EuroHedge

An all-weather approach

BY **HUGH LEASK**

Gladstone Lasker, the long/short strategy run by one-time chess International Master and former Lansdowne man George Michelakis, triumphed in a torrid year for equities

Hedge funds, as few people need reminding, are not supposed to move in tandem with broader equity markets.

Their relative underperformance during strong equity markets is the price to be paid for their dramatic outperformance in a downturn – or so the popular pitch goes. If you're hedged on the way up, you should be making gains on the way down.

But what happens when the model goes awry, and supposedly "hedged" equity portfolios quite spectacularly fail to deliver the goods when equities take a tumble? It's a question that has loomed large over this industry, particularly in light of performance last year when hedge funds of all shades were knocked sideways by the market maelstrom.

It's a challenge to which Gladstone Capital Management, the London-based global long/short firm led by former Lansdowne man and chess International Master George Michelakis, has emphatically risen.

The $750m strategy has recorded consistently strong performances over the course of more than 13 years, in markedly different market environments and varying investment conditions.

"It comes back almost to a question of identity," Michelakis – a South African of Greek descent – tells *EuroHedge* in a meeting at Gladstone's offices in Mayfair. "What is the point of hedging? I think there is a little bit of an identity crisis within certain categories of hedge funds.

"For us, we are trying to create a much more all-weather approach to stock-picking, portfolio construction and risk management," he adds.

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The Gladstone strategy has suffered just two down years since launching in 2006, frequently generating double-digit annual returns during its 13-year run. An eye-catching 37.4% gain in 2017 led to its triumph in the sub-$500m long/short European equity category at that year's EuroHedge Awards, while its 22.8% rise a year later led it to victory in the over $500m category. Those striking back-to-back gains – in two sharply contrasting years for financial markets – also ultimately helped Gladstone Lasker win the overall Fund of the Year category at 2018's ceremony.

"The whole beauty of being able to outperform in 2017 when there were strong tail winds, and outperform in 2018 when you had strong headwinds, without actually even changing the portfolio much, is testament to precisely what we are trying to achieve here," Michelakis says of the firm's recent successes.

Before establishing Gladstone with initial seed capital from cornerstone investor Protégé Partners (the firm is now 100% owned by Gladstone's partners), Michelakis spent two years at Lansdowne, where he was a member of the UK equity team, a period he describes as a "great experience". Earlier, he spent four years at private equity investor Capital Z, an early seeder of Swedish activist manager Cevian Capital.

"It truly was an alternatives firm, we did a number of different forms of alternatives," he recalls of Capital Z. "For the 1990s, it was quite ahead of its time."

His background is refreshingly varied: prior to his investment career, Michelakis came third in the World Under-20 Chess Championships in 1992 and is a holder of the FIDE International Chess Master title.

A pre-emptive approach

Today, Gladstone manages some $750m in assets; the Lasker Fund – named after former world chess champion Emanuel Lasker – runs $250m, with the remainder held in several managed accounts.

The strategy takes long and short core bets, which may be accompanied by related positions to isolate specific opportunities and risk in certain cases. Its aim to fuse superior stock selection with a strong beta-reduction has long been part of both the firm's underlying approach to markets since launch, as well as Michelakis' personal investment philosophy.

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FIRM FACTS

GLADSTONE CAPITAL MANAGEMENT

- Firm-wide assets of $750m; $250m in the Gladstone Lasker vehicle, with the remainder in several managed accounts running the same investment strategy
- Originally seeded by NY-based Protégé Partners, it has been 100% partner-owned since 2011
- London-based, with a staff of 12

its own during a period of increasing market unpredictability and underwhelming hedge fund performance.

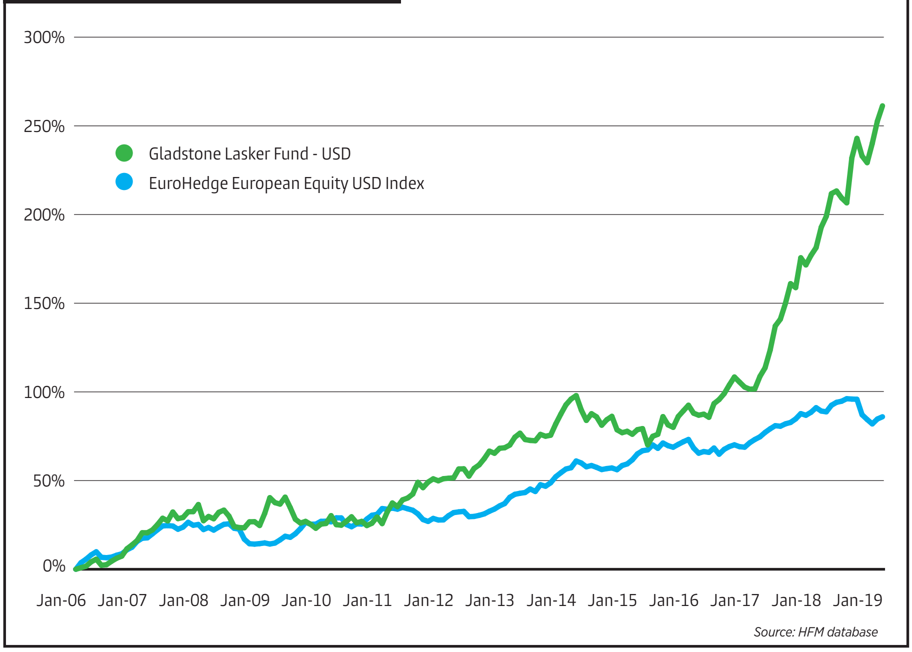
"Setting up a portfolio in a straightforward way to be long certain assets and short certain assets hasn't really worked for managers," he says. "It hasn't been straightforward because you've had politics, you've had threats of recession, you've had trade wars – a lot of disruption which has meant that any single narrative hasn't lasted long."

