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to tap returns in
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Loïc Féry, founder and managing partner,
Chenavari Investment Managers

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The ebb and flow of unease that has characterised credit markets since 2008 is the enduring consequence of the Lehman default. In late 2011, the risks to credit investing moved further into the spotlight as the difficulties, previously faced by only a handful of Eurozone sovereign borrowers, spread to encompass all 17 single currency members. A reckoning may be at hand.

With the sovereign bedrock of the credit market in turmoil it is a time of heightened risk, but with elevated reward, for investors in corporate credit strategies covering asset-backed, regulated capital structure finance and real estate. In this respect, Europe offers a dazzling range of opportunities to those with the knowledge, experience and risk management nous to run active trading strategies.

Chenavari Investment Managers, founded by Managing Partner Loïc Féry in 2007, is one of a new breed of alternative credit managers generating performance out of this unfamiliar market environment. Although up +2% in 2011 to late November, the Chenavari Multi-Strategy Credit Spread Neutral Corporate Strategy has made an annualised return of 14.4% since launch at the outset of the fourth quarter of 2008 (See Table 1).

“We have done well maybe because we have a particular way of managing our risk,” Féry says in an interview at Chenavari’s stripped back, spartan offices at Grosvenor Place near Hyde Park Corner. “Our flagship corporate strategy is credit spread neutral. We are trying to have less sensitivity to the absolute level of stress. It is a combination of fundamental picks while playing the technicals of the market and remaining credit spread neutral at the book level.”

The Multi-Strategy Credit strategy launched amid the collateral damage that hit markets in September 2008 with less than \$50 million. In May 2009, Toro Capital I, a play strictly focused on mezzanine European asset-backed securities, opened. In just three years Chenavari has grown to \$1.7 billion in assets under management, including \$700 million split relatively equally between the two hedge funds.

A career in credit

Chenavari’s pedigree in credit begins with Féry himself. His passion may be French Ligue 1 football side FC Lorient where he is President, but Féry’s portfolio management track record is all about growing expertise in credit. Prior to setting up the firm Féry was managing director, global head of credit markets and collateralised debt obligations at Calyon in London after joining in 2001 with a mandate to start from scratch structured credit and credit derivatives activities. He was responsible for credit, structured credit and high yield activities of the bank, including credit trading, structuring and credit sales. Before that he ran the Asian credit derivatives desk for Société Générale in Hong Kong and helped set up several asset management companies focused on structured credit.

Among the team members are Managing Director Frederic Couderc who joined early on and started Chenavari’s dedicated asset-backed securities and structured finance team, after senior roles at Bear Stearns and Natixis. Another key member is Chief Risk Officer Sofiane Gharred who previously headed global correlation trading at Calyon after being an exotic credit trader.

At the heart of Chenavari’s proposition to investors is alignment of interest. The firm’s 10 partners have over \$45 million invested in its funds.

“We are strongly aligned with our investors” says Féry. “We seed all our strategies: if we lose money, we suffer more from our own investment than from the loss of NAV and the drop in fees. I believe this is a new model of asset management.” Taking this further, a significant part of compensation is deferred and locked into funds, a practice which is perhaps likely to increase among hedge funds as both regulators and investors increasingly require it.

Classic multi-strategy fund

Chenavari operates as a true multi-strategy fund manager (see Table 2). It has added secondary ABS, European real estate debt and regulatory capital structure finance to the feeder fund using a multi-strategy share class structure to allocate across all the strategies. Each of the multi-strategy desks is

also being offered as dedicated single shares with varying liquidity terms and lock ups. Though it will operate as a multi-strategy share class, the focus is kept on fixed income credit.

“We want to allow investors to keep investing in the specific strategy they require,” says Féry. “Some investors are with us only for the credit spread neutral strategy, while some are with us only for ABS or other investors are only with us for regulatory capital.” The benefit for an investor of being in a multi-strategy fund is that Chenavari can freely allocate to the best opportunities on behalf of investors who also get a lower base fee and a higher hurdle on the performance fee.

