EuroHedge

Volume 7 Issue 10 November/December 2005 A HedgeFund Intelligence publication

Wermuth's macro and micro mix exploits Russia expertise

Jochen Wermuth's Greater Europe Fund has delivered stellar returns from its unique blend of global macro and Russia-specific investing. Now it is moving into more illiquid situations

There is such a strong family involvement at Wermuth Asset Management that it feels almost as much like a family office as a hedge fund. But there is no doubting its stellar investment record.

Investment adviser to the hugely successful Greater Europe Fund for over seven years now, Wermuth Asset Management (WAM) is about to offer investors a new version of its strategy of "broad value investing" in greater Europe – spanning both western and eastern European economies, but with a particular focus on Russia.

The Greater Europe Deep Value Fund will have even more of a focus on long-term undervalued investments – with a two-year lock-up and a 'C' share class for illiquid plays that may have up to a three-year investment period and a two-year unwind.

WAM is confident that the new vehicle will generate returns that might outstrip even the outstanding performance of the Greater Europe Fund – which has seen NAV grow more than 10 times from the fund's inception in March 1998, with a total return of over 35% per annum. It is up by 32% this year to date, despite a 7% fall in October.

Despite its exceptional track record, the Greater Europe Fund is only just soft-closed – after a rapid recent inflow of assets to take the fund's size from $130 million to around $200 million – and expects to close to all investors at $250 million.

There are no fewer than four members of the Wermuth family involved in WAM – and a substantial chunk of the family's wealth is tied up in the fund. Jochen Wermuth, the firm's founder and managing partner, is the driving force behind its investment strategy.

A German-born economist who is also fluent in Russian, English and French, Jochen has been closely involved with Russia since 1993 – working as a government adviser, an international banker and, since 1998, an investor.

Having graduated from Brown in the US with an MA in Economics, a BA in both Mathematics and Economics, magna cum laude honours and the Lampert Prize for the best thesis in Economics, he had just started his studies towards a D. Phil in Economics at Oxford when he was recruited to work for the Russian ministry of finance in early 1993.

As a foreign advisor and founder of the Economic Expert Group, he worked for five finance ministers in Moscow between 1993 and 1997 and participated on the Russian side in the debt restructuring negotiations with the IMF, the World Bank and Russia's creditors.

Jochen Wermuth, founder and managing partner of Wermuth Asset Management

In 1996 he was responsible for preparing the economic and financial documentation on behalf of the Russian government for its debut international credit rating and its first Eurobond issue. He also advised a number of Russian regions on their international capital-raising programmes as well.

His work for the Russian government led to his hiring by Deutsche Bank as a grade-one director – still aged only 27 – to help set up and manage the bank's new Moscow office and to be responsible for raising capital for Russia on international capital markets.

In 1997 and 1998, before the rouble devaluation and subsequent economic and financial meltdown, Wermuth's team at Deutsche raised more than $8 billion for Russian entities. He left the bank in 1998, setting up WAM along with some colleagues from Deutsche.

But Jochen is not the only Wermuth in the firm. His father, Dr Dieter Wermuth, has had a long career as a strategist and economist and, like his son, has a distinguished academic history as a Fulbright Scholar with a Ph.D in Economics from Tufts University – is also a key advisory figure.

Dieter, who previously worked in senior roles with several leading banks, is a leading ECB watcher, a former staff member of the German Council of Wise Men and a seasoned forecaster of global equity indices, interest rates and economic growth. He provides global macro views to the Greater Europe Fund and conducts the firm's in-house macro research.

A central figure on the operational side is Dr Horst Guenter Wermuth, Dieter's brother, who oversees the back office and the firm's operations as its CFO – and who previously spent more than 20 years as a financial and operational controller at Siemens and a corporate consultant at Deloitte.

And the family involvement is completed by Jochen's brother Martin, who plays twin roles as administrator of the Wermuth family office's substantial interest in the fund and as due diligence officer for the firm.

Family members aside, other key people in the firm are Dimitry Malykhin (the Moscow-based head of research and trading), chief compliance officer Michael Hyuk Choi, geopolitical analyst Tom Mundy, a team of five analysts and administrative assistants in Moscow headed by Katya Bazdireva and an IT/back-up team in Germany.

And the fund also benefits from the advice of two heavyweight independent directors – former Irish prime minister Garret FitzGerald and Professor Lord Skidelsky, the biographer of John Maynard Keynes and an investor and political reform activist in Russia – as well as the market expertise of Rick Haller, who headed Deutsche's emerging market business in the 1990s and founded the Emerging Market Traders Association.

It is an impressive line-up, with an exceptional track record and a very solid infrastructure. Although registered in Frankfurt, WAM's management headquarters is in Wiesbaden with a rep office in Moscow and back-up facilities in two other places in the event of any disaster recovery needs.

