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Eclectica Asset Management
Hugh Hendry and Simon Batten
on life after Odey

Eclectica Asset Management

Simon Kerr

A manager that does not have an edge in data or information; a fund that has 300-400 positions but that is not diversified; a fund that turns over 25 times a year but where the manager doesn't speak to brokers: these are the qualities attached to Hugh Hendry and his Eclectica Fund. The Hedge Fund Journal went to London's Bayswater to find out how these conundrums are resolved in the mind of the freewheeling and free-thinking money manager.

When Hugh Hendry is on a public platform he speaks in a series of epithets that stick in the mind to leave an impression of a bright, confident investor operating in their own radius of certainty. He spits out his observations and convictions like a politician on the hustings. He cannot come across as a sober-suited scientist addressing a conference of like-minded peers talking about a statistically rigorous paper. This is not analysis based on the scientific method and “standing on the shoulders of giants”. This is “like me, and please subscribe some capital to my fund”, or at least “reinforce my ideas by putting your capital to work in the same direction”.

Given he has ended up in the hedge fund world Hugh Hendry's first appointment in investment management may seem almost antithetical. He first had exposure to the money management business as an analyst at Baillie Gifford, doyen of the avowedly long-term Edinburgh investment companies. Baillie Gifford carefully manages investment trusts, and unit trusts, and latterly segregated institutional mandates, and equally carefully manages its own growth. A livewire such as Hendry may have found the place culturally stifling after eight years there, but what a great grounding professionally – seasoned investors, a thorough methodology and years of hard work before the payoff of partnership.

Of course an alternative to waiting for the elevation to the position of partner is to move to more stimulating environments. The first move South for Scotsman Hendry was as an associate director at Credit Suisse Asset Management in London, but his more significant step was to join Odey Asset Management in 1999. At this stage Odey Asset Management (OAM) consisted of a dozen people and between \$500-600m in AUM, so the move had some risk on both sides.

It may therefore come as a shock to read that Hendry was intimidated for a period after his arrival at OAM. In the context of the time it is less surprising. The 29-year old Hendry was joining one of the very few hedge fund businesses in Europe that had been around in the earlier part of the 1990s. The principal of the firm, Crispin Odey, had made his name and newspaper headlines in 1993 with the success of his European equity long/short fund. The investment style of the firm was very much based in the macro view of the owner/manager. This has led to the pattern of return of Odey's funds being different from other funds with the same strategy label – most of the peer group tend to be driven by bottom up (stock selection) factors. Odey has strong, well-informed and well-articulated views on economies and markets.

Hugh Hendry's time at Odey went through several phases. In the first phase it was very much “what have I done? I'm going to keep quiet, and soak up what is going on here.”

“It was a 12-month tunnel for me, and I was paying my dues,” explains Hendry.

The second phase could be characterised as “That is an interesting view you're giving me, here's what I think.” A further stage was Hendry's realisation that, like himself, Odey could be wrong on markets, even when his macroeconomic argument was well constructed.

A key point here is the importance of technical analysis to both Hugh Hendry and OAM. For some years veteran chartist Brian Marber had provided a technical input on markets/stocks/sectors to the investment professionals at OAM. Through the course of time Hendry came to recognise that he was placing more reliance on the chart patterns and levels than his mentor Odey. Just as Hendry was increasingly relying on technical signals to tell him he was right (or wrong) on the timing or correctness of his market and stock views, sometimes Crispin Odey's stance on the economic fundamentals was firmly fixed in his mind.

This difference of perception is not necessarily a problem. Sometimes an investment culture can sustain a multiplicity of views. Further there

are investment management organisations where such differences are encouraged to generate internal diversification. However, to the extent that an organisation has a dominant investment philosophy, and varying with the degree of influence that a dominant individual or pair of investors has in the firm, such differences can become an issue.

