

Why eclectic excellence is the k

3C has an interesting range of funds and is launching into another based on options and futures trading, so bringing its investors returns from private equity, through to a Japanese product focused on the China growth story, as David Walker reports

For few hedge fund houses could the word 'eclectic' be used more aptly than for City Capital Corporation Limited, the London firm whose name is abbreviated neatly to 3C.

The five-year-old company, as Scott Beattie, partner at 3C explains, has four business streams, namely corporate finance; securities research and broking, a property investing arm; and, of course, hedge funds, within City Capital Asset Management (3CAM).

As part of its first leg, 3C is a stock-exchange member and offers the services of standard investment bank; in its direct property investment activities 3C owns two major corporate headquarters in Bucharest, and is looking to purchase shopping centres and leisure portfolios in Croatia, Bulgaria and the Ukraine, among others.

In hedge fund or hedge fund-type products it has two products currently and is launching a third at the start of May. Let us start with the new launch first.

HIGH FLYER

Iron Condor is a volatility fund combining two derivatives-based strategies, trading US and European options, run by two experts at 3CAM, strategies that complement one another to produce a smoother return.

Its strategy involves selling short-dated exchange-traded out-of-the-money options, which are hedged. "Iron Condor is a volatility fund trading index options on the FTSE and Eurostoxx in Europe, and the Dow Jones and S&P 500 in the US," explains Beattie.

The fund, with dollar and euro-hedged share classes, may have proved particularly attractive after March's jolts in Shanghai, which helped the VIX Index jump from nine to 17 in a matter of days.

To achieve its 'mid-teens' return target on moderate volatility, it employs two complementary strategies – one non-directional and unleveraged, the other directional and leveraged, and each earning a return primarily through premium paid for writing options on the indices.

Paul Gleeson, running Iron Condor's non-directional approach, has worked for employers including

Lehman Brothers, Gourlay Wolff, GNI and Union CAL. Responsible for European markets at Iron Condor, he previously ran \$90m at Arcanum based on a similar strategy to his programme at 3CAM. Returns on his strategy, running actual money, are 11% compound annual growth (CAG) since October 1997 to December 2006.

"You sell a put and a call on either side of the index and hedge it by buying a put and a call slightly further out," Beattie explains. "This should make 12%-15% per annum. It's all about execution, you need to know the market-makers to give you the best prices and why you should buy at a particular level against the index."

THOROUGH RESEARCH

Gleeson has conducted analysis of 277 months of the frequency of various monthly percentage moves 11 days out from FTSE 100 options' expiry.

As an example, a call can be sold 3.78% above, and 5.39% below the index level respectively, with premium earned on each. Insurance slightly beyond these levels can then be bought, a call on the upside, a put on the downside.

"The trading approach involves the simultaneous selling of short-dated...exchange-traded, out-of-the-money call and put options on the FTSE 100 or EuroStoxx 50 Index, and the purchase of further out-of-the-money put and call options as a hedge," Beattie explains.

"The level at which the options are purchased and sold are calculated 11 days prior to their expiry based on probability tables, having regard for recent volatility. The pattern of returns on the indices shows you usually make 1%-2% per month. If you write a put or call 5% away (from the index level), the chances of you being exercised are very small."

Working within 11 days of expiry, time decay is fast, Beattie adds, and if you are exercised, you are hedged.

If the premia that could be made do not at least compensate for the risk of placing the trade, Gleeson will not make the trade – differentiating him from other options

traders who may feel impelled or compelled to be active in the market regardless of the risks involved. While an ongoing risk is market-gapping beyond the safety hedge, for example, Beattie says global markets have evolved in investor types, liquidity and information flows in past years to reduce the chance of such gapping.

"If this was a strategy on its own, I would say it is interesting, but not as exciting as some of the other options funds out there," Beattie says.

COMPLEMENTARY SKILLS

Enter Marc Robbert-Rasmussen, who runs the directional approach having worked previously at McKinley Allsopp, running their emerging markets desk, and

market just 11 days before options' expiry for Gleeson.

"Robbert-Rasmussen will write a put 5%-7% away (from the index) then hedge it out by selling a future, and collects the 2%-2.5% premium," says Beattie. "Options expire every month, futures every quarter, and as the index comes down towards the strike price of the put, Robbert-Rasmussen increases his hedge."

