

Success lies in keeping it simple

SATURDAY
INTERVIEW

ANDREW KELLY
Hedge fund manager
tells **Tim Sharp** of the
value of being away
from noise of the City

THE hedge fund with one of the strongest claims to being the best in Europe is not being run out of a trendy Mayfair office or a Swiss investment bank but from Edinburgh city centre where staff at tiny investment boutique Cartesian have made investors a return of 31.14% in the past year even as markets plummeted.

Hedge funds have been criticised for aggressive bets against ailing banks but on the flip-side many have attracted the ire of investors because, despite being bought to provide steady absolute returns whatever market conditions, they have seen losses mount. The average hedge fund has lost 10.82% in the last 12 months.

One notable exception is the £160m Ignis Cartesian UK Equity Long-Short fund run by the tight-knit investment trio of Andrew Kelly, David Stevenson and Jeremy Hall. The fund is up 85.31% since launch in April 2006, ranking it as the top performing European long-short hedge fund over that period from a field of 129. It is also the top fund over the last year.

It is a remarkable success for a business that was only established in 2005 when Kelly and Stevenson left SVM Asset Management to set up on their own. The business is a 50/50 joint venture with Ignis Asset Management, formerly Resolution Asset Management, which provides most of the administration support.

The pair has since been joined by Hall and Susan Rafferty, who runs the office in the city's Melville Street, both also from SVM.

Kelly, who takes a lead on the hedge fund, said: "Pretty much from starting the fund two-and-a-half years ago we adopted a fairly cautious view of the world.

"We saw enough to regard the financial sector as a problem from early last year and we were early into a cautious view on areas like property and areas like banks."

The benefit of a running a long-short equity hedge fund is that the manager can not only buy shares in companies they think are going to do well – their long book – but they can bet against companies they think are going to perform poorly by borrowing shares and selling them in the

hope that they can profit by buying them back later at a lower price, so-called shorting.

Among the areas targeted on the short side by Cartesian were resources companies which the fund has been shorting since 2006. Despite losing money as the sector soared, even through the early months of this year, Kelly upped the short positions over the summer and benefited as investors pulled out.

The company was also among the much criticised hedge funds that shorted banks.

"We closed those out in the middle of the year, in hindsight way too soon. The reality was we found other areas that people were not involved in such as the mining sector and resource-related stocks."

Kelly is clearly anxious to dispel the image of ruthless spivs taking advantage of others' problems to make a quick profit.

"Whenever we short a company the expectation is that it is not a short-term trade, it is based on whether the shares will materially underperform the market over a reasonably extended period of time. We would regard them as long-term investment decisions."

"We think best a long time ahead of putting positions in. We have to think ahead of possible problems with companies long before the market recognises it.

"We went into last summer, which marked a turning point for markets, with a net exposure of zero. Our short book was as big as our long book. We had short positions on around 40 companies. The reality is we got to 40 by having 37 the month before. You cannot create 40 short positions overnight."

Kelly comes over more as a reassuring if cautious accountant than aggressive trader. His background is not on the trading desk of an investment bank. Rather he is a trained actuary who came to Edinburgh in the late 1980s to work for Standard Life.

He sees Cartesian's investment philosophy as far more in keeping with the long-term ethos of traditional investment trusts than the sometimes aggressive hedge fund community in London.

"When I started working in Scotland in 1987 the story back then, certainly from the investment community in Scotland, was about conservatism



THREE OF A KIND: (left to right) Andrew Kelly, Jeremy Hall and David Stevenson have made investors a return of 31.14% in the past year. Picture: Julie Howden

and long-term investing. That probably doesn't fit well with the idea of running a hedge fund but the way we operate, all our investment decisions are long term. We are not changing the portfolio around every day."

The Cartesian team tends to work on a five-year investment horizon and Kelly is a strong advocate of the merits of common sense when investing, noting "there are times when we do not have to think too hard".

He added: "If the average person cannot afford to buy a house then it probably means the average house price is too high. I think what is probably surprising is how the market reacted to that information, how it failed to take a longer-term view."