Playing the CAJAS

In 2011, Chenavari profitably traded out of Spanish residential mortgage-backed securities. Many of the Iberian RMBS instruments were bought at prices in the 20s, 30s and 40s up to the beginning of the year. Since Spain’s regional banks or CAJAS were the main issuers each RMBS was different from the others. Chenavari thus focused on the issuers more than the price level, performing in-depth collateral analysis and examining the structural features of different deals.

An accelerating deterioration in the macro environment saw Chenavari sell the assets. Gains were monetised – ironically selling mostly to sophisticated investors (including some credit fund competitors) and exposure fell to zero. Now they are considering buying back the assets at cheaper prices. Féry likens this to a ‘buy and hold’ strategy that is opportunistically geared to take profit.

“We have tried to be very consistent in what we’ve been doing,” he says. “We have been buying selective mezzanine ABS and we’ve had a strategy that is buy to hold but we opportunistically trade (see Fig.1). European ABS is a fairly inefficient market. So when the macro environment is bull or bear-biased there are price movements in reaction. We monetise those market moves around trading assets that we think are fundamentally sound.”

This opportunistic trading approach has produced profits. While European mezzanine ABS lost an

Table 1 Performance of the Chenavari Multi-Strategy Credit Fund - Share Class M1 USD (as of 31st October 2011)

Source: Chenavari

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	YTD
2008	-	-	-	-	-	-	-	-	-	0.82%	2.28%	0.41%	3.53%
2009	1.58%	0.40%	2.30%	3.79%	3.25%	2.28%	2.42%	1.65%	2.23%	1.35%	0.57%	2.88%	27.65%
2010	0.49%	0.26%	2.92%	1.24%	-0.61%	1.01%	-1.53%	0.14%	4.75%	1.30%	1.46%	0.47%	12.41%
2011	0.78%	1.19%	0.07%	0.65%	-0.09%	-1.19%	0.11%	-5.72%	5.22%	-0.50%	-	-	0.19%

Total return since inception: **48.85%** Annualised return since inception: **13.77%** 2011 YTD return: **0.19%** Annualised daily volatility: **6.44%**

Note: The above track record derives from a managed account (from Oct 08 to Oct 09) and the fund (Nov 09 onwards) pursuing the same strategy, with constant 2-20% fee structure

Table 2 Investment strategies in credit markets Source: Chenavari

INVESTMENT VEHICLE	CREDIT UNDERLYING	STRATEGY	INVESTMENT SHARES
The Chenavari Multi-Strategy Credit Fund¹	Multi-strategy	Chenavari discretionary allocation	MS, MS2, MS5 shares (depending on lock-up)
		Credit spread neutral	A1 shares
	Credit	Directional	M1, F1 shares ³
		Real estate debt	B1 shares
		Regulatory capital	R1 shares
	European structured finance	Mezzanine asset-backed securities (ABS)	D1 shares
		E1 shares	
Toro Capital I SICAV²			Toro IA (closed for subscriptions)
			Toro IB

1. The Chenavari Multi-Strategy Credit Fund is a Cayman-domiciled fund
 2. Toro Capital I is a Luxembourg-regulated SICAV
 3. M1 and F1 shares are a discretionary combination of credit spread neutral and credit directional strategies

average 30% of their value in 2011, the Chenavari ABS trading strategy, led by Couderc and senior portfolio manager Benoit Pellegrini, has shown a 24.36% year to date gain as of 1st November, with an annualized net return of 85.5% since inception in 2009.

The Multi-Strategy Credit Fund's third anniversary at the end of September means that pension funds will now look closer at allocating. Chenavari's goal is to be one of the few credit and structured finance managers to show significantly positive performance on all its funds in 2011 – a year that unlike 2009 or 2010 isn't a beta play.

Two sides to credit investment

Current conditions in the credit markets defy straightforward analysis. Féry is clear about the importance of fundamental analysis in any investment, but notes that the market has become very technical. Fundamental research, of course, is a bottom up process of analysing particular credits, while technical analysis focuses on understanding the impact of correlation on credit spreads.

During 2000-2008, trillions of dollars of exotic payoffs on corporate credit were sold to the market. Banks delta hedged those payoffs with very long maturities in the same way an equity derivative trader sells, say, an equity put on the S&P 500 to manage his book to maturity as a function of the stock price and volatility.

