Prime Capital

15 years of long-term manager selection and alpha

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Fifteen years ago, the current CIO of Prime Capital AG, Dr. Werner Goricki, started the hedge fund business and four years ago he handed the baton to Tilo Wendorff, who now leads the Absolute Return team. Both have over 20 years of experience in the hedge fund space. Marking this anniversary with all products delivering positive performance in 2022 amid such difficult times for broader financial markets is something to celebrate.

(L-R): **Robin Ravel; Victor Heinrich, CFA; Philipp Zehrer, Philip Rotering, CFA; Anastasia Roiterstein, Tilo Wendorff**

Prime Capital's thoroughbred absolute return multi-manager offering, running around $2 billion, has received multiple industry awards reflecting its distinguished investment philosophy, performance and process: "Hedge funds are not an asset class. They are risk-controlled strategies operating within and across various asset classes. And managers of funds of hedge funds need to demonstrate really differentiated returns to make sense for portfolios," says Head of Absolute Return, Tilo Wendorff. The firm doubts whether the average hedge fund manager generates any alpha after fees, and insisting on top quartile manager performance is one part of Prime's process as a thorough long-term investor applying deep due diligence and extensive analysis.

If some multi-manager programs (and many alternative risk premia strategies) have disappointed investors in terms of absolute returns and alpha, for Prime Capital, 2022 was a very typical year for risk and return. The flagship product, PCAM Blue Chip returned around 6.9%, which is in line with its average return of 7.0% p.a. since inception in 2007. The long run Sharpe of 1.3 has surpassed its target of 1 with low equity market correlation and beta, meaning that over 95% of returns are estimated to be alpha versus global equities.

Prime Capital's approach is in some ways "old school", generating alpha substantially from manager selection, giving investors exposure to leading managers that can be hard to access, and carrying out on-site ODD pre and post investment (which continued throughout the Covid crisis). Prime also forges long term relationships and invests over multi-year time horizons. Though the Prime team has certainly added some value (around 1% annualized) through dynamic style and strategy rebalancing, and via manager re-sizing, the bulk of returns (around 6% annualized) has come from manager selection.

Complementing these traditional qualities, Prime is also very much a 21st century manager, employing state of the art quantitative risk and portfolio analytics that help construct well diversified and resilient portfolios. Beyond comingled funds, it also offers investors efficient structuring, customisation and access solutions, including managed accounts for large institutional investors.

This article focuses on two multi-strategy funds of hedge funds and one liquid alternative credit fund of funds, which seek different sorts of alpha. PCAM Blue Chip focuses on "scale alpha" from around 12 managers running at least $5 billion with track records of five or more years, though many of them are considerably larger and much older. PCAM Select instead emphasizes "niche alpha" from 15-20 managers running at least $300 million who have been around at least 3 years, though again most are bigger and longer established. The newest product, Liquid Alternative Credit, is seeking to pick up complexity, rather than illiquidity, premia from short-term private credit strategies.

A multi-cultural and dynamic firm

This trinity of perspectives on alpha generation is one example of diverse thinking, which comes partly from cultural diversity. Prime Capital has been a multi-cultural firm since inception, with a level of diversity that would be more typical of a medium sized or large London or New York hedge fund manager. 20 nationalities are represented amongst its 120 staff in Frankfurt and Luxembourg. "This helps to diversify our mindset and brings diversity of thought and viewpoints, which we value highly," says Wendorff. "We are fortunate to have so many cultures and nationalities," says Philip Rotering, Executive Director. Staff are attracted by the chance to have real and early impact across investment due diligence, operational due diligence and statistical strategy analysis.

Unanimous IDD and ODD approvals

Analysts work in pairs with one lead and one shadow analyst, who both present to the investment committee (IC). The investment process respects differences of opinion and unanimity is required from the IC. "Sometimes it is tough for an analyst when an IC team member vetoes an investment idea, but this ultimately improves the product and process," says Wendorff.

Investment due diligence (IDD) vetoes have in fact been relatively rare whereas vetoes from the independent operational due diligence (ODD) team are somewhat more common. The ODD specialists follow a completely separate process, visiting managers and doing calls separately, to avoid any bias. Even some of the largest and most celebrated hedge fund managers have failed Prime Capital's ODD: "In one case of a systematic manager running tens of billions there was not enough intra-month transparency between the manager, administrator and accountants," explains Wendorff.

Remote and/or outsourced due diligence has become more widespread since Covid, but even during the Covid crisis, Prime obtained a national interest exemption, and continued travelling to the US for its own site visits. "We read through all of the paragraphs of the US regulations, identified the word investment at the end of one paragraph, and approached the US embassy in Germany, who agreed," says Wendorff. Ordinarily, background

checks are the only outsourced part of the ODD process.