In Jochen's mind, key to the firm's success since 1998 is a nimble team that has the majority of its personal assets invested in the fund in the form of deferred compensation. "The team sees the fund as its pension fund," he says.

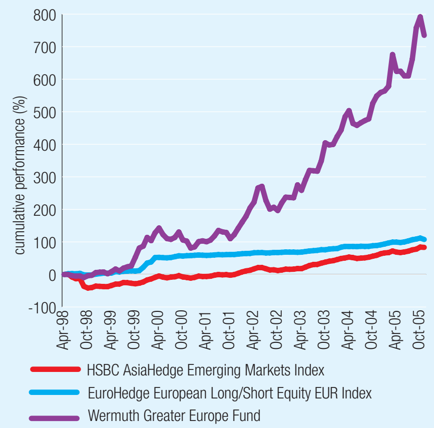
He believes that the mix of global macro and geopolitical views with in-depth local knowledge and bottom-up analysis – particularly in the former Soviet Union – is both unique and powerful.

"This leads to a strategy of long and short stock-picking down to deal-making for the benefit of the fund," he says, "while seeking to benefit from global macro or geopolitical trends and hedging against possible pitfalls."

The 12-strong team is truly international, it has worked together for over seven years and it combines an independent macro view with an in-depth knowledge of the region, its decision-makers, its cultures and its languages.

This expertise allows the managers to conduct on-site visits to companies and authorities throughout the region and focus on a few positions that it believes offer fundamental value.

PERFORMANCE:
WERMUTH GREATER EUROPE FUND



The fund's limited size until now has enabled it to operate a flexible mandate, moving quickly in and out of countries and positions, while employing active risk management through its team of four mathematicians and economists.

Although the firm checks its VaR regularly, it regards the measure as too optimistic. Instead it focuses on its own estimates of "loss at fire-sale" in both neutral and adverse markets to calculate its risk at any time.

It tests both with stress scenarios – based on the 1929, 1987 and 1998 collapses – as well as with core scenarios for medium-term global economic development. It employs limited leverage (rarely more than 1.2x), allocates assets roughly equally into four categories ranked by liquidity and uses derivatives extensively to buy insurance against global shocks.

The fund has only had one negative year – in 2000, when it lost 13.63%. Although returns have inevitably been quite volatile, with a Sharpe ratio of 1.2, the downside volatility has been fairly limited – producing a Sortino ratio of 2.6. In terms of returns and vol, it has comfortably outperformed Russian funds over the last seven years.

Its best-ever month was a return of over 20%, back in 1999, although this year it has twice produced monthly returns of over 15% – in February and August. The worst month was a drop of 11.7%, although the S&P 500 index's biggest monthly fall in the same time was 14.6% and the biggest single-month drop in the Russian RTS index was 56%.

The fact that it has not lost money in any of the last five years, although investing in an area that is prone to high returns and equally sharp drawdowns, is mainly down to this blend of top-down and bottom-up analysis.

Crucially, the fund anticipated the 1998 Russian default even before it was properly up and running. Other key success stories include the positioning for significant tightening in German long bond yields from 1999 onwards and the early recognition in 2003 and 2004 of the likely demise of Yukos – enabling the fund to put on long-term short positions that provided massive outperformance against its peers.

The fund is a macro strategy in the sense that it uses all the global macro tools – debt, FX, derivatives and commodities as well as equities – but with the majority of its bottom-up company equity investments in Russia.

The result is a broadly split portfolio – with, at the end of September, 60% of the portfolio invested in western Europe as opposed to 47% in eastern Europe – and a diversified spread of asset classes (49% FX, 39% equity, 16% derivatives and 2% debt).

At a macro level, WAM's view is bearish. It continues to believe, despite the fact that the world economy is "blistering" ahead at record levels, that the imbalances in the US economy will eventually trigger a painful unwinding.

This, it believes, will lead to a significant fall in US housing prices, US consumption, world economic growth and valuations in overvalued OECD equity markets.

"The fact that this has been forecast for a long time – making it ever more difficult to make the case that it will eventually happen, given that the boom still continues – doesn't weaken the case," says Wermuth.

The fund is pursuing what he sees as "outstanding" opportunities – looking to benefit from raw material demand from China and India in places like Kazakhstan, the integration of Ukraine into the world economy and the consumer boom – while shorting US and central European equities exposed to the risks that come from higher interest rates, a possibly inverted yield curve and a general flight to quality.

Looking forward, Wermuth sees no reason why the Greater Europe Fund should not continue to produce the same excellent returns as before – even at its much larger size. But he also believes that there is a huge opportunity in more illiquid investments – and that is what the new Deep Value vehicle is designed to exploit.

Although the Greater Europe Fund has a flexible mandate and can run a concentrated portfolio – with up to 20% in a single position, and often no more than 20-30 positions in total – its liquidity terms mean that it only has a three-month notice and thus typically has no more than 25% of its portfolio in less liquid small-cap and mid-cap stocks.