Hugh Hendry had assumed full responsibility for the long-only funds at Odey AM in the summer of 1999. The long-only funds he managed were run with consideration of the absolute returns – so the index decline of 28% in 2002 can be contrasted with the +3% return of the Continental equity fund run by Hendry. With this record and the backing of his largest investor he launched the Eclectica long/short equity fund in September of 2002. Thus Hendry had portfolios in which he could implement his style of investing and approach to markets. He also had successes which were externally acknowledged – Hendry was the Lipper Citywire All Stars 2003 Europe ex-UK Winner; and he won an award as Top Performing Newcomer in Hedge Funds in 2004 for the Odey Eclectica Fund. His style of management came out directly from working with Odey: “I am the “Frankenstein's child” of Crispin Odey,” he chortles.

In 2003 Hendry generated terrific returns with the Eclectica Fund (see Table 1). Whilst there were a number of themes that paid off in contributing to the 49.9% return of that year (and the successes on the long-only side) the bet on gold was well publicised. There was some lobbying by competitors on the long-only side to have the fund de-classified as an equity fund because of cash and bond holdings. At the end of May 2003, after a 16.2% up month the top three holdings of Eclectica were Newmont Mining (17.5%), Royal Gold (11.9%), and Barrick Gold (5.0% of NAV). The next month the top equity holdings were Newmont Mining (13.8%), United Utilities (5.6%), and Agnico-Eagle Mines (2.6%).

Such activity around this time was indicative in a couple of ways. The stated investment objective of the Odey Eclectica Fund (as it was called then) in 2003 was “through investment, short and long, primarily in quoted equities, bonds and currencies in the United Kingdom. Investments may also be made in other quoted



Table 1. Monthly Returns (USD) of Eclectica Fund

Year	2002	2003	2004	2005	2006
January		+5.2	+4.2	+2.3	+13.0
February		-8.4	-1.0	+9.9	
March		-4.8	+4.3	-2.4	
April		+8.9	-4.9	+0.0	
May		+16.7	-1.0	-4.7	
June		+1.8	-1.8	+3.5	
July		+1.7	-0.1	+0.1	
August		+4.2	+0.6	+4.4	
September	+0.0	+7.8	+3.4	+8.5	
October	-5.0	+1.8	+5.8	-7.0	
November	-0.1	-3.6	+1.8	-4.5	
December	+0.6	+12.6	-2.9	+6.0	
YTD	-4.5	+49.9	+8.1	+15.6	+13.0

Source: Eclectica Asset Management

securities and related instruments including securities issued by companies not related to the United Kingdom.”

Hendry clearly didn't feel constrained by this investment objective, and acted to protect existing capital/grow that capital as best he could. The same attitude applied on the long-only products (Hendry ran the pan-European and Europe ex-UK products at OAM). The important point is that Hendry was prepared to go his own way in an investment sense. Secondly, the small snapshot of top holdings (and indeed fund shape/asset allocation too) shows that the manager of the fund did not act as if he was constrained by holding periods of positions or turnover of positions or, in the case of the long only funds, index weightings. The turnover of the Eclectica Fund runs at about 25x a year. That turnover each month is roughly equivalent to twice the portfolio size.

2003 must have been a significant year in the psychology of Hugh Hendry as an investor in markets. He was vindicated by markets and validated by markets. The approach to investing he had been building over the previous four years had had the kind of pay-off that he felt his approach could generate. Whilst the returns produced by the Eclectica Fund in 2004 (+8.1%) and 2005 (+15.6%) did not grab the attention of external investors in the way that those of 2003 did, they did contain significance to the manager. “The returns of 2004 and 2005 for Eclectica were okay-to-good by most hedge fund measures,” says Hendry, “but the way I look at them is that I got so much wrong in those years,

and yet I still produced the positive absolute returns that we look to give our investors on a calendar year basis.”