In credit those exotic pay-offs mean that the exotic desk has to adjust its book on a daily basis, according to the moves of credit spreads. The equivalent to volatility in equities is correlation in credit. Thus when correlation is moving it triggers a very large amount of buy-and-sell protection from the banks. Some estimates put these flows at

20-30% of the overall flows in daily credit derivative volumes.

"You can't ignore a technical force that represents 20-30% of the daily flows," Féry says. "The fact is that most credit managers completely ignore this. It is not just being aware that there is such a force. You need to be able to qualify it, track it and arbitrage it."

Chenavari isn't actively trading correlation but is trying to factor in the moves that correlation has on credit spreads. Mastering it gives the portfolio managers an edge. It is then combined with the fundamental analysis of different credits to incorporate both disciplines in the same trading book.

Spread per turn of leverage

Another analytical focus is the spread per turn of leverage. In April 2009, for example, spreads were at high levels as companies were heavily levered. Since then, the more highly geared European corporates have paid down debt, with net debt to EBITDA sliding from 3.9 to 2.9 for the average Euro high-yield issuer. Despite these stronger fundamentals, corporate spreads have remained largely constant with levels at the peak of the crisis, meaning that the spread amount divided by the turn of leverage of each company is higher. This makes the relative value opportunity much better now than it was in 2008-09.

"From the second quarter of 2009 until the end of 2010, we saw a massive wave of issuance which has pushed the refinancing requirements of corporates out several years," Féry says. "At the moment there is an imbalance between the credit curve that has widened significantly (and the rate of default which has not). Even in a deteriorating

environment Chenavari could potentially make money on both sides of the trade." Given the underlying fundamentals a long play would profit if short-dated credits rallied, while on the short side if spreads widen, the fund could also trade that profitably.

Stressed outlook

Chenavari is cautious on the internal rate of return on European ABS given the stressed market outlook. Even in a stressed scenario Féry expects the assets they have to generate an IRR of 15% annually over the next three to four years. The key risk is mark to market sensitivity if assets are comprehensively re-priced. To mitigate that the fund has very active volatility management, using some of the proceeds from cash returns to buy premiums via put options to cover the portfolio.

The approach Chenavari takes is to hold through to maturity and hedge along the way. But the managers are keen to have the appropriate liability profile to enable selling. The key focus is thus on risk control to protect the downside. For example, when many ABS funds lost between 7-15% in August, the Chenavari book of mainly European mezzanine ABS was down only 2.9%.

Regulatory capital

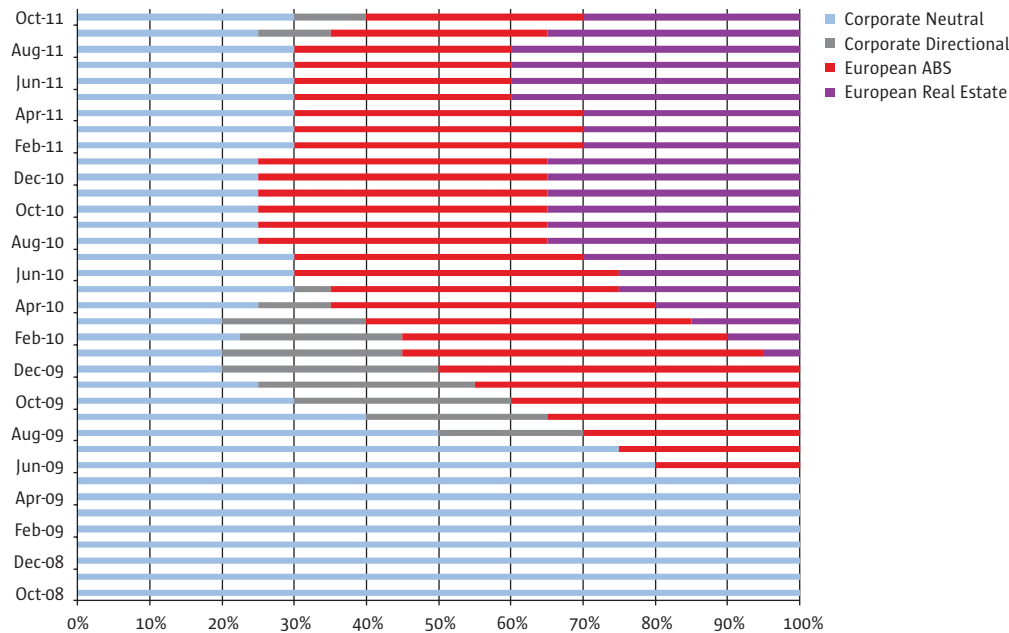
New demands from Basle III and wobbly European sovereign borrowers have combined to have a profound impact on bank balance sheets and funding costs. For example, there were over 90 lenders in European real estate debt a few months ago, but in late 2011 only 10 are left. This creates opportunities for opportunistic money to be deployed in real estate debt, as Chenavari does with its Real Estate Debt two-year lock-up share class.

