Consultants for change

BY **JASMIN LEITNER**

EuroHedge sits down with Albourne Partners co-founder Simon Ruddick to discuss fraud warnings, allocating in the aftermath of Lehman and shifting the conversation on fees

The collapse of LTCM and Bernie Madoff's fraud: events that occurred almost a decade apart with little in common, except that they played a key role in cementing Albourne's credibility as a leading investment consultant for hedge funds.

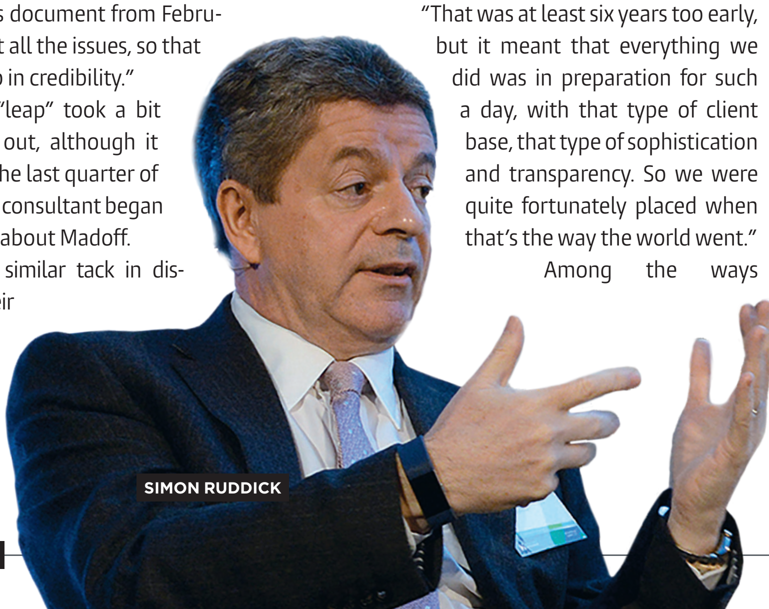
In February 1998 the London-based firm produced a document that was hugely bearish on fixed income arbitrage. It was one of Albourne's first strategy reports, drafted by Hitoshi Nagata, whose hedge fund, Cambridge Financial Products, had recently closed and returned investor capital because of the limited opportunity set.

Unlike other pieces of research, which were only shared with clients, Albourne widely distributed its concerns on fixed income arb, which played out a few months later when hedge fund giant LTCM saw the value of its trades drop by 50% as a result of Russian currency devaluations and a flight to US treasuries.

"It wasn't luck that we wrote that, it was skill, but what was luck was that we gave it to everyone we knew," explains co-founder Simon Ruddick. "In the summer of 1998 that was the whole story and we had this document from February pointing out all the issues, so that was a huge leap in credibility."

The second "leap" took a bit longer to play out, although it also started in the last quarter of 1998, when the consultant began to warn people about Madoff.

They took a similar tack in disseminating their views, telling "everyone", not just clients, that they should avoid Madoff.



SIMON RUDDICK

Ruddick recalls that they were "teased enormously" by their peers for talking about something that, at the time, didn't seem to materialise.

"If you keep going on about something, it sounds like you were wrong," he says. Eventually – a decade later – they were proven right, once again boosting their status in the hedge fund advisory world.

Right but wrong

The *raison d'être* for setting up Albourne was also an example of Ruddick and his colleagues being right at the wrong time.

Founded in 1994 by derivatives traders Ruddick and Guy Ingram, who had worked together at Westminster Equity, Albourne was established to help a small group of clients assess the risks in their portfolios. This select group of allocators was already too sophisticated to use a FoHF and just wanted some advice, says Ruddick, adding that from there, they "just over-extrapolated".

"We were absolutely convinced, in 1994, that institutions would want advice to be able to top up their direct investments.

"That was at least six years too early, but it meant that everything we did was in preparation for such a day, with that type of client base, that type of sophistication and transparency. So we were quite fortunately placed when that's the way the world went."

Among the ways Albourne differentiated itself was that it researched hard-closed funds as well as those raising assets, unlike some of their competitors, who only focused on funds they could put client money into.

Their approach served them well during the crisis, Ruddick says. "In the fourth quarter of 2008 no one was closed. All the top funds reopened, and we were allocating client money to firms that were previously impossible to get into.

"That helped our clients, but also those funds, who thought it was a miracle to be getting money at that time."

Alphatraz and Opera

The aftermath of the crisis was sobering for many reasons, but was a reminder of what Albourne wanted to focus on.

Ruddick recalls the firm's corporate planning committee gathering after the collapse of Lehman Brothers. At prior meetings, the discussion had always been around how the consultant could continue on its 50% annualised growth trajectory, but post-Lehman it was obvious that such a focus was inappropriate.

