managers. At that moment, these managers must be properly identified and monitored, and you must be certain that they possess the required capacities.

B&F: Do you have the impression that allocation changes have accelerated over the past two to three years?

P.S.: It is not an impression but a fact. Initially, we were very stable and the trend consisted of constructing all-weather portfolios. Gradually, as we gained in experience, we have begun favouring the over- / underweighting of strategies according to our market forecasts. Incidentally, those who weren't heavily invested in long / short by the end of 2004 and in 2005 have by now seen their performance suffer accordingly.

B&F: EIM claims to have "developed a unique approach in the fund selection, monitoring and risk management". What makes it unique?

P.S.: Unique is maybe not the optimally chosen term. I would rather say that we have a number of key assets. Firstly, our geographic distribution is ideally suited to our activity as we are present on all key financial centres for hedge fund managers (London, New York, Singapore). The strictness of our selection and monitoring process is another such asset. Each of our analysts only follows about ten managers, which is far less than the market average of 25-30 managers per analyst. I also wish to remind you that our entire investment process is ISO 9001-certified (editor's note: in 1999, EIM was one of the first companies to implement a systematic, methodical and ISO-certified analytical process applied to all managers, be they newly selected or already invested).

B&F: What is the added value of this standard?

P.S.: Firstly, its added value is internal. When, in 1997-98, I predicted that we would raise one billion a year by 2000, I thought that we would need to find a means to structure ourselves to absorb such enormous quantities of capital. After some research, we opted for the ISO standard, which had the advantage of being extremely dynamic. Indeed, part of the ISO certification is only renewed if the company has demonstrated that its organisation and risk management has evolved in step with its business and turnover. I deemed this approach to be of a highly process-driven nature and I am retrospectively convinced that we have been well advised to adopt it. ISO has forced us to constantly reorganise ourselves and has provided us with a set of tools enabling us to precisely assess the quality of our work. As for the external aspect, the ISO standard certifies that we indeed do what we claim to be doing, which, in itself, is already quite good.

B&F: Have other companies emulated you?

P.S.: Only very few. One of them, however, is based in Zurich. Others have applied ISO standards, but only to part of the investment process.

B&F: Why such little enthusiasm?

P.S.: I believe that in our industry, many companies have grown and thrived without structuring themselves.

B&F: EIM claims that “absolute risk control is as important as performance”. Do you believe that in this area, you are more actively involved than your competitors?

P.S.: In my opinion, the key advantage of hedge funds lies in their capacity to provide strong returns combined with a very strict control of risk exposure. To state that hedge funds are totally market-decorrelated would be untrue; yet they do have the capacity to considerably minimise what one may call bad moments. An illustration of this claim lies in the fact that we have weathered the first half of this choppy decade without losing any money on our clients’ behalf. And this makes a considerable difference.

B&F: Are you more active than others in the field of risk management?

P.S.: Various philosophies exist. Certain professionals emphasise performance to the point of increasing volatility. Given the nature of our client base, such an orientation would, however, be wholly inadequate.

B&F: Beyond ISO, EIM has been one of the first fund-of-hedge-fund companies to adopt GIPS (Global Investment Performance Standards). What were the reasons for this move?

P.S.: We are one of the very few players in this industry to offer truly tailor-made products, whereby we create accounts that meet the specific requirements of each client. More precisely, these accounts meet the risk-management requirements specific to part of their portfolios. Contrary to others, we do not offer leading products that would allow us to boast a given level of performance. Therefore we needed to find another way to advertise indisputable performance. This led us to adopt GIPS, which are, by the way, commonly used in private asset management.

B&F: Do you think that the use of GIPS is becoming widespread?

P.S.: If tailor-made products gain in popularity, I hardly see another solution. Today, however, the entrance barriers to this market segment are extremely high.

B&F: How do you rate EIM in comparison with its competitors in the area of performance?

P.S.: On average, I would say that we rank among the top quartile. One of our key assets lies in our capacity to construct

excellent strategic allocations with regard to market conditions. Our organisation enables us to conduct market scenario analyses and, hence, to efficiently determine their impact on all various styles and sub-styles.

B&F: Does that mean that you have a large team of macroeconomic analysts?

P.S.: I always enjoy claiming that we probably have the largest research team, composed of almost 180 managers with whom we are invested and who, obviously, all conduct research. As we are in contact with them on a monthly basis, the result is a market view that is both very global and very particular. In combining this view with that of our in-house specialists, we obtain a highly interesting synopsis.

B&F: You have recently opened an office in Singapore: for what purpose?

P.S.: Initially, we need to have a research team on site to find out what really goes on in this market. In part, our business consists in garnering information, which cannot be done from a distance. The Asian market remains rather limited today, and hedge fund managers there still only have limited capacity. Yet they have entered a structuring phase and, therefore, now is the time for us to position ourselves.

B&F: Structured products represent 11% of the strategies you offer. Their overall performance is surprisingly similar to that of direct strategies. How can this be explained?

P.S.: The structured-product specialists with whom we operate know us well. In particular, they are familiar with our risk-management approach. This familiarity and trust enables them to make favourable quotes.

B&F: More than 10% in structured products seems quite a lot. Why such a large share and where does demand for these products emanate from?

P.S.: In my view, 11% is very little, at least in comparison with those of our competitors who almost exclusively deal in them. As far as we are concerned, demand for these products mainly originates with banks whose clients wish to enter the hedge-fund universe but require capital protection. It also emanates from pension funds that are not authorised to invest in hedge funds unless they have such protection. That being said, I am not the first specialist to recommend structured products on hedge funds.

B&F: Do you believe that demand for these products will grow?

P.S.: No, I believe some investors have been hugely disappointed. And part of the clients who have played with these products in the past will probably avoid them in future.

B&F: When can one expect lower commissions in the hedge-fund industry?

P.S.: A reduction of commission rates over the medium term is not excluded, yet it will be limited. The more professional you are, the more you realise what amounts of work are required to build a hedge-fund portfolio. Furthermore, this work is not free of charge: it is provided by experienced and highly qualified specialists.

On the other hand, the hedge-fund universe is not infinite in the sense that capacities are

not unlimited. As I was saying earlier, the time span during which a hedge fund is accessible is getting shorter and, consequently, the efforts to identify and track new manager become more and more important. When one has trouble finding capacity, one doesn't discuss commissions. And if clients want an offer that is qualitatively beyond reproach, they will have to pay for it.

B&F: Aren't some players already offering highly competitive rates?

P.S.: Indeed, but with the drawback that their clients also get what they paid for. As it were, some clients have already come back to us, now convinced of the necessity of a proper due-diligence process.

V.B.