It is this burgeoning confidence in the investment process that was one factor behind Hugh Hendry and Simon Batten setting up Eclectica Asset Management. It was public knowledge in the first quarter of last year that the pair were in discussion with OAM management over the management contract of the Eclectica Fund. At that time the fund assets were about \$330m. It turned out that Hendry and Batten had decided to own outright the management contract for the Eclectica Fund: they both wanted to have their hands on the tiller for their respective spheres of activity – Batten on the business side and Hendry on the investment side. Eclectica Asset Management received authorisation from the FSA to operate in June last year.

Potential investors may not expect a fund that can lose 7% in a month and has a rolling 12-month standard deviation of return of 17.1% to be described by its manager as having a “disciplined approach”, but that is the reality. Most hedge funds are managed with one specific timeframe – weekly and monthly timeframes dominate the industry. The Eclectica Fund, like many high-end CTA funds, is run with multiple time frames of 1-month, 3-months and 1-year, though of course the CTAs are overwhelmingly systematic traders and Hendry's approach is judgemental. The key point is that Eclectica Asset Management seeks to build a long-term track record by stringing together a sequence of high absolute returns for discrete calendar years.

The performance fee arrangements are exactly aligned with this precept – a 20% performance fee paid out after the year-end, subject to a high water mark.

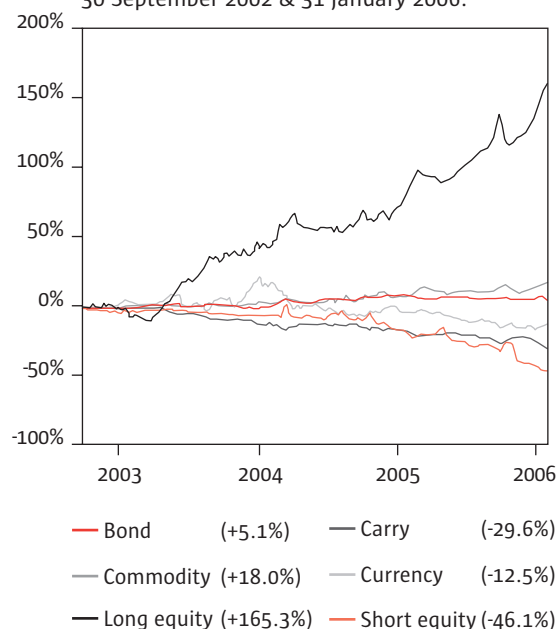
The dominance of the calendar year period comes out in several ways apart from the fee structure. “We aim to avoid calendar year losses: I'm desperate to be a survivor,” says Hendry. “Once there is a cushion there, and for us that would be 10-12% return on the year to date, then risk (leverage) can be increased as we try to ratchet up returns to investors.”

That risk inflexion point came in April of 2003 (2003 return 49.9%), it was not attained in 2004 until November and so was too late to affect risk appetite (2004 return 8.1%), and last year returns got above 10% on a YTD basis in February (return for year 15.6%). As Eclectica has been off to such a good start for 2006, Hendry has 11 months to commit more fully to markets to generate large absolute returns.

A second manifestation of a 12-month time frame is in investment management/risk management. Position sizing and stop loss levels are a function of opportunity at Eclectica. The decision rules Hendry uses to both assess the scale of the

Performance Attribution

This chart approximates the drivers of performance by asset class between 30 September 2002 & 31 January 2006.



opportunity (profit potential) and the stop loss levels are functions of moving averages and scale of price change over time. It comes out in discussion of any traded market: “the Nikkei has traded at an average level of 17,000 over the last 25 years,” (copper is rather exuberant being 38% above its 1yr MA) says Hendry.

“When the NASDAQ peaked in 2000 it was running at 65% above its 12-month moving average,” is a typical comment. These measurements and observations of how markets have traded historically feed into Hendry’s expectations for how markets will trade in future. His target price for crude oil of \$80 a barrel was based on a blow-off of 65% above the 12-month average price that would emerge.

There are other examples from Japan. “The Japanese personal sector displays more financial conservatism than the Victorians – they’ve lost 80% to 90% of the value of their homes and stock portfolios...Tokyo property prices fell over 80% after the bubble burst.”

