Stable growth is good growth at 50 South Capital

The fund of hedge funds team is seeing more interest in customised solutions from institutional clients

By Chris Clair

Nearly four years ago, managing director Robert Morgan said he thought his hedge fund team at Northern Trust Alternatives Group would be disappointed if assets under management weren't at $5 billion in five or six years.

A lot has happened since then. Hedge fund returns flattened out. The fund of funds industry underwent a wave of consolidation and retrenchment as firms had a harder time justifying their fees to institutional investors that began opting for direct investments or getting out of hedge funds entirely. And, in 2015, Northern Trust Alternatives Group was carved out into its own entity — 50 South Capital Management, named for the address of Northern Trust's iconic building on LaSalle Street in Chicago.

In early 2013 Northern Trust Alternatives Group had $2.3 billion in assets and the fund of funds industry was enjoying its best performance since 2009, according to the InvestHedge Composite Index. A doubling, or more, of assets didn't seem out of the realm of possibility.

As of 31 December, 50 South Capital had $3.1 billion in hedge fund assets. It's not lights-out, but given all that's gone on in the fund of hedge funds space over the past few years, any growth is good. And Morgan and his team say they're happy about the stable growth the firm has managed over the past couple of years.

Jessica Chu, vice president for product strategy and investor relations at 50 South Capital, says the firm had more than $300 million in inflows in 2015 and another $300 million total last year into its strategies. "It's good growth, especially in light of the broader space," she says.

Performance has helped drive growth. Going forward, Morgan says markets today are set up nicely for hedge fund managers, and that clients see that potential.

Tristan Thomas, director of portfolio strategy at 50 South Capital, says the rebranding in 2015 also helped growth by making the group more visible. "We've had a number of instances where we've had investors — potential investors — call us up, enquiring about what we're doing," Thomas says. "Previously, when we weren't 50 South Capital, they didn't really have an interest in working with a group that was inside a larger bank. A separate entity, with more autonomous decision-making has driven greater client interest."

And that was one of the main goals behind the move — combine the greater autonomy of a boutique firm with the international resources of Northern Trust's 16,000-plus employees and nearly $1 trillion in assets under management. In announcing the formation of 50 South Capital, Northern Trust Asset Management president Stephen Potter said the spin-off would better align the firm's alternatives talent with the institutional and other investors interested in that space.

"That's the beauty," Morgan says. "It's like we're a little boutique within this large structure that has vast resources to draw on as needed. That's been a nice combo."

Morgan says another benefit of the spin-out was the effect it had on employees — the sense of ownership is motivating. "It's fun to grow a business and be a part of that," Morgan says. "And I think it helps us attract talent."

Indeed, since 2013 50 South Capital has seen some senior-level people depart for other firms, only to be replaced with new talent. 50 South Capital does not comment on personnel moves, but Anthony Zanolla, who was the head of hedge fund portfolio management for eight years, left in 2014 to become a portfolio manager at K2 Advisors. Likewise Tony Lizzuzzo, for nearly four years Northern Trust Alternatives Group's director of research, left in mid-2015. He's now senior investment director at Cambridge Associates.

Thomas took over Zanolla's duties while John Frede joined as 50 South Capital's director of manager research in the fourth quarter of 2015. He previously worked at Mesirow Advanced Strategies, where he was head of hedge fund research management.

And in October 50 South Capital hired Citadel's former director of global distribution, Chris Bires, for a newly created role of managing investor relations and business development.

Overall, 50 South Capital had $6.7 billion in assets as of 31 December. That total includes both hedge funds and private equity funds. 50 South Capital is also building out its capabilities in private credit, infrastructure


Robert Morgan


Tristan Thomas


John Frede

and real asset investments.

Morgan says generally, 50 South Capital's client base is becoming more institutional and more interested in customised solutions. The firm has seen strong client growth in the foundation and endowment space, and in corporate pension plans, Morgan says. Of the $3.1 billion in hedge fund assets, just less than half is in commingled funds of funds and $1.3 billion is under advisement in customised solutions.

That's a decent amount when you consider that 50 South Capital's specialty is investing in smaller managers, or managers with less than $1 billion in assets. Chu says the median size of the hedge funds with which the firm invests is about $600 million.

50 South Capital has traditionally sought to identify talent early. Nearly three-quarters (74%) of managers with which 50 South Capital has invested had less than $1 billion in assets under management at the time of investment. While on the long/short equity side managers often have less than $1 billion, there are certain strategies where size and scale can be an advantage, such as distressed credit. However, Frede says that conversations with fixed-income divisions regarding liquidity and crowding rules changed the 50 South Capital team's perspective to focus on smaller, more nimble credit managers that can "trade under the radar and not get hung up".