Controlling palpable and latent equity beta

Prime is eagle eyed and vigilant about operational risks and IDD; for example, Prime is assiduous about identifying the appropriate balance and true nature of strategies' return drivers.

At the highest level, Prime categorizes hedge fund strategies and alpha generation under three umbrellas. *Convergence* strategies, such as equity market neutral, statistical arbitrage and relative value type strategies, are wagering on re-convergence in misaligned relative valuations within or between equities, credit, convertibles, or other assets. Styles, factors and spreads drive returns, which can generate high Sharpe ratios with low correlations in normal conditions. In contrast, *Divergence* strategies, such as discretionary and systematic tactical traders including global macro, managed futures and CTAs, will average a lower Sharpe over a full cycle, but in turbulent markets they can generate exceptional absolute and risk-adjusted returns. Neither *Convergence* nor *Divergence* should on average exhibit substantial equity market beta over time, whereas Prime's distinctive concept of *Value* alpha – in event driven, merger arbitrage and distressed – does have some beta. Equity long/short strategies would typically be included in Prime's *Value* category, but the firm only invests in such strategies if they are run in a market neutral format.

The net impact is marginal equity exposure. "We try to build all-weather portfolios which only have small residual beta to equity markets. Though we avoid long-biased equity long/short, we recognize that *Value* has some second derivative equity exposure because equity stress can spill over into credit markets," says Rotering. "Structured credit is also a very small weighting because of the tail risk," he adds.

Recent strategy considerations

At certain points in the cycle, and especially in recent years, Prime has expressed stronger opinions about the relative opportunity set and weightings between and within its strategy groupings.

For much of the track record, there was a roughly even split between the three styles, but *Value* exposure was decreased in 2019 and further reduced in early 2020. This top-down adjustment to expand the *Convergence* allocation to around half the book, mainly through fundamental equity market neutral and statistical arbitrage, was made to adjust the portfolio to stretched valuations after a prolonged period of loose monetary policy, and

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also reflected Prime's perception of shift in alpha generation opportunity sets in the industry. Within the *Divergence* tactical trading allocations, there is always some blend between discretionary and quant styles, though Prime can sometimes tilt the portfolio towards systematic strategies: Prime took a somewhat contrarian stance adding to quant in late 2020 when it was very much out of favour. Prime allocates to some pure quantitative managers in the US and Europe as well as multi-strategy funds with quantitative and macro sleeves.

Avoiding structural directional bias

It is important to distinguish between tactical and structural equity exposure.

Explicit directional exposure to equities is mainly obtained through the tactical trading managers, who can be long or short, rather than managers with a hard-wired bias in either direction. As well as eschewing dedicated short sellers, Prime avoids long only or long-biased equity strategies which represent 60%+ of the industry, and also activist managers. "Long-term, their return looks very much like a long only investment and it is usually not worth paying 2 and 20 for this. Separating alpha from beta can actually be quite tricky, and the danger of being caught on the wrong foot is typically not worth it for us," says Rotering.

Could 2008 be repeated?

Controlling equity exposure is intended to ensure resilience during equity bear markets, when Prime has preserved capital or profited with one exception. The hardest test for any asset manager might be to review their most challenging moments, how they coped and what lessons were learned. The worst performance year (and only losing calendar year) for PCAM Blue Chip was 2008, partly due to one well-known multi-strategy manager being down 50%. The recovery was swift: the 2009 return was more than double the 2008 loss, and taking the two years together, the average annual return was close to the historical norm.

But by having steered clear of managers that suffered permanent losses or went out of business, even that difficult year was by and large business as usual. The product continued normal liquidity terms, and only had about 1% in side pockets from underlying managers, which were subsequently sold to aggregators at regular intervals. (In 2022 there were no side pockets.)

PCAM Blue Chip was resilient in 2022. The worst performing fund in PCAM Blue Chip was down around -3.5% for the year and Prime judge that a repeat of the 2008 losses is unlikely, for several reasons.

As already mentioned, Prime's top-down *Value* exposure has been reduced in general. And the underlying managers have also changed their approach. "The largest Value managers need to deploy a lot of capital and can become correlated, but their position overlaps are now much lower. In 2008, these sorts of managers were more concentrated in their alpha sources and had more tail risk. Now they are more diversified," says Rotering. "In addition, managers who bear the scars of a traumatic 2008 have sharpened their focus on risk management, and are more creative in their hedging," points out Wendorff.

Low manager turnover

Managers' own adaptability has often, but not always, reduced the need for turnover.
Prime has followed some managers' evolution over the full 15 years since 2007. Prime does add and remove managers for various reasons, but the full list of manager changes over 15 years fits onto one slide in the presentation. Reasons for redeeming have included style drift, undesirable forms of credit exposure, ODD concerns, performance or asset declines. Some managers redeemed from were subsequently reinvested in.