Hendry contrasts these statistics with boom times elsewhere to show the upside potential: “note that an investment in 1990 in the Californian based house builder, Toll Brothers, would have yielded an 80 bagger in price appreciation” ; and “just like Keynes bought bombed out steel companies for less than 10% of sales, we own a lousy Japanese metal basher that has revenues of \$1bn that can be bought for \$30m. These are 10-bagger opportunities. Or to put it another way, we consider that these trades have optionality.”

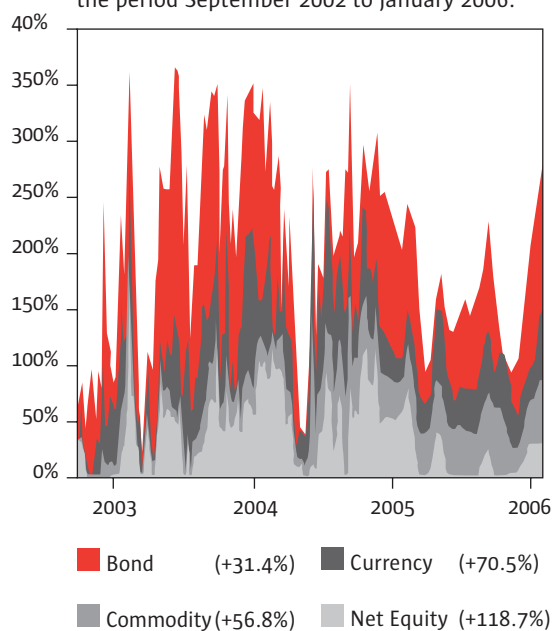
Table 2. The Eclectica Fund Asset Allocation as at 31 January 2006.

	% of NAV
Bond	+31.4
Commodity	+56.8
Currency	+70.5
Long equity	+223.6
Short equity	-104.9
Total	+277.4

Hendry’s long term target for the Nikkei index is 40,000 in the year 2015. This exemplifies his reference to the cyclical influences at work in traded markets. “It takes 35 years for stock markets to travel from peak to peak – for example

Asset Allocation

Asset allocation as a percentage of equity over the period September 2002 to January 2006.



(From 15 December 2003 index derivatives have been included on a delta'd basis.)

Source: Eclectica Asset Management

1929-66, and 1966-2000...Gold has been in a 19-year bear market which has destroyed the asset’s credibility; the next 16 years are the benevolent ones for gold.”

The core of what Hendry does he describes as being like a code-breaker - seeking to identify what he sees as “a series of virgin bull markets”. He says his aim is to “keep our sanity/solvency by investing exclusively in rising price trends. It’s like walking past restaurants: I only want to go in if I can see it’s busy.”

Hendry uses long-term price data and charts to point out when bear markets have finished and when they are showing evidence of entering primary bull markets. A significant chart pattern may be as basic as a double bottom or a sequence of higher lows on a multi-year basis. Interestingly he uses relative price charts (performance against the index) for stocks for the same reason. A set up of observations over a couple of decades, and where price exceeds some long term moving average, gives potential for a multi-year upside, but short term timing may be difficult. In such circumstances Hendry

may implement the view using options (which are in all likelihood cheap if the market is emerging from a bear). When a bull market has been established positions may be taken in futures (outright risk assumption).

Not that all the positions are directional. The Eclectica fund often has variance swaps or options to implement views of volatility, and an increasing though still small component of the fund is in matched positions. One such pair was long AMD versus short Intel, and recently Hendry has put on a long Sainsbury’s position against a short in Tesco. “The way I see it,” says Hendry, “in a world where all asset classes are expensive (equities/bonds/housing/collectables/some commodities), it’s a way of avoiding taking market risk and it brings another facet to the fund.”