SMOOTH RESULT

"You have one manager who can make around 1.5% per month along with someone making 2%-2.5% but with more volatility and who may lose more money. Once combined you smooth out the returns and volatility."

Iron Condor will start with around \$10m, though Beattie says it can take in up to \$200m. While it can stand alone in an allocator's portfolio, Max Schmid, managing director of fund marketing, notes it can also work as an effective overlay on equities portfolios.

Investors in Iron Condor will incur a 2% management and 20% incentive fee with a high watermark. Iron Condor's target size is \$200m, and it has a three-month lock-in and monthly entrance and exit with 30 days' notice.

GETTING IN EARLY

The first of 3CAM's existing funds is AM2, launched in January 2006, and is up a very healthy 20% to end of February 2007, according to the group.

AM2, a non-leveraged, pre-IPO investment fund, invests in private firms that are within 12 months of their listing – the key factor here being within 12 months of what 3CAM, and not the company's own management, thinks is its likely IPO date, as Beattie explains there is on average a 7.1 month "drift" between planned IPO date, and the actual IPO date.

AM2 complements 3C's investment-banking operations, which included assisting companies that want to come to market.

"Clients liked what we had been doing for three or four years on that side," Beattie says, "and came to us saying: 'I like your expertise but I can't pick companies and I'm locked in, what about a fund?'"

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has 22 years in the investment industry. Using real money on an options strategy similar to that he will apply for Iron Condor, he has returned 18% compound annual growth (CAG) since November 2003, according to 3CAM.

Robbert-Rasmussen's strategy involves selling out-of-the-money puts on the Dow Jones or S&P 500 Index, with these positions initially delta-hedged but with futures but with the hedge actively managed to take into account the movement of the markets.

While the non-directional strategy works 11 days out from option expiry, Iron Condor's directional portion works on a time frame of one option expiry cycle.

Another difference is that Robbert-Rasmussen is in the market every day, compared to being in the

Key unlocking 3C's success

The result, AM2, is a Bermuda-domiciled fund with about \$20m that it invests in pre-IPO firms, which are heading for a listing within 12 months of the investment being made. Its investors incur 1.5% management fee and 20% performance with a 10% preferred return to investors, and have a six-month lock-in.

MAINTAINING CONTROL

"With the fund, investors can participate in the space in a more diversified and controlled environment," he adds, "so I do not have one stock shooting up 200% and another one collapsing." A niche fund with \$20m, it is expected to close to investors at \$50m.

"The companies we are looking for should make a 40% uplift from when we invest to when they could do an IPO," Beattie says, a healthy expected return that naturally includes an illiquidity premium for AM2 and its investors being locked in for the period.

"However, with a private equity fund, it is typically structured as a general partnership/limited partnership and investors are locked in for five years or more, whereas with AM2 – and AM2 could be seen as a type of event-driven fund – there is a monthly lock-up and redemptions with quarterly notice.

"Private equity investors are looking for 3.5 times, meaning 35% IRR over a long period, whereas we are looking for investments of six to nine months to one year and 40% IRR," Beattie explains.

What are the other benefits of getting in shortly before the IPO?

KEY TO PRIVATE SUCCESS

In contrast to private equity financing, pre-IPO investing allows the managers the ability to deploy and redeploy capital rapidly. And in contrast to IPO financing, it allows

for a corporate-finance view of the transaction, and board influence and direct access to management information and co-investment rights.

AM2 has made 30 investments so far, and had five IPOs, plus another one that was expected in March, and another two slated for April. "It is important to have a spread of sectors and geographies to mitigate your risk, and also a spread of instruments," Beattie says. No exposure to a single security can exceed 15%-20% of net asset value (NAV) at cost, or 25%-30% of NAV after purchase, and the enterprise value of an investee company will typically be £20m-£50m. While the fund's typical stake is less than 10%, it cannot exceed 29.9%.

On portfolio diversification as assets grow target companies will still number around 30 so allocations to each grow from around £500,000 to around £1m.