"I started the meeting by saying, instead of talking about 50% growth, why don't we talk about how we potentially manage a business through what could be a severe corporate-life-threatening decline and [prioritise] the best interests of our clients as well as trying to secure employment for our colleagues, given it's their livelihood and the livelihood of their dependents."

He describes the experience as salutary and sobering, adding that while he wouldn't want to repeat it, it brought home the idea that corporate responsibility went far beyond bonuses and dividends.

A slightly more bizarre anecdote Ruddick shares from the days following Lehman's collapse relates to a client event called *Escape to Alphatraz*, held at Alcatraz Prison, which had been planned for months and included convict-style jackets to be handed to clients.

"I remember thinking, it's slightly awkward because this might be the end of the world…when's a good time to hand out the convict jackets?"

Albourne's themed events are not simply a way to show the world the company's quirky culture, they serve a distinct purpose – arguably to push their clients, and the industry, forward on the path to institutionalisation.

Among the things born out of the crisis were administrator transparency reports and Open Protocol, a risk reporting standard initially dubbed 'Opera', launched in 2011.

Ruddick is keen to stress that the industry had started considering what was best practice before the crisis, evidenced by a hedge fund working group which evolved to become the Hedge Fund Standards Board (and since renamed the Standards Board for Alternative Investments).

He adds: "2008 was a huge wake-up call and it triggered a lot of changes that we were passionate about. Some of them happened quickly, some of them happened slowly and some of them have absolutely not happened at all."

He emphasises that many of the problems that led to the last financial crisis have returned. "It concerns me deeply that we have not learnt the lessons that really count and matter from 2008."

These include high levels of leverage and weak lending documentation related to structured products which are now parked in money market funds and other products sold to the mass market.

"If the last financial crisis felt scary, we will literally have seen nothing yet. A financial crisis gets most scary when retail investors realise it's happening."

Regulators, frustratingly, have the wherewithal to model and manage systemic risk but are failing to do so, he says, due to a lack of harmonisation and cooperation between jurisdictions.

Performance plight

And what is Albourne's take on the sector's underperformance over the last few years? "With institutional money and their longer time-frames, there is less flight of capital risk than in the past," says Ruddick.

"The more stable capital base and greater amounts of capital have been paradigm shifts which mean the rational expectation of return is smaller now."

While investors should have moderated their return expectations, he caveats that performance should not have been as disappointing as it has been.

Ruddick says that the performance of the "Fangs" – Facebook, Amazon, Apple, Netflix and Google – has made active managers, and hedge funds in particular, look like "charlatans", but that this is a phase and not a paradigm shift.

"The key thing for hedge funds at the moment…is there is less tail risk in hedge fund portfolios than in a long bond portfolio. Hedge funds are a phenomenally complicated way of earning almost no money, but they are still just about worth it."

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>
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He predicts that hedge funds will do well out of the next crisis, not because of their holdings at the time, but because of their ability to react in the aftermath.

"People like to think that hedge funds should gain during a crisis – if markets go down, hedge funds rise – but it is completely coincidental what they're holding.

"Their job is not to guess what others will do and do the opposite, their job is to be smarter than everyone else if there is a spike of inefficiency in the market and use their more flexible mandate to profit. The best time for them is immediately after a disruption and the reversion to a long-term norm or equilibrium."

He likens hedge funds to hyenas "poking around in the aftermath of a kill and scavenging returns."

Fees and future innovations

Investor disappointment with the less-than-meaty returns of 2014, 2015 and 2016 tipped the balance and allowed Albourne to bring to fruition a campaign it had started much earlier – creating a more equal conversation around fees.

At the end of 2016, Albourne and one of its largest clients, the $155bn Teachers' Retirement System of Texas, revealed a new fee structure, 1 or 30.

The 'or' structure is designed to ensure that allocators receive 70% of alpha or outperformance generated by managers, while also guaranteeing the latter a fee – the higher of performance or management – regardless of returns generated.

Having conquered that industry bone of contention, some might think Ruddick would be content to take a step back from pushing for further reform.

They couldn't be further from the truth. In October, Albourne unveiled its second Investor Manifesto (IMII), having released an initial tome in 2013.

The document, revealed during Albourne's annual meeting in London, contains 50 proposals designed to improve the alternative asset management industry for the benefit of investors and fund managers, with Ruddick stepping down from Albourne's executive committee to focus on championing the initiative.

Given the number of proposals on the table, Albourne doesn't anticipate delivering all of them and intends to spend the next 12 months carrying out further consultations with clients and managers to determine what to focus on.

Ruddick is fiercely committed to the sector and "passionately" convinced that hedge funds are good for Albourne's clients and for the world.

But he is also never one to shy away from speaking his mind and has some strong views on how a number of Europe's heavyweights have involved themselves in the political debate around Brexit.

"The crowning irony of Brexit, if it happens, will be that those who voted for it will suffer the most while those hedge fund managers that funded it will most likely benefit as they run businesses with US dollar-denominated revenue and a sterling cost-base." ◘