Positions are cut and sold entirely when they breach the appropriate moving average of the price. All multi-year bull markets will have interim consolidations and corrections. The very longest moving averages are used to determine the primary position – long term bullish. The signal to take an interim profit (primary bull intact) will come when the traded price drops through a shorter term moving average. Hendry will take it that he was wrong on the primary bull market if the price drops through the longer term moving average (bull market signal aborted). Outside the MAV discipline the manager is also allowed to use option money to commit small amounts of capital.

It is the job of the Eclectica dealer Suren Patel to track the price versus moving averages across all 400 positions. Not all positions have hard stop losses, and none have price targets. There is some debate within Eclectica about the closing of positions. Sometimes an analyst, the dealer, or Simon Batten will throw their weight behind implementing a closing trade, but it is ultimately the decision of Hugh Hendry. The debates can last some time, extending over days and even weeks. Mostly Hendry has a bias to action. “If we start to consider a change to a position, I tend to cut a third and think about the rest. I’ve found acting first and philosophising later (to paraphrase Soros) to be the best approach.”

There is a philosophical reason for the absence of price targets. “Yes we do have an idea

of where a security should trade,” confesses Hendry, “As we usually enter a position where there is a positive trend we look to stay in the position provided the trend remains unbroken.” Internally this is summarised as “conviction is overruled if it lacks market confirmation.” According to Hendry he bows down in acknowledgement of Crispin Odey’s strength in this area: “Crispin says that within a trend I’m the best. I’d also say that understanding turning points was a big insight I gained from working with Crispin.”

The portfolio manager and trader at Eclectica do not do any of the fundamental research. Consequently they have all of their time available for portfolio monitoring and construction. “The analysts speak to the protagonists on a company or industry,” says Hendry. “I’m in my ivory tower, and we (the dealer and I) are governed by the markets. The analysts are there to validate my ideas – they get the detail, and are the ones getting grubby rooting around. They increasingly are coming forward with their own ideas. The

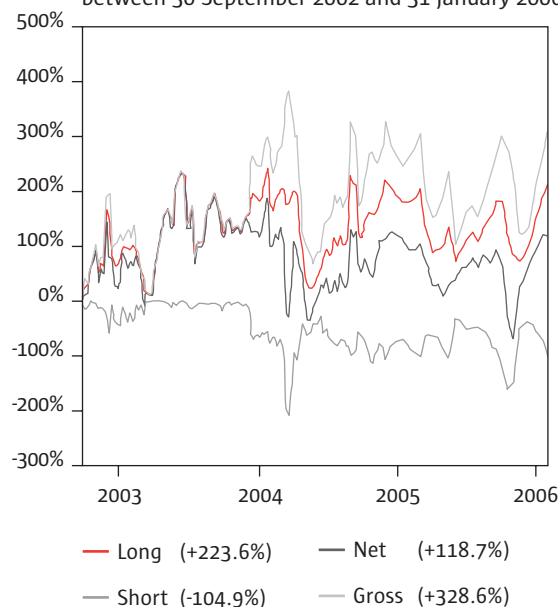
combination of the dealer and the analysts are there for me to make sure we fulfil our overall mission as disciplined deviants.”

What is Eclectica Fund? It is described by its management company as “an opportunistic fund investing in global equity, fixed income, currency and commodity markets,” and it “aims to fully utilise the balance sheet.” The last part expresses the risk appetite necessary to produce “superior risk-adjusted returns over the long term”. The approach to risk control that is used has been developed “to contain the mistakes of the manager,” according to the manager himself.

Eclectica Asset Management. The name ups the ante. It can’t be associated with a “me too” European equity long/short hedge fund with a handle like that, and it isn’t. It is quite appropriate that investors look to the US to find a comparison (see Q&A) because there is not another fund in Europe like the Eclectica Fund. The fund comparisons that come to mind are not even latter day American hedge

Long/Short Equity Weighting

This chart depicts the equity exposure over time on a long, short, net and gross exposure basis between 30 September 2002 and 31 January 2006.