AM2 can invest in plain equity,

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but also will consider PIK notes, warrants, preference shares and others to gain access to a deal. "You have convertible notes, for example, where you get the IPO stock at a discount to the IPO price, say a 20%-50%

discount," Beattie says. "This caps your upside and, although they're defensive instruments, you sometimes can get a running yield.

"Then you have equity and equity-related instruments geared to the performance of the stock. This is more risky but you usually get more return. You can use, for example, equity or equity-with-warrant instruments and equity-with-a-warrant and a ratchet."

DRIFTING DANGER

If the IPO date drifts, conditions attached to the 'ratchet' can compel management to give up an increasing portion of equity to shareholders for the same price as their initial outlay – so 'encouraging' management to list on time.

Sectors AM2's investment have been made in renewables (Finavera Renewables, IPO in January), Mining (Diamondcorp, IPO in February), and oil and gas (Nighthawk, IPO in March).

Beattie explains there are four kinds of IPO investments. The first is 'dirty' pre-IPOs, where companies seek investment funds alone and have not had due diligence conducted by third parties. AM2 avoids these. The second type, and the most prevalent for pre-IPOs, are from companies in late-stage private equity rounds, with the firm, and its private equity backers for it, seeking top-up financing before listing.

"These deals take longer to do from our perspective but we are comfortable with them; they tend to be technology or business services, for example," says Beattie.

One firm AM2 invested in was also backed by Siemens, 3i, and Logitech, among others, co-investors whose reputation and own due diligence can give comfort to AM2's managers when investing.

BROKER-LED IPO

The third type of pre-IPO is broker-led, the type of pre-IPO which constitutes about half of AM2's portfolio. While AM2 takes note of the material the broker will provide on the firm when conducting its own due diligence, Beattie says it also examines whether the broker's expertise fits the type of company it is helping to market.

While 3C is also involved on the corporate-broking side in these types of pre-IPOs, and although three of AM2's 30 investments are in 3C's corporate finance client firms, Beattie says the same due diligence is conducted on these before investing as on other IPO-bound firms.

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SAFETY IN NUMBERS

"We will not go in as sole investor and, typically, we look to take 10%-20% of a deal and, if it is a 3C deal, it needs to be syndicated to other people and you're expecting other parties to validate the business, and the price for that business. So the market corrects the conflict."

The fourth kind of IPO is 'special situations,' where a management group may want to sell some shares in the company, for example, there has been a failed settlement on a pre-IPO.

While the method of valuing a private equity deal may be a particular focus of investors, Beattie notes coming in shortly before a company's IPO with a number of venture capital/private equity rounds behind it gives a good indication of the value of the business. Most of the investee companies have listed in London, the rest in Canada.

When researching companies, AM2 enlists the expertise of approximately 10 independent analysts across eight sectors.

SINO-JAPANESE PROFITS

The final 3CAM fund, Korokan, a Japanese long/short portfolio, aims to profit from Japanese-listed companies with significant exposure to China either through direct trade or joint ventures, for example. The fund was presented at *Hedge Funds Review's* last family office luncheon at Claridge's in London.

Guy Howard, responsible for the overall strategy of Korokan, was manager of Morgan Stanley Wealth Management's \$80m Japan Core Sicav and \$250m Kentoshi Sicav, from 1999 to 2005.

Simon Munn, who presented to the family offices at Claridge's, is responsible for Korokan's short book, and worked previously at Morgan Stanley in the institutional equity division in London.

Launched in November 2005 Korokan ended the year 5.06% up, before facing a difficult 2006 that left it 11.12% down. It made up more than half this decline in January 2007, when it returned investors 6.83%, and is up 3.66% in February, according to figures from 3CAM. Its annualised volatility is 17.27%. Korokan has had top decile performance in its class over the last quarter.

FTSE 100 INDEX 11-DAY % MOVE FREQUENCY DISTRIBUTION (PROBABILITY TABLE)

	% movement	Months	Probability
Number of up months exceeding	5%	23	8.30%
Number of down months exceeding	-5%	9	3.25%
Total		32	11.55%
Number of monthly rises exceeding	6%	15	5.42%
	7%	10	3.61%
	8%	4	1.44%
	9%	3	1.08%
Number of monthly falls exceeding	-6%	4	1.44%
	-7%	2	0.72%
	-8%	1	0.36%