Those conversations took place partly because Thomas sits on a broader committee at Northern Trust that includes the leaders of various investment teams. Once a month these team leaders meet for discussions focused on the markets. Thomas describes it as an "unfiltered discussion".

"There's no sales spin. These are just completely unbiased opinions that really form the base of our own macro view which we then adjust to incorporate the team's view on hedge fund strategies. This serves as a framework for positioning," Thomas adds. "It's a huge benefit."

For instance, Frede says in late 2015 50 South Capital saw that the opportunity set in the distressed credit of energy firms, retailers, and industrial companies looked to be improving. Frede says sometimes in the distressed space investors look to larger managers because they have teams of lawyers who can comb through the complex bankruptcy documents looking for investment opportunities. But the fixed-income division observed that moving smaller blocks of bonds – say $25 million – was not difficult. However, moving larger blocks was proving more difficult because a lack of liquidity was driving up bid-ask spreads.

"So that made us think a little bit differently about how we should be approaching credit in that we didn't want to enter into crowded trade risk," Frede says. "That was a little bit counterintuitive, but that view was very much formed by connecting with our fixed-income group. Having a resource that is unbiased is helpful in charting the course for how we allocate."

Frede says being a subsidiary of a larger institution with experts on whose wisdom and experience Frede and the rest of the team can draw, combined with the nimbleness to change course quickly in response to that information, makes all the difference.

> *"We look at what the manager does and the universe of securities they trade and we form a hypothesis on why we think the manager is skilled and whether we think that can be repeated over time"*

And the benefits go both ways. Thomas says at the same meeting where the investment team leaders talk strategy, he shares what hedge funds are doing, how they're positioning themselves and what they're thinking.

Performance has always been about having an edge, and in the fund of funds space that edge seems increasingly thin. Some funds of funds hang their hats on their boutique culture and independence, others boast about their scale. 50 South Capital can claim a bit of both. The insights available to it from the rest of Northern Trust and the ability to react quickly have both contributed to Northern Trust's performance and, indirectly, its growth.

Two-thirds of the value generated by 50 South Capital can be attributed to manager selection. The other third comes from allocation decisions.

50 South Capital tends to run smaller, more concentrated portfolios. The firm has about 50 managers with which it actively invests. Depending on the mandate, manager concentration could range from as few as a handful to as many as 40.

Frede says 50 South Capital looks top-down at where it should be investing and then analyses what its capacity is with managers specialising in those strategies. The results of that analysis drives 50 South Capital's priorities when it comes to finding managers in long/short equity, event-driven and credit, relative value and macro.

"I would say typically there are two to three high-priority managers in each strategy that the team is working on, and then there's the manager opportunities behind that that we're watching closely," Thomas says. "That list is pretty dynamic. We like to kill things early in the process when we know it's not going to move forward and we move on to the next opportunity."

The competition among managers for 50 South's capital can be intense. The firm's research team meets with 500 to 600 managers a year, but thousands reach out trying to get a meeting. Sometimes those managers can get pretty creative with their efforts. They come in from meetings elsewhere in the bank and call anyone and everyone on the team. Firm spokesman John O'Connell says some managers have even called him. Collectively 50 South Capital's executives and researchers have almost 200 years of experience. Thomas says their business cards are scattered throughout the industry.

Cold calling isn't always effective. Frede says primarily 50 South Capital uses word of mouth from its existing managers to source new talent. "They know who they're trading against, who's smart, who's not," Frede says.

50 South Capital also uses word of mouth from inside Northern Trust — which includes custody and administration services — and from capital introduction events.

Managers want to get on 50 South Capital's radar because Frede says the firm has net positive flows, which means it has capital to put to work, and because its client base is an attractive mix of high-net-worth and institutional investors.

The biggest challenge for the research team isn't finding managers, it's sifting through all of them.

Frede says 50 South Capital looks for skill first because skill is repeatable. He defines "skill" as alpha, the ability to generate "true, different, unique returns that aren't correlated to the market."

50 South Capital's research process is what Frede describes as evidence and expectations-based. "We look at what the manager does and the universe of securities they trade and we form a hypothesis on why we think the manager is skilled and whether we think that can be repeated over time," Frede says. "So that's where we marry this top-down allocation view with the current market today, do we think that the skill is going to be effective in that market environment? We're looking for points of independent verification to support the view of whether they're actually skilled or not. And that builds our confidence in our overall hypothesis and manager assessment."

