INVESTMENT & PENSIONS EUROPE
IPE
DECEMBER 2017

INTERVIEW

DIXON BOARDMAN

Optima's founder tells Liam Kennedy he has found a way to tap hedge fund skill in long/short US equities

DIXON BOARDMAN
- Founder and CEO of Optima Fund Management
- Founded Optima in 1988
- Previously at Kidder and Paine Webber

Can you replicate hedge fund skill through research and public information? This is a question that the New York-based fund of hedge funds Optima Fund Management has asked itself – and answered in an unexpected way.

Like other funds of hedge funds, Optima had to deal with a change in perception of hedge funds since the 2008 financial crisis. Following the post-2001 crash, investing in hedge funds was seen as a must for sophisticated investors. Impressive and consistent returns swept away concerns about rising fees, lock-ins and opacity.

Since then, the pre-crisis high tide has receded in the hedge fund world. Many investors, although by no means all, have realised that a large swath of managers have simply been charging high fees for not a lot more than market beta performance, or for factor exposure that can be replicated quantitatively.

Hedge funds of funds, which charge an extra layer of fees after all, have been disintermediated to some extent. Some investors have chosen single-manager strategies and others still have exited hedge funds altogether. A source of frustration is that good managers are closed to investors.

"I still think the best managers in the world do run hedge funds. There aren't 10,000 geniuses but the good ones are really good, even if they have not done so well recently," says Boardman.

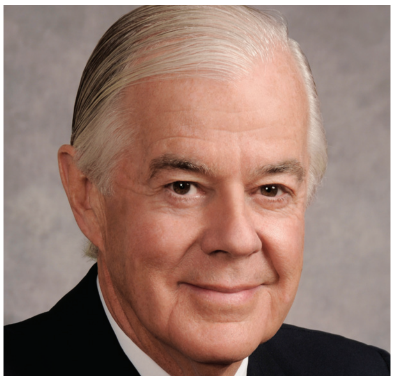
Rather than tweak the fund of hedge funds model, Boardman came up with a new idea altogether.

His ingeniously simple idea seems far too straightforward to work at first glance. Starting with the premise that much of the performance of equity long/short managers can be attributed to long-term holdings of high-conviction stocks, could you tap some of the "edge" of the best hedge fund managers simply by hanging onto the coat-tails of the long holdings reported in public filings?

Under US federal law, any entity with discretion over more than $100m in securities, including asset managers, pension funds, insurance companies or hedge funds, must report their domestic-listed equity holdings, including ETFs and certain convertible bonds, to the SEC within 45 days of the end of each calendar quarter. These are made on the SEC's form 13F, hence the term 13F filings.

Optima's STAR strategy creates a portfolio of 50 stocks based on the top US long/short equity hedge fund managers according to its proprietary research. The foundation of the strategy is that the highest conviction holdings will have the highest portfolio weightings, and that replicating these in a portfolio gives access to the best ideas of Optima's best long/short US equity managers.

"If you talk to a manager about their highest conviction holdings they are so animated, so excited," Boardman says. "They know the companies inside out. If you talk to them about their 1% or 0.5% positions they say 'one of my analysts put that in'. So, if we pick our managers correctly, which is what we think we are good at, you are getting punchy, good ideas the managers themselves know inside out."


Dixon Boardman

A team at Optima, led by managing director Yehuda Spindler, analysed the top holdings of several hundred managers, working on the assumption that these are their highest conviction ideas. Boardman says: "Provided you did't pick Steven Cohen, who trades four times a day, and you chose managers who keep their holdings for a longish period, it is extraordinary the excess returns you got from their longest holdings." A back test over 11 years was constructed, which convinced Boardman and his colleagues to create a live portfolio in early 2016.

The "secret sauce", as Boardman sees it, is Optima's manager research capability. So using the 13F holdings data, the strategy takes the top five holdings each for 10 managers to create a portfolio of about 50 stocks. If more than two managers have exposure to the same stock, it will be capped at 4%. Because of the long-term nature of these holdings, market timing should be less important, the contention runs.

Rebalancing is quarterly, as dictated by the publication of the 13F data, with a 45-day information lag.

For Boardman, the strategy overcomes two objections to hedge funds – fees and liquidity: "Instead of charging 2-and-20 or any incentive fee at all, we get the managers, by definition, for free, and we charge only a fixed managment fee."

The strategy has performed well since inception in early 2016. "Our timing for starting 16 months ago couldn't have been better but it's done phenomenally well," says Boardman. But the current track record of less than two years is short and as he concedes, "this market tests nothing".

However, as the names of the 10 underlying managers are not made public, the strategy does little to overcome the perceived opacity of the hedge fund sector. Although it uses a range of manager styles, including growth and value, it is effectively restricted to US long/short managers because of the nature of the 13F filings. It could not be applied to global macro managers, for instance, because the 13F filings do not include currency positions or non US stocks.

"Hedge funds are out of fashion at the moment but the best brains are in this best space and this gets their best ideas in an economical way," Boardman concludes. Another market cycle or two should prove whether his contention is correct.