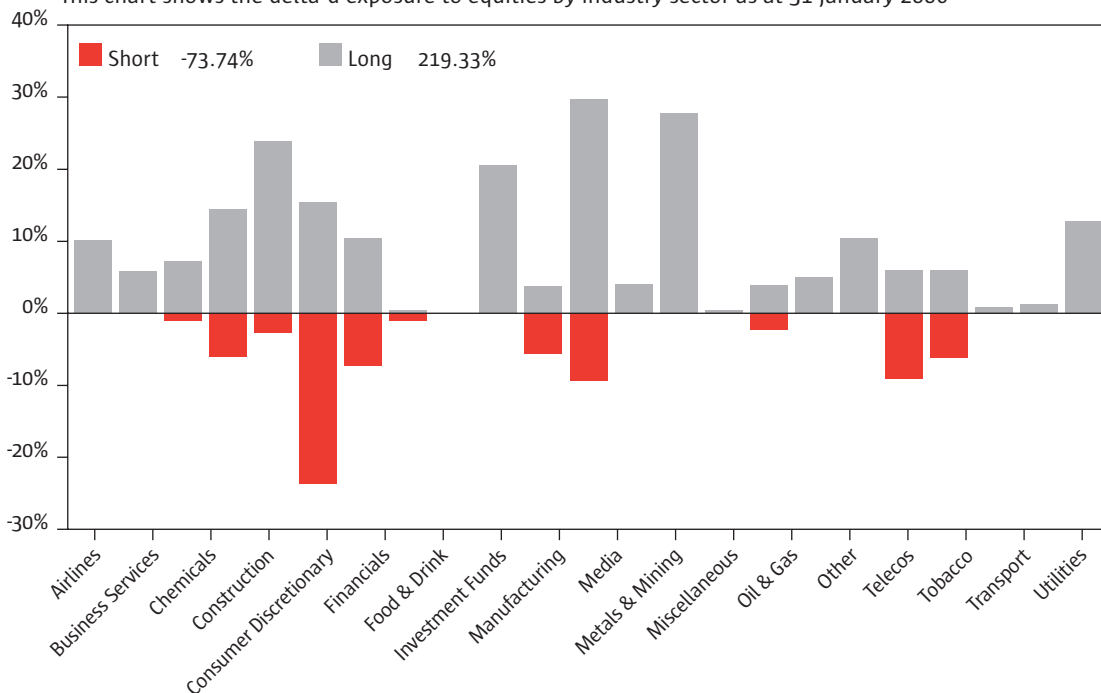


funds: Hugh Hendry is on a path to re-create the funds that Steinhardt, Soros and to some extent Robertson became, funds that outgrew their equity-focussed beginnings, and that flowered to utilise the full scope of wide investment powers.

The European landscape of the hedge fund business is dotted with funds and individuals that produced large returns early in their track records and never again even tried to extend their balance sheets to produce top ranking performance. The yearly returns of the Eclectica Fund give a verisimilitude in this regard for Hugh Hendry. But it would be a mis-reading of the history of the fund. The return of 49.9% in 2003 represented success, but the returns of 8.1% in 2004 and even 15.6% in 2005 did not reflect success in the mind of the manager. The returns of the last two years have been described by him as those produced in bad years. When he is in gear with markets and makes fewer mistakes he expects to replicate the returns of 2003 and do better still. If CEO Batten is right and Hendry is getting better, then investors had better prepare themselves for some big numbers in the years ahead.

Asset Allocation By Industry Sector

This chart shows the delta'd exposure to equities by industry sector as at 31 January 2006*



*Bond related contracts are not shown in 10 year equivalent values and therefore shorter duration holdings, such as bills and interest rate contracts, will appear inflated.

Business issues

A Q&A with Simon Batten, Chief Executive Officer and founding Partner of Eclectica Asset Management

When you started Eclectica Asset Management which lessons for running a business were uppermost in your mind?