On average, one manager per year has changed, which equates to roughly 10% of NAV on average, for the relatively concentrated Blue Chip strategy.

Turnover is low partly because managers have performed consistently but also due to Prime's investment philosophy. "Some allocators want

PCAM Select: Niche alpha

Prime are not only covering multi-billion managers but have also ferreted out different sorts of alpha from smaller yet not necessarily less experienced managers (not start ups).

"First and foremost, we are in the business of finding and generating attractive, uncorrelated returns for our investors," says Rotering. "When we started our Blue Chip hedge fund program in 2007, we initially focused on large, well-known managers. And then over the years, we found similar desirable characteristics in a completely different segment of the hedge fund market: namely smaller, niche focused hedge funds that are often unsung because they do not do much marketing and have limited capacity."

To offer dedicated access to these sorts of managers, Prime launched its PCAM Select fund of hedge fund in 2018. The broader investment philosophy and emphasis on alpha and avoidance of traditional market beta has remained unchanged. According to Prime, managers' expertise and focus on a particular market, geography or style, lets them exploit and extract larger and richer sources of alpha, and thus needs on average less leverage to generate compelling returns at portfolio level. Managers are required to have at least 3 years of track record, and more than $300 million in assets under management, though current investee managers have been in business for an average of 10 years and run larger assets. "Investors sometimes equate 'smaller' and 'niche', with 'emerging' or 'seeding'," says Rotering. "This is definitely not the case. Quite the opposite: many managers are at capacity or closed." The program is not targeting seeding nor emerging manager investing. "This involves a different type of business risk that requires different levels of return, which might include revenue shares or equity stakes," says Rotering, who has previously worked for seeder Stable Asset Management.

In terms of strategies, PCAM Select allocates broadly to different forms of arbitrage and relative value than Blue Chip, including convertible arbitrage, dual listing arbitrage, equity market neutral sector specialists, and alternative market trend following. In some other respects, Select has similarities with Blue Chip. It targets all-weather returns with very low equity market correlation and views strategies through the same three prisms of *Convergence, Divergence* and *Value*. It also applies the same IDD and ODD processes and offers investors access to scarce capacity: "The number of managers failing ODD is not any higher, as these businesses are also of very high, institutional quality," says Rotering.

While generally all sorts of strategies are in scope, Prime is cautious on some controversial markets including the largest emerging market as well as digital currencies: "We avoid China, because top-down themes across politics or geopolitics tend to dwarf bottom-up analysis. And while we recognize that crypto is institutionalising and actively follow it, we avoid any direct allocations for the time being," says Wendorff.

All in all, Select is expected to have slightly higher return targets than Blue Chip, albeit with slightly higher expected volatility. Despite a challenging wider financial market environment, both PCAM Blue Chip and PCAM Select delivered positive returns to investors in 2022.

There is some overlap between the investor bases for the two products but also some segmentation. "Clients who already have scale alpha exposures and do not have time to do DD on niche managers may prefer Select. Whereas clients who have niche managers but cannot access larger funds may prefer Blue Chip," explains Rotering. There are also many clients who invest in both products to create a more diversified hedge fund exposure.

to focus on what is in vogue. Our mindset is always that we want to hold funds forever unless they deteriorate at some point in time, and we underwrite with an infinite time horizon. We still own some of the funds we invested in at the start in 2007," explains Rotering.

Nonetheless, funds are always competing to keep their place, and strategy overlaps identified amongst funds could be another reason to redeem.

Strategy rebalancing partly at manager level

Strategy weights have changed somewhat more than manager weights, because they also move around as a consequence of multi-strategy managers' rebalancing of strategy sleeves, which Prime view as desirable for some strategies. Prime reports its strategy weights on a look through basis, including breakdowns of multi-strategy manager exposures.

Macro for example has grown partly because many multi-strategy managers have been bulking up their *Divergence* allocations including global macro, which filters through to a slightly bigger *Divergence* weight at the PCAM Blue Chip level.

Some strategy weighting and timing decisions are delegated to managers. However, on balance, Prime's own strategy allocation changes still matter more. "Overall, we estimate that strategy rebalancing decisions are mainly due to our decisions, because the underlying managers tend to make more slow and gradual changes which have only marginal impact on the overall balance," says Rotering.

Multi-strategy platforms: an all-weather alpha engine

Nonetheless, multi-strategy platforms are the largest sleeve.

PCAM Blue Chip's biggest thematic grouping is the large multi-strategy managers, and this reflects continuing confidence in the persistence of their alpha generation. "Their plug and play model attracts talented portfolio managers who might find it harder and more expensive to set up their own fund, with higher levels of assets needed to break even," says Rotering.