Against this disruption, and a lack of any major overarching investment narrative, Gladstone has delved deeper into smaller, sector-level themes within its target industries. This, Michelakis explains, has allowed the firm to run a tighter portfolio – 70 positions in total, comprising 25 longs and 45 shorts – which has thrived over a tumultuous three-and-a-half years, spanning the February 2016 sell-off, the Brexit vote, Trump's election victory, and the 2017 rally through to the 2018 sell-off.

"The philosophy underpinning portfolio construction has evolved," he adds. "We have become more pre-emptive in how we construct our portfolio."

Asked what sets Gladstone apart from other typical European long/short firms, Michelakis believes that most managers tend to rely on alpha-generation from the long side. Some take their short bets more seriously than others, he adds, while many use shorts simply to hedge. Crucially, though, what many fundamental managers do not often focus on is the third element: how longs and shorts are combined and blended effectively in a portfolio.

PERFORMANCE: GLADSTONE LASKER FUND



Source: HFM database

"Some of the platforms have done that, and the quants have done that. But the fundamental managers haven't done that," he suggests. "A phenomenal long stock-picker can do 10% alpha. A phenomenal short stock-picker – assuming the long indication is anything to go by – can probably do 10% alpha. But if the third area, your portfolio construction, and how you combine the longs and shorts together, can add some type of alpha, then you can have a whole lot of alpha relative to the index."

Warming to this theme, he underlines the point with a footballing analogy. "Manchester City has a great attack but look at that defence. Our approach is saying attack and defence are two different things, but I think too many managers tend to just tack the short process onto their long process. You need different minded people and different processes."

Gladstone's approach is to compartmentalise the three discreetly, looking at each in and of itself in terms of their ability to generate money, as well as how they interact together.

"In general, it's quite a difficult thing to have those things co-exist," he continues, before borrowing another sporting metaphor. "You can work on your first serve and maybe you will become the best and fastest highest percentage first server in tennis. But the person with the best first serve in the modern game might not even be in the top 100 in the world. You have to exhibit serve, forehand, backhand, baseline – you have to do it all, at least at some minimum level.

"What does Djokovic do best in the world? Possibly nothing but, boy, he's not weak anywhere, and he does everything really well."

The same goes for an investment strategy. "It's really about putting all those things together so you don't end up just trying to trade the market. I think that when you are pushed into trying to trade the market, you are pushed to compete with machines. If you don't come prepared, you just end up doing battle with computers."

The challenge of competing with computers is one Michelakis is keenly aware of, given his background as a chess master. He has long observed the implications of machines becoming faster and better than humans, and is

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clear about the need for managers to adapt to those developments.

"I think the machines will always figure out what you are likely to do tomorrow before you do," he says. "The chess world has been profoundly impacted by computers."

He adds: "Ironically, while you could argue that trading volumes have been taken up by machines, we are yet to see whether the full impact of how machines will affect the fundamental long/short space, or even just long-only. We haven't quite yet seen what happens when machines don't trade on five-day or 10-day intervals, i.e. when they're not looking for short term alpha, but their alpha goes to 15 days, or 20 or 25 days. That's going to start having a more profound impact on managers and their ability to outperform."

Picking positions

The fund invests predominantly in mid-cap and large-cap stocks, with around 60% of the portfolio in Europe, and 40% in the US, South Africa, Australia, Canada and other English-speaking countries.

Its focus spans four sectors – consumers, industrials, financials, and technology, media and telecoms (TMT) – which are then split into some 20 individual sub-sectors. Within financials, for instance, the fund will focus on banks, fintech, insurance, real estate and financials, while the consumer bracket includes consumer tech, consumer staples and consumer discretionary.

"We prefer to have more shorts than longs. Going back to the way that these sub-portfolios are built, you typically have a core long and two, or three, or four shorts built around that," he explains.

He estimates that over the course of 2017 and 2018, the strategy made money in 16 out of its 20 target sub-sectors, and in roughly nine countries out of 10. In 2017, both longs and shorts generated returns for the fund, but in 2018, gains were powered predominantly by short positions as markets globally went into retreat.