I joined Odey Asset Management in 1992, so I have had time to find out what was necessary to run a successful hedge fund business. We knew well the infrastructure requirements we had to cover at Eclectica, and so we have built a platform here that could handle up to \$4bn of assets under management.

From a strategic perspective I saw that there is a tremendous strength in having a long-only business run in tandem with a hedge fund business. I think it gives your overall business better balance to run capital in both styles, and for our way of money management it also is a strength for the investment process. The capital is always committed to markets in the running of the long-only portfolios, whereas there can be times when capital commitments have been reduced on the hedge fund side. So running the long-only money allows Hugh to stay in the flow of markets even when, for example, stop loss limits have taken us out of the markets on the hedge fund side. He gets rehabilitated quicker and I think this explains why he tends to come back quickly from draw-downs.

Have you had any positive surprises from running your own business?

I'd say that just doing our own thing has been a very positive experience. In our case lifestyle choices have been a factor. So yes, we [Hendry and Batten] had to mortgage our houses to buy out the management contracts from Odey Asset Management, but on the plus side I live 10 minutes away from where we work and Hugh lives five minutes away. We can put in place routines for Hugh and I that allow the business to get the most of our abilities.

The fact that we had people in each position with previous relevant experience has been a

big plus for us. So our business was approved to operate by the FSA six and a half weeks after application. That kind of thing does not happen too often.

Why do you have subscriptions and redemptions as frequently as twice a month?

We used to have weekly dealing at Odey [Asset Management], so this is cutting back [laughs]. It really is a hang-over from that time. Conceptually we do not have a problem if investors are not comfortable with what we are doing on their behalf and they want to exit. We don't want to keep unhappy investors. It can mean that we have some variation in the asset base, but one of the lessons from our previous employers was that we had to work with investors that really understood and believed in what we are doing. Thankfully, we have that for the most part. We have a tremendous investor base and we try hard to communicate clearly and openly with them. Despite the upheavals in 2005, our investor base increased by 10% (and we have 300 investors).

Whose returns do you look for in the trade press or websites?

We don't track other funds, and there isn't really a peer group for what we do. The hedge fund that other people say is similar in approach to our fund is Clarium run by Peter Thiel.

Where do you want the business to be in the medium term?

We have our priorities, and what we will be doing is "climbing the nearest mountain". In our terms that nearest peak is the \$1.0bn of assets that Hugh managed in long only accounts in February of last year. What we want to do is to get back to that figure first.

We have some work to do on fund launches in the meantime: we intend to launch two long-

only funds next month. Hugh has a great track record running long-only funds, and we want to capitalise on his reputation there. We will have two UK-domiciled UCITS – the Eclectica European Fund (EEF) will cover pan-European equities, whilst the Eclectica Continental European Fund (ECF) will be Europe ex-UK. After that we have some thoughts about what other sort of fund would work well in our framework. As I've mentioned I see the running of long-only funds as complementary to our hedge fund process. It makes a lot of sense to us to have a global long-only fund, as well as our planned European products. We also think that it would make a lot of sense to have a Japanese fund run from here, given our (constructive) view on Japan.

What do you observe going on in the hedge fund industry as a whole?

There has clearly been too much capital allocated to the industry, so it is unsurprising that there has been a compression of returns. A consequence of those flows is the industrialisation of the hedge fund business, by which I mean several things. There has been a focus on asset gathering by some; the entry of long-only firms to the business with all their huge non-investment infrastructures has an impact on how everyone is viewed; and then what were originally small nimble innovators in the business have become multi-manager platforms themselves. The industrial scale is not for us – we're still very much focussed on the returns, and in that we have some expectations. I believe that our skill-sets at Eclectica are still improving, and in particular we are getting better at bonds, FX and commodities, so I see a lot of scope for improvement in what we deliver to investors. Our aim is to continue to generate similar returns going forward, but it will be from these asset classes if equity markets (e.g. Nasdaq/Dax) don't double over the next three years as they have over the last three.