The multi-strategy platforms demonstrate consistent and repeatable alpha through multiple years and cycles, but the quantum of their alpha is not improbably high when leverage is considered: some of them average gross exposure of 1000% or 10-times leverage. Alpha per turn of leverage is therefore likely to be estimated at around a low single digit percentage.

Since 2007, Prime has been exposed to many of the large multi-strategy managers at one time or another, but always on a highly selective basis: "To own six of them at once could place too much weight on their core alpha source of fundamental stock-picking at the strategy level," says Wendorff. This selective approach has also helped to avoid all the various blow-ups that have unfortunately also occurred in this highly respected peer group.

Incidentally, at the position level, Prime has scraped regulatory filings to gauge position overlaps but decided that aggregating this information is of limited value for the multi-strategy firms when their portfolio turnover is high – and when individual teams within the firms may have opposite positions.

Access and lockups

These alpha streams are not always easy to access. For instance, the large multi-strategy managers may now set minimum direct investments as high as $50 or $100 million, depending on relationships. "This reflects the time managers want to devote to investor transparency and investor relations. And even some smaller managers are raising their minimums," says Rotering. Some of these managers are also demanding longer lockups of 2 years+ for new investors, and occasionally also existing investors. "We remain invested in older share classes that are well aligned with our own quarterly liquidity terms," explains Rotering.

Secondary markets in hedge funds could provide one way to get better liquidity, but Wendorff points out that "some managers will not consent to transfers of ownership, and in any case, we like to use secondary markets more as a source of market intelligence".

In recent years, investors have been especially grateful to access these extraordinary pools of talent and alpha in multi-strategy funds and more specialized and narrowly focused managers.

Liquid Alternative Credit

If Blue Chip champions scale alpha and Select identifies niche alpha in the hedge fund space, PCAM Liquid Alternative Credit (LAC) strategy is more about private debt type managers targeting exotic complexity risk premia than alpha and this can involve smaller and younger managers.

LAC offers quarterly liquidity and distributions. It is specifically focused on fund maturities up to one year, with underlying asset maturities between 30 days and 18 months. The assets tend to be amortising and self-liquidating.

Complexity and scarcity premia

Given the short maturities, Prime argue that there is in fact no illiquidity premia in LAC. The return instead comes from complexity and lack of competition, which is partly due to regulations deterring bank lending in some areas, which makes them more attractive at least for the time being. "Large inflows could drive down returns as we saw for insurance linked securities and some areas of trade finance," says Wendorff.

Neglected opportunity is a virtue that leads Prime to forage in a universe of more than 300 managers including more than 200 that are not present in databases. Prime also receives many reverse enquiries.

"Typically, ex-bankers start a business with their own capital, or friends and family money, and can be located in some odd places," says Wendorff. "In fact, we spend a lot of time on the road to carry out DD on these managers and strategies."

Though the managers are in multiple locations sometimes thousands of miles apart – from Sydney to Singapore, Los Angeles, New York, London and Johannesburg – they share some common features, such as using common law based legal systems, that are ultimately based on English law.

Return targets and types of complexity premia

The LAC return target is 6-8% net of fees overall, though for individual sub-strategies it can range between 6% and 12%. This is seen as a reward for complexity and Prime has sub-divided complexity into investment and operational types, which are each ranked.

Senior secured exposure and recovery rates

Most of the exposure across all sub-strategies is senior and secured, and it is possible to estimate credit ratings equivalent to investment grade based on default and recovery models. Defaults are low and recoveries are high, but zero defaults and 100% recoveries were not realistic in 2022. Recent LAC newsletters show recovery rates have been declining from near 100% to levels that are still above 90%. "This is partly because it takes time and money to take over collateral in some strategies, where the legal costs can be quite high. Managers should factor these risks and costs into their underwriting and yield," says Wendorff.

Yield pickups and floating interest rates

Whereas long only public market credit in 2022 was down double digits whether it is investment grade or high yield, LAC's base level of return – floating interest rates – avoids the interest rate duration sensitivity that has inflicted losses on most fixed income credit strategies.

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The level of yield pickup obtainable versus listed public credit does fluctuate with interest rate and credit spread cycles. In some months in mid-2022 it appeared that the quantum of yield pickup from liquid private credit might have fallen, but this was probably temporary because yields are a moving target. Most of the LAC strategies are referenced to floating interest rates, and so are growing their absolute yields as rates rose sharply in 2022.

Opportunistic sub-strategy allocations

LAC can allocate to trade finance; specialty real estate lending; specialty SME lending; other asset-backed lending strategies; regulatory capital; tax liens, receivables and factoring.

In October 2022 the fund was exposed to seven sub-strategies, but the weights were not equal. Real estate bridge lending was over 40%, while trade finance and factoring taken together were around the same proportion. "The philosophy is opportunistic and all of them are competing for capital. Any one of them could go down to zero," says Wendorff. **THFJ**