HSBC Alternative Investments Limited
Build their business
HSBC's single manager hedge fund business, HSBC Alternative Investments Limited, has been a long time in gestation, but is starting to gather consultants – also referred to as active/passive that mirrors the core/satellite designations of investors – a business structure A further round of corporate restructuring plan that led to the development of HSBC Management in order to run funds. The strategic construction of an in-house hedge funds unit, HSBC has followed a different path than that taken by other big firms that have chosen to diversify into alternative investments. Its early experiences were not as successful as it would have liked: the UK market neutral fund managed by Peter Harnett was closed in 2002 by mutual agreement with Harnett. It did not put the firm off, however, and it has helped HSBC to evolve its own philosophy about the construction of an in-house hedge funds unit, one that differs radically from some of the other models out there.

“There is nothing about that period that we are ashamed about,” says Bill Maldonado, CEO at HSBC Alternative Investments. “We handled a very difficult situation well and frequently discuss it with existing and potential clients. Don’t forget the fund annualised double digits over its entire life.”

It took the appointment in 2001 of a new head of the whole asset management business at HSBC to initiate the creation of a dedicated single manager hedge fund unit that relied on recruiting talent from outside HSBC Asset Management in order to run funds. The strategic plan that led to the development of HSBC Alternative Investments was drawn up in 2002, and the firm was formed in January 2003 as a unit of HSBC Asset Management Limited. A further round of corporate restructuring has seen the creation of a business structure that mirrors the core/satellite designations of consultants – also referred to as active/passive and beta/alpha focused. HSBC Investments is the new global business responsible for managing core investment products, while HSBC Alternative Investments is now part of HSBC Halbis Partners, a unit that includes the active investment management teams that will focus on UK and European equities and that cover Asian equities and emerging markets as well as fixed income strategies.

One of the central planks at HSBC Alternative Investments is that it is difficult for managers to keep one eye on a long-only fund and a long/short fund at the same time: performance will suffer somewhere, they argue, more likely as not in the long-only fund. Maldonado’s managers are focused exclusively on their hedge fund portfolios.

“I believe passionately that the skill set for a long-only manager is very different from that of a hedge fund manager,” Maldonado says. “It is very difficult to mix the two.” There has been no shortage of talent within HSBC Asset Management that could have been elevated to hedge fund manager status, the likes of Sherry Sadeque (now at RAB Capital), Tim Russell, Chris Rice, and Steve Cordell were all at HSBC AM when Maldonado signed up Vincent Bourgeois and Michael O’Mara (now running the $130 million European Alpha Fund), but he has stuck to his guns. The only exception to hiring in-group thus far has been John-Moore Stanley and the rest of the merger arbitrage team, who were hired out of HSBC’s prop trading operation.

“We’re not dogmatic,” Maldonado says. “There may be opportunities when we will do funds [with existing HSBC fund managers], but it would have to be properly structured.” But offering the chance to run a hedge fund in-house as a means to reward or retain investment talent is, in his view, “completely flawed.”

“It’s difficult to reward good long-only managers these days – the only way to get paid more seems to be to grow the assets in a fund. Beyond a certain level, this could be detrimental to the strategy. To suggest adding hedge funds to this already explosive cocktail is wrong. Adding hedge funds to a long-only desk is simply a sticking plaster for the problem. Re-engineering the structural deficiencies in the long only business is a sounder solution and the trend towards incorporating performance fees in traditional mutual funds is a healthy example of addressing these issues.”

The considered Dr Maldonado (he has a Doctorate in Laser Physics from Oxford University) has put a lot of effort into building the business framework to support hedge fund talent at HSBC. Whilst acting as a circuit-breaker between the senior management within HSBC AM and the managers, he brings his own long experience of markets to bear in discussions on investment management and risk management issues. The 12-year veteran of the firm has been involved in markets for many years. “I spend a couple of hours a day on Bloomberg keeping up with markets and looking at specific holdings of our managers,” he says. “That way I can have a very good idea of what is going in the funds.”

His sympathetic ear is attuned to when managers need to discuss investment issues, for example when they need to rehearse their rationale for being in a stock or sector, or why they have retained a particular balance sheet shape for the fund.

“We’re not after size for the sake of it.” The operation is buttressing from a position of strength when it comes to talking to the institutional investment community: for starters, remuneration of its managers has been an issue tackled very early on. They are not compensated out of annual management fees. Hedge fund managers, Maldonado feels, should be motivated to produce real returns as opposed to being rewarded to gather assets and live off management fees. The potential size of funds also reflects this point. He and the managers agree to what scale the funds can grow while remaining effective in terms of returns.
“We are not after size for the sake of it, and while we would be happy to have a fund with potential to grow to a billion dollars, we want to build a business that is diversified in the sources of fees,” Maldonado argues.

This means that HSBC can afford to close funds when the manager himself becomes worried that investment performance will be compromised by size. Maldonado is not a fan of giant flagship funds hauling a billion dollars around the market, regardless of the massive revenues such vehicles can bring in. While he recognises that some of the strategies the bank is currently running could sustain growth to that level, long/short equity is not one of them.

This model makes us a lot more scaleable,” he says. “Nearly everyone in the front end of the business is a fund manager. We don’t want to build large behemoths – nothing scares me more. If we have to have a given offering, I’d rather we raise the money, and add scale with more discrete teams working on discrete sources of alpha.”

Both Maldonado and his colleague, Charles Robinson, the former executive director of Goldman Sachs in Asia who was taken on to spearhead marketing efforts, have been surprised that their managers seem ready to close their funds earlier than the competition, until you consider the compensation factor.

“Investors are very sensitive to this,” Robinson explains. “We simply not in the business of big, gargantuan funds.”

Right now the business is not yet anywhere close to having to call time on any of its funds, and some, like its arbitrage strategy, have a lot further to go. But the money is coming in, they say, the HSBC European Alpha Fund has been taking in around $20 million a month, which at current rates will see a soft close within the next 6 months.

The addition of the Bank of Bermuda to HSBC’s spruiling financial services empire in 2003 has been a big bonus to the hedge funds team. Both BoB and earlier acquirers have provided the bank with a specialist back office capability that can support a range of new strategies. Rather than have to go back to the administrator relationship every time a new fund strategy comes up for consideration, Maldonado knows that the in-house capability is already there. “Given our wealth of resources, there’s no strategy we could not incubate,” he says.

“There are a lot of firms out there that can only service long/short at the moment.”

Also given the high rates of failure amongst hedge funds due to operational crises, this is something the new breed of institutional investor find comforting. When pension funds and their advisers are performing due diligence checks, the wealth of back office experience that HSBC can call on is a major boon.

Robinson also admits that the HSBC name has been able to open doors in Asia that were firmly closed when he was knocking on them with his Goldman Sachs hat on. It means that the business is particularly well-positioned at the moment, with demand for hedge fund products increasing in Asian markets, and likely to continue through its own regional mushrooming demand cycle in the near future. “I was perpetually competing against the ‘home town’ bank,” he admits ruefully.

But being part of a large institution is not all roses: it can work against you as well. Robinson feels there is still a lot of work to be done in the US, for example, where HSBC Alternative Investments has less penetration of the market, and where there is a great deal more sophistication on the part of the institutional investor. In addition, many of the more long-term investors in hedge funds, largely in the traditional wealth management part of the market, are averse to investing with so-called institutional shops. The HSBC brand may be able to get him access to senior executives at CEO or CFO level in Europe