Kepler Absolute Hedge

Short-form report

4th July 2018

# Schroder UK Dynamic Absolute Return

**Non-independent research.**

**See important disclaimers at the end of this note.**

**Kepler Rating: 5**

### Fund Objective
The fund aims to achieve absolute returns whilst maintaining low levels of volatility.

### Fund Managers
**Paul Marriage, John Warren**

### Geography
**UK**

### Strategy
**Equity Long/Short**

### Fund Size
**£350m**

### Firm Assets
**£420m**

### Fund Inception
**September 2009**

### Liquidity
**Weekly**

### AMC
**1%**

### Performance Fee
**20%**


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## Summary


- A UK equity long/short fund with a fundamental approach to stock picking, primarily focussed on small and mid-cap UK companies.
- While the fund usually holds a cash net long position, on a beta adjusted basis it is quite conservative, typically -10% to +20%. Gross exposure normally ranges from 110% to 140%.
- Since its inception, the fund has strong risk-adjusted returns, while also exhibiting low correlation and beta to the wider UK equity market in which it invests.


The Schroder UK Dynamic Absolute Return fund was launched in UCITS in September 2009, having been run in offshore format since 2005. Since inception, the strategy has been run by Paul Marriage (and John Warren since 2010), initially in house at Cazenove/Schroders, but since October 2017 at their new company, Tellworth Investments (a BennBridge boutique). Investment ideas are generated using a bottom up approach to stock picking, with a bias towards small and mid-cap companies in the UK market. Engagement with company management and fundamental analysis has proven crucial to the team, who on the long side implement a predominantly buy and hold approach in the small cap space. Shorts tend to be either structurally challenged, poor businesses, index derivates or baskets of stocks that can hedge risks inherent in the long book. Since inception in UCITS, the fund has delivered a strong Sharpe ratio of 0.97, while exhibiting only moderate drawdowns. Given the vast experience of the team of investing in UK small and mid-caps, as well as the strong risk-adjusted returns, we are happy to award the fund a five star rating.

## Performance Review

Since inception of the UCITS fund, returns have annualised at 7.49% with an annualised volatility of 6.68%, resulting in an impressive Sharpe ratio of 0.97 (1% RFR). On a risk-adjusted basis, this is in excess of the FTSE All Share, which has annualised at 9.26% with a volatility of 11.17% (Sharpe of 0.74). Given the ~30% average net exposure over this period, it is reassuring to see the correlation to the FTSE All Share has remained low at 0.26, whilst beta is just 0.16. This is in line with the fund's objectives, and despite the optically high average net exposure, on a beta-adjusted basis this is typically much lower. The maximum drawdown of the UCITS fund is -11.2% (occurring between March 2014 and January 2015) versus -14.5% for the FTSE All Share (occurring between April and September 2011). However, when looking at the strategy's extended track record (which began in 2005), the capital protection delivered is more impressive, with the fund losing just -1.0% between August 2008 and February 2009, versus a loss of -31.4% for the index during the same period. As shown in Fig. 3 overleaf, the fund has surpassed its major peers on an absolute return basis, and compares well considering risk and drawdowns.

**Fig 1: Fund Performance: Schroder UK Dynamic Absolute Return Fund**

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2009 | | | | | | | | | | 0.6 | -0.4 | -0.4 | -0.2 |
| 2010 | -0.5 | -2.6 | 2.7 | -0.4 | -4.1 | -2.6 | 0.8 | 2.3 | 4.1 | 4.7 | -2.0 | 3.4 | 5.6 |
| 2011 | 3.0 | 0.9 | 0.5 | 2.7 | 2.6 | 3.4 | 1.5 | -3.2 | 0.3 | -1.1 | -1.2 | 0.1 | 9.5 |
| 2012 | 2.6 | 0.5 | 0.0 | 0.4 | 0.0 | 0.8 | 1.1 | 1.2 | 2.5 | 0.9 | 0.5 | 1.8 | 13.0 |
| 2013 | -0.5 | 1.8 | -0.5 | 2.4 | 3.3 | 0.4 | 3.1 | 2.7 | 1.0 | 2.8 | 1.2 | 0.0 | 19.1 |
| 2014 | 1.3 | 0.2 | -2.8 | -2.7 | 1.0 | -2.8 | 0.9 | -0.8 | -0.1 | -2.0 | -1.9 | 1.4 | -8.2 |
| 2015 | -1.9 | 1.3 | 1.0 | 2.8 | 3.5 | 2.3 | 2.3 | 0.9 | 0.1 | -1.3 | -1.9 | 1.5 | 11.1 |
| 2016 | -3.0 | -1.8 | 1.3 | 0.1 | 1.4 | -6.0 | 4.0 | 3.9 | 2.0 | -1.2 | 1.8 | 1.8 | 3.7 |
| 2017 | 2.6 | 1.9 | 1.6 | 2.4 | -0.1 | 0.6 | 1.5 | 0.1 | -0.2 | 2.3 | -1.9 | 0.1 | 11.4 |
| 2018 | 0.7 | 0.0 | -0.1 | 1.3 | -0.9 | 1.7 | | | | | | | 2.8 |

Source: FE Analytics. Class P2 Acc GBP (IE00BLP59769). Fees for this class are 1.00% and 20%.