Also, just as banks are facing up to being under-capitalised, investment to fund stronger balance sheets has largely dried up. For investors with a long-term horizon the opportunity is substantial. Chenavari's Regulatory Capital investment share class is a rare example of this strategy being offered in Europe. A five-year lock-up lets the managers cast a wide net in considering opportunities emerging out of a beleaguered European banking sector.

The credit crisis redux of 2011, where spreads have widened and ratings downgrades have increased, is forcing banks to increase the risk weighting of existing credit portfolios as Basle III comes into force. In addition, banks' active credit trading books by the end of 2011 bear additional capital charges, especially on derivatives portfolios. As well, bank capital structures are being crimped by a systemic risk buffer via a new 'leverage ratio' (matching assets and capital) plus a revised minimum core Tier

Fig.1

Source: Chenavari Investment Managers



“Chenavari’s links with the credit portfolio management groups of the European banks gives it an edge in sourcing deals at a time when financial institutions are under increasing pressure to act.”

One capital ratio to exceed 6% with an additional 2.5% buffer.

Chenavari’s links with the credit portfolio management groups of the European banks gives it an edge in sourcing deals at a time when financial institutions are under increasing pressure to act. For them, Chenavari’s ability to commit capital to secondary ABS deals spanning three years, and more, makes the asset manager an attractive investor.

“These are basically trades that will be very efficient for the banks in terms of regulatory capital and liquidity,” says Féry. “But they are also very attractive to investors who can secure 12-20% IRRs. Buyers can’t take a tiny piece. They need to take the full deal and thus the liquidity would be less than what you could obtain in the secondary market.”

Europe: too big to fail?

As a French citizen, it is instructive to canvas Féry’s view on the European sovereign credit crisis. His estimation of how the sovereign debt issue gets solved is somewhat surprising.

“Eventually there will be a very big backstop,” he says. “The mistake the Europeans have made is to not do enough and then do it too late. The only way out is to put up a true backstop for all European members. This needs a huge amount of money and needs to be credible enough to be believed. Doing it step by step won’t work. At the moment there is a lack of political tools to enforce this. That is why I’m

of the opinion that the actual safety net might also come from external sources: perhaps a combination of the ECB and the IMF, with the possible involvement of emerging market countries.”

Ever the trader, Féry sees a once in a lifetime opportunity. Except in this scenario, the trade is much, much bigger than anything Chenavari might take on. Putting on the hat of a chief investment officer at a Chinese sovereign fund, Féry sees a “wonderful” trade to do.

“The good trade is to take the massive profit on Treasuries and invest this in privatising what can be privatised in Europe,” he says. “The logic of the trade – buy cheap European assets and take profits on Treasuries – makes sense from an economic standpoint, but (the Chinese) won’t take the profit due to political pressure. What this crisis is about is a shift of power from the European countries to the new world.”

Through all this, markets will continue to grapple with the fallout from the euro zone. As a trader, Féry focuses on fundamentals, while keeping in mind market technicals and remaining long volatility.

“Those are the three things I’m sure about,” he says. “The fundamentals matter, but the technicals need to be embraced – that is where most of the question marks are. And because there will be volatility we make sure the portfolio remains long volatility.” **THFJ**