The team works very closely together on the running of their £600m-strong portfolios. Kelly takes the lead on the Ignis Cartesian UK Equity Long Short fund, which charges a basic fee of 2% and takes 20% of absolute returns. Jeremy Hall is in charge of the £50m Ignis Cartesian 130/30 fund, essentially a conventional fund that allows some degree of shorting and is open to private investors. Stevenson heads up the long-only

Cartesian UK Opportunities fund that comprises the bulk of assets.

"We all work very closely together. We all sit within six feet of each other, we do discuss ideas and there is consistency across the portfolios.

"We act as both analysts and investment managers of the funds. There is not a reporting process where analysts go away

'We always wanted a structure where we could spend a significant majority of our time running our funds'

and think about things and then give ideas to the portfolio managers. We do both."

A lot of time is spent exploring scenarios for the months ahead.

"We talk around issues such as what happens if there is a sharp recovery in the next year. We don't think that its going to happen but we have to think about the situation and do our preparation before it happens."

A key element in the company's structure is its relationship with Glasgow-based Ignis Asset Management, formerly Resolution Asset Management. It provided capital for the business and continues to undertake sales and administration work for the business, handling compliance, information technology and "paying the bills". In return Ignis gets a share of the revenue. The rest is split between the four Cartesian partners.

"We always wanted a structure where we could spend a significant majority of our time running our funds.

"It is quite a straightforward structure. It sounds slightly basic but we are not left worrying about whether somebody needs a pay rise or somebody doesn't.

We are all highly motivated to perform well. In terms of that revenue split, it is highly likely that if we perform well performance fees will be the majority of our revenues so that is quite motivating as well. We clearly have a vested interest in making Cartesian work well as a business."

Kelly views the company's location as important to the way they work. "It is highly

valuable being away from some of the noise and some of the gloom in other parts of the market. As we manage the funds we try to take an independent view from the noise of the City. That environment now is more valuable than ever."

Of course there is more to a hedge fund than its short positions. The long book on the hedge fund closely resembles the portfolio of the long-only Ignis Cartesian UK Opportunities fund. This has struggled in absolute return terms as markets have plummeted, returning -31.65% slightly ahead of the FTSE All-Share index at -32.24%. It is still outperforming most of its peers with a position of 87 out of 332 in its sector.

The 150/30 fund, which employs an element of shorting, is down 18.85% over 12 months.

"Our long book has done fine. Although it is not immune to the impact of falling markets we can still find companies that are going to outperform. Some companies will cope with these conditions better than others."

The portfolio is heavy with companies such as utility National Grid, transport company FirstGroup and food

retailer Tesco whose businesses should be more resilient to the economic downturn than others.

The team is also bullish about the prospects for non-life insurance companies such as Royal Sun Alliance because "people still have to insure their cars, still have to insure their home," Kelly said but the sector is also benefiting from a shortage of capital that is boosting the rates they can charge.

The hedge fund can borrow money to amplify returns and Kelly said the fund's "natural stance" is to be 1.5 times geared. But at the moment overall exposure is around 90% with 45% each in long and short positions and the rest in cash.

"What has happened over the course of this year, volatility has been increasingly high. That means performance flies around all over the place. We have reduced the gearing as a simple investment rule is do not pretend you know what exactly is going on in the market all the time."

Kelly reckons the company year will be marked by share offers by a number of companies as they seek alternatives to the bank finance they would previously have utilised.

"I think that 2009 will be marked by companies having to raise equity."

For Cartesian the coming year could see a so-called soft-close of the hedge funds only existing investors are allowed to keep putting money in.

"We have indicated a soft close at the £200m mark. What we want to do is allow people who have been good supporters to us to date the chance to keep investing. We have always maintained there is a limit to how much we can manage under the approach we use."

"There is a danger you grow you put more and more positions into the fund simply because you cannot get the positions. We operate in a universe of 400 to 500 companies we can practically take positions in."

He points that the fund, which has a minimum investment level of €250,000 (£238,000), can sustain a maximum of 30 long positions and 50 shorts.

But he dismisses the idea that the team will launch further funds in an effort to attract assets.

"We are very positive about Cartesian's prospects. We have got three product areas with a broad range of clients both retail and institutional and the key is clearly to keep performing well in these areas. We can grow the business from current levels three to four times the level of current assets without having to overcomplicate things.

"We are not empire-building at all. The main thing is to keep things simple."