# Schroder UK Dynamic Absolute Return

## Investment Process

Ideas are generated using a bottom up stock picking process, predominantly based on management meetings and fundamental analysis. The managers see more than 300 companies per year, meeting CEOs/CFOs to understand the business model. For the long book, positions tend to be buy-and-hold small cap ideas, with companies analysed using the team's 'P3M' framework (Product, Market, Margin, Management). This requires businesses to have a strong product in a growing market, with sufficient margin and capable management. In addition to this, the managers will also opportunistically take positions in more short-term trading opportunities. On the short side, positions tend to be where forecasts or valuations afforded by the market are significantly out of line with the team's, or companies which are structurally challenged. These single stock shorts typically make up a third of the short exposure, with the remaining exposure used for capital protection and exposure management. These are implemented through index derivatives or baskets shorts, to help offset the market, sector or industry risks inherent in the long positions. The investment universe for the fund is at the small and mid-cap end of the UK market. When this is filtered to include only stocks with market cap >£75 million and excluding stocks that the team deem uninvestible, there are approximately 500 stocks remaining in which the fund can invest. The managers are not constrained by sector or industry.

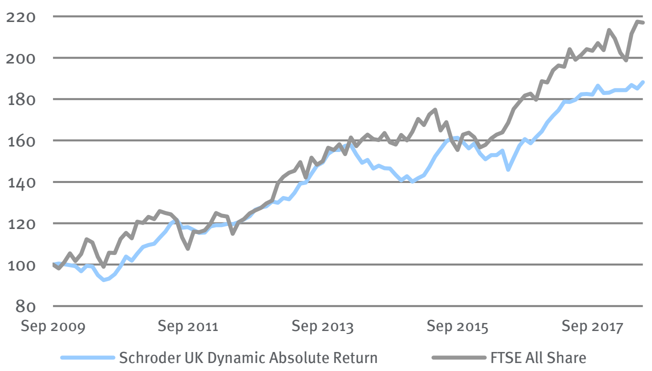
## Risk Management

Risk management is crucial to building the portfolio, and considering potential risks is an integral part of the investment process. This starts with exposure management, with gross exposure capped at 250%, though typically 110-140%. Net exposure is capped at 75% on a cash basis, though typically runs at 30-50%. When beta-adjusted, this is usually between -10% and +20%. Positions are normally sized at <5% of NAV, and the team will not invest in unquoted stocks. The portfolio is subject to daily VaR monitoring and stress testing, as well as independent factor analysis, liquidity analysis and performance analysis. There are no hard stop loss policies.

## Fees and Management

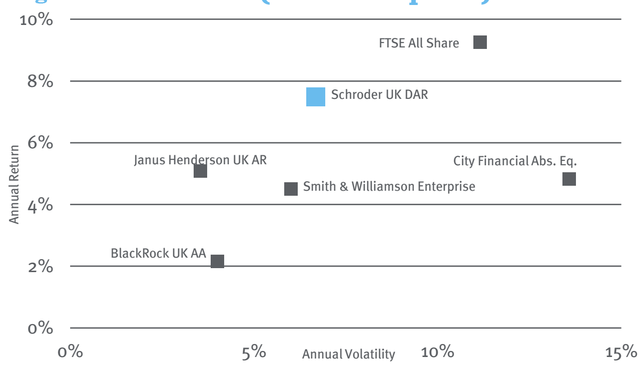
The fund charges an annual management charge of 1% and a performance fee of 20% with a high watermark. The fund is managed at Tellworth (which is an appointed representative of the investment manager, BennBridge) by the same managers (Paul Marriage & John Warren) who previously managed the fund at Schroders/Cazenove. The portfolio managers are supported by 3 other members of the investment team, namely Seb Jory, James Gerlis and Stephen Nash. The fund currently has AUM of £350m, though the wider strategy has £420m of assets.

### Fig 2: Track Record (Since Inception)




Source: Financial Express; www.absolutehedge.com

### Fig 3: Risk/Return (Since Inception)




Source: Financial Express; www.absolutehedge.com

## Outlook and Recommendation

There is somewhat of a lack of high quality UK long short funds available to UCITS investors. Over an extended period of time Paul Marriage (and more recently John Warren) have proven their ability to produce strong and consistent results with a focus on small and mid-cap names. Having previously run the strategy at Schroders, we view the new BennBridge/Tellworth structure favourably as it gives the managers the flexibility to implement their investment process in an unencumbered manner, while benefitting from the infrastructure and resources of BennBridge (part of the AUD$10b Bennelong Funds Management business). Since inception of the UCITS fund in 2009, returns have been strong, with low correlation and beta to the wider market. The managers are very active in the idea generation process and meet with companies regularly, something which is increasingly important in an area of the market where research coverage of stocks is relatively light. While the fund currently trades weekly, it is expected this will move to daily in the near future, in line with most peers. The strategy is capacity constrained, something which been managed in a prudent manner over the life of the fund. Based on the longevity of the track record and strength of returns, we award the fund a five star rating.