It takes about 100 hours for 50 South Capital to vet a manager to its satisfaction — more in some cases, less in others. Most of that time is spent conducting a qualitative assessment, Frede says, speaking to the portfolio manager to understand the investment process and to other members of the team to build the case for why the manager fits with 50 South Capital's hypothesis of what makes it special.

Frede and Thomas say 50 South Capital has no set type of manager it looks for; the firm doesn't have a pre-conceived notion of a "50 South-style manager." While each manager's attributes are unique, a few that tend to appear across the programme are smaller managers, managers that take singular risks, and managers that run short books. "We don't tend to do a lot with longer-biased managers or managers that are just using indices on the short side," Thomas says. "We want guys that are doing real alpha-driven shorting throughout the portfolio."

> *"Frede says 50 South has exited a few managers in 2016 because they saw those mangers' strategies being opportunity-challenged in the next nine to 18 months"*

Frede says that leads to hedge fund portfolios that demonstrate why an investor should be in hedge funds in the first place — a return or alpha stream that's different from the traditional assets in the portfolio. Hedge fund investments should diversify the investor's portfolio and provide some downside protection.

"At the moment we've got multiple managers that are actually running net short," Thomas says. "There's a real focus on shorting and being opportunistic around positioning. We really like managers in the long/short equity space that might be, when the opportunity is there, 30% net long and when the opportunity set flips they might be 10% net short. But they're not dogmatic about their exposure; they can move with the opportunity set."

Sometimes, though, the opportunity set just isn't there, in the 50 South Capital team's view. When a strategy appears to be facing longer-term headwinds, it can be time to move on from a manager. Other reasons for redemption range from a key people leaving to an unexpected drawdown to an unexpected increase in assets, which could take the manager beyond the size at which 50 South Capital feels comfortable.

Any member of the investment team can, with the support of one other team member, initiate the redemption process from a manager. This can lead to an immediate redemption, or the manager may be placed on a watch list to determine whether the issues at hand can be remedied in a time frame the investment team considers reasonable.

Turnover among the list of approved managers at 50 South has averaged about 20% per year. Which isn't to say that the firm's entire roster of managers has turned over in the past five years. One unnamed long/short equity manager out of London has been with 50 South Capital since 2007.

Frede says 50 South has exited a few managers in 2016 because they saw those mangers' strategies being opportunity-challenged in the next nine to 18 months. For example, 50 South Capital redeemed from one activist manager who's been managing money for the fund of funds for the past five years, not because there was anything wrong organisationally but because 50 South Capital's team thinks the particular brand of activism practiced by that manager is late in its opportunity cycle.

"If the market environment turns in their favour, we hope they will open the dialogue with us again," Frede says. "We try to be as clear as we can with managers as to our reasons for exiting so there isn't any confusion or hard feelings."

50 South Capital uses RiskMetrics for ongoing monitoring through position-level transparency. The firm also speaks to many of its managers at least monthly to conduct a performance check-up and understand what the larger contributors to performance are at the time. The frequency of these check-ins is determined by a risk-based monitoring philosophy that flags smaller or new managers, or managers who run more complex strategies, for more frequent evaluation.

"That feeds back to Tristan's group on the portfolio team," Frede says. "One of the most challenging things about his job is the managers are shifting their allocation. Tristan has to be thinking about what that means to the broader programme. That position-level risk transparency is really helpful in looking at that on a monthly snapshot basis to see where the ground is. And then that informs our forward looking views as well."

Beyond that 50 South Capital performs more of a formal check-up on its managers every six months to make sure the investment hypothesis is still valid.

Looking ahead, 50 South Capital may yet see $5 billion or $6 billion in assets, but the team seems to be in no hurry to get there. Beyond a planned acquisition in 2016 of Aurora Investment Management that fell through, 50 South Capital has no plans to grow by acquisition. And the Aurora deal wasn't about growth as much as it was about combining with a complementary firm.

Future growth at 50 South Capital is likely to be in customised funds, Frede says, because the reasons clients get into hedge funds are so diverse. Some want returns while others want diversification and still others are seeking defensive positions. Customised funds can accommodate those differences.

"The institutional community is thinking of how hedge funds can impact a client's overall asset allocation, rather than just be a stand-alone slice of their asset allocation pie," Frede says. "Hedge funds are no longer viewed as a stand-alone entity, but rather a solution for the whole portfolio."