

The Interview - Paul Netherwood, Beach Horizon: "We expect investor interest in managed futures to increase significantly in the year ahead"

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Dr Paul Netherwood, a partner with managed futures specialist Beach Horizon, says the strategy is set to increase its appeal not only because of its standout returns in 2008 but because it offers the transparency and liquidity that investors increasingly demand, and because managers' familiarity with enhanced transparency requirements will leave them better placed to cope with increased regulation than many others in the alternatives sector.

HW: What is the background to your company and fund?

PN: David Beach, Sanjeev Lakhanpal, Alan Goulding and myself founded Beach Horizon in 2004. The programme had been developed and paper-traded over a three-year period at Beach Capital Management and was launched in May 2005.

The managers have an established fund management pedigree with a long track record in trading futures and forward markets. Sanjeev, Alan and myself previously worked together at AHL, now part of Man Investments, while David Beach ran the Discretionary Programme, a managed futures fund with a successful track record spanning 17 years. In 1998 David founded Beach Capital Management, which at its peak in April 2005 had more than USD1.4bn in assets under management.

In March 2006 David decided to retire as fund manager of the Discretionary Programme. The programme closed at a new fund high and all assets were returned to investors. Beach Capital Management ceased trading and Beach Horizon LLP became an independent entity.

David is the senior partner and chief investment officer at Beach Horizon, and is actively involved in all aspects of the business, including research. The core staff at Beach Capital Management from trading, operations, IT, research and marketing transferred to Beach Horizon. Beach Horizon also took on the firm's well-developed infrastructure and has continued to enhance it since.

Beach Horizon LLP has USD150m in assets under management split between the Beach Horizon fund and several managed accounts.

HW: Who are your service providers?

PN: The service providers for the fund are KPMG as auditor, Maples & Calder as

legal counsel, Newedge as futures clearing and foreign exchange prime broker, Northern Trust as custodian, Horizon Cash Management (no relation) as cash manager, RBC Dexia as administrator and Don Seymour and David Bree of DMS Management as directors.

HW: How do you distribute the funds? What is the profile of your client base?

PN: We distribute the funds globally using our in-house marketing team. We target institutional clients including funds of funds, hedge fund platforms, family offices and wealth managers.

HW: What is the investment process of your funds?

PN: All trading decisions are made by a fully-automated trading system that implements the Beach Horizon trading model. Models are trading ideas that have been converted into rules and algorithms that are then automated using computers. The investment process and therefore the trading decisions are the initial and ongoing design of the model.

With a model-driven investment process you make your trading decisions up-front and refine those decisions through research. We have a set of trading philosophies that help us guide our research effort in order to evolve the model.

Being able to back-test a trading idea is one of the great strengths of systematic trading. It is also one of the great pitfalls for the inexperienced. It is often very tempting to fine-tune your model so that it produces good returns when run over historical data. The danger is that there is no guarantee that historical performance will be replicated in the future. This is called 'curve-fitting' in the model-driven world.

At Beach Horizon we have a rigorous research process designed to avoid this pitfall by ensuring that trading ideas work across a variety of markets in many different time periods and in differing market and economic conditions. Consistent performance in a variety of conditions leads to a more robust model that is more likely to perform in the future.

HW: How do you generate ideas for your funds?

PN: The research team that includes the original developers is the generator of ideas. Research and model development are fundamental to our approach. The team has more than 50 years' combined research and development expertise in the managed futures industry and a proven track record of creating and running both systematic and discretionary trading strategies.

We use a rigorous research process that follows scientific method. The goal is to remove any form of judgmental bias in the analysis of research results. The model is backed by meticulous research that shows the consistency of the model over many time frames and environments. This work is ongoing and will focus on improvements in operational efficiency, improvements to the existing systems and 'blue-sky' research into new systems.

Fund evolution is a core part of the strategy. The main goal is constantly to improve our understanding of market and trading system behaviour and build this into the strategy. This approach of continuous long-term adaptability is key to staying competitive and delivering consistent returns for our clients.

HW: What is your approach to managing risk?

PN: Risk management in managed futures is a combination of asset allocation and market risk allocation and leverage. Beach Horizon balances these factors to avoid over-concentration of risk to any one market or sector and to target a long-term strategy return volatility of 15 per cent. These factors are applied to each market position many times a day.

The main principles used in the design of the portfolio are to be as diversified as possible, to avoid over-concentration of risk, and to adjust continuously for the prevailing market risk. The Horizon model is based on a dynamically balanced approach and aims to maintain an even balance of risk allocation in the long term to each of the sectors that we trade.

No one market or sector is favoured over another. This avoids over concentration of risk in any one market or sector. The high weighting in commodities (roughly 60 per cent of the portfolio) is as a result of the high level of diversification inherent in the design of our dynamically balanced approach.

HW: Has your performance been as per budget and expectations?

PN: Performance has been in line with expectations for current market conditions. Managed futures strategies are known to perform well in times of crisis and 2008 has been no exception, with the strategy ending the year with an annual return of 59.82 per cent.

During this year the model was continually adapting to the increased volatility by reducing risk. This is evident from the average margin-to-equity ratio for 2008 being approximately 10 per cent as opposed to 15 per cent for 2007. In addition, our approach to avoid over-concentration of risk has served us well in turbulent times.

These key features of the strategy will not change and will continue to be important in 2009. However, with our emphasis on strategy evolution through research, we will continue to build on the successes of 2008.

HW: What opportunities are you looking at right now?

PN: Beach Horizon has an extensive pipeline of research projects and ideas. These projects are varied and cover areas such as improvements in operational efficiency and improving our algorithmic electronic execution to research into new trading systems.

HW: What developments do you expect to see in the year ahead?

PN: Despite the current market conditions we expect investor interest in managed futures to increase significantly in the year ahead. Not only were managed futures funds a standout performer in 2008, but investors will see the benefits of transparency, liquidity and high regulation that the sector offers. In the post-Madoff era we expect that transparency and liquidity will move from being 'nice-to-haves' to 'must-haves'.

The managed futures industry has always had a high degree of transparency due to the exchange-traded nature of the markets and the exchanges' reporting requirements. The industry is better placed to cope with increased regulation and greater transparency than many in the alternatives space. The high liquidity of the assets we trade enables us to liquidate our positions within a very short space of time, enabling us to provide liquidity to our clients - something that has become increasingly important to investors in the recent environment.

Being a systematic manager we are not in the business of making predictions on fundamentals. However, events in the global markets are likely to continue to present volatile market conditions from which our strategy has proved that it is well placed to capture and generate returns.

HW: How will these developments affect your own portfolio?

PN: Increased regulation and transparency will have an impact on the operational aspects of the firm and consequently on operational risk. Beach Horizon is well placed to handle this due to its well-developed infrastructure (previously built up at Beach Capital Management) over the last 10 years. The adaptable nature of the portfolio and market risk balancing will allow the strategy to cope with market volatility in 2009.

HW: What differentiates you from other managers in your sector?

PN: The strategy has proven itself in some of the most difficult market conditions ever experienced in the industry. Its high weighting to commodities and its avoidance of over-concentration of risk are some of the main differentiators and some of the key reasons for its success.

The managers have an established fund management pedigree with a long track record in trading futures and forward markets. This, coupled with the team's research experience and pipeline of future research work, will keep the strategy competitive well into the future.

HW: Do you have any plans for other product launches in the near future?

PN: Beach Horizon is focusing on enhancing and building assets in its core managed futures programme and has no plans for new products in the near future. In the longer term we will use our quantitative trading skills to develop new complimentary programmes.

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