Key shorts included Maxar, the Canadian robotics and surveillance technology manufacturer, stricken UK construction management business Carillion, and Banco Popular in Spain. Elsewhere, the fund had exited its positions within the FAANG group (Facebook, Amazon, Apple, Netflix and Google) by May 2018, having been investors in Apple since 2009 and in Google since 2010.

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"It wasn't any deep reason, it was not a trading call," he says of the FAANG switch. "It was more that we just didn't need to be there – our conviction had waned with price appreciation and we felt there were other things that we were getting more excited about."

He adds: "Our willingness to move in and out of sectors is quite high. It doesn't mean we are exiting completely, but it just means our gross exposure to a sector could actually change over time. It may be the alpha has gone from that view, and there may be higher alpha elsewhere. We prefer to be in a place where the themes are clearer, where what's happening is clearer to us."

Gladstone analyses the typical metrics in the stock-picking process – quality of business, market position, earnings, and capital consumption. But a key element to the portfolio-building is corporate governance, and otherwise-strong firms may be quickly eliminated from the screening process due to historically poor governance, he explains.

"We try to get to the heart of why certain companies can continue to succeed while some may continue to fail. Just because a company's management may be good at capital allocation doesn't mean they have good corporate governance," Michelakis observes. "That is something we have been far more attuned to historically than the average person I speak to who picks stocks."

He adds: "Do we pick stocks like a lot of the other fundamental long/short managers? Absolutely. And we also go about picking shorts in the same way, probably, with much more respect for needing to get that right in and of itself.

"But we don't just pick some longs, and then figure out some shorts along the way. We spend a lot of time thinking very hard about how we have put those two things together to create a portfolio structure that is, for the most part, agnostic to whether the market is going to be up or down by 10%. As long as it's within a reasonable range, and not something like 40% which is a severe dislocation, we almost don't care."

The fund remains positioned largely the same as during the past few years, though the prevailing backdrop – underpinned by a lack of clarity among policymakers and uncertainties over the general market direction at the macroeconomic level – have given Michelakis and his team cause for caution.

"We're not trying to take a view on the direction, but I think we have been prudent around gross exposure. We have a little less gross than in the past, we've taken that down a notch, so we're running closer to 200% gross, whereas we've been higher over the last few years," he explains. "We're not bearish or bullish. What we're saying is the ability for markets to get roiled in ways that are unpredictable is causing us to be just a little bit more cautious."

This year the fund was up approximately 7.2% to the end of the March, and its consistent performance in dramatically different markets continues to provide a sense of optimism, Michelakis says.

"If everything is quite well-proportioned and well spread out across sectors and countries, with not much net exposure in any particular bucket, and the stock-picking is consistently good in each sub-sector and each country, you can literally produce enough alpha that you don't really care whether the market is up or down."

Alignment is an artform

But what of the many broader difficulties facing the hedge fund industry? For Michelakis, one of the perennial challenges is ensuring alignment with investors. As hedge fund performances have failed to keep up with the fees that many managers wish to charge clients, allocators have become clearer-minded about what they are willing to pay for, he says.

Despite a recovery among many brand name long/short managers during February following a brutal end to 2018, investors appear to remain lukewarm on the strategy, according to recent research by Lyxor Asset Management.

"Investors' appetite for long/short equity remains low," the Paris-based investor said in a note earlier in April, observing how both directional and market neutral equity hedge fund strategies suffered "substantial" outflows in January and February, with March flows "meagre".

For Gladstone, alignment with its investor base – which consists mainly of foundation and endowment allocators, predominantly based in the US – is core to its business.

"The industry struggles at times to get its head around the idea that we're providing a service to clients," Michelakis suggests. "We've taken it upon ourselves to try and get the model to be as functional and as client-serving as it can be."

He adds: "When long/short equity is done well, it monumentally outperforms traditional long-only investing. When you get alpha on both sides, with good portfolio construction, you can outperform in an up year, and then also have strong positive performance in a down year like 2018. When long/short equity is done well, it's well worth paying for. It's just that it's done well so rarely that it's lost its shine."

As the conversation draws to a close, Michelakis reflects on his career path thus far, and how he plans to continue to make money in this most unpredictable of industries.

"I think there's a competitive, sporting dimension," he says of the hedge fund business, drawing on his experience as a chess champion. "I very much enjoy the sporting dimension. To me, it's all about seeing all the constituent parts of what we do as these unique pieces.

"There are elements of an artform – we're taking views on markets with decisions and signs, profit and loss, collecting data – and then there's the competitive aspect. We're very much now carving up, or almost deconstructing, the long/short strategy into its constituent parts and pushing further down that road, which is very much a unique path, a path of independence, for us."

That, ultimately, sets the firm's entire investment philosophy apart from competitors, he adds.

"It's a much more absolute return mindset from the get-go, and so we're running quite neutral to begin with, with diversified pots of risk, that each should, over time, stand on their own two feet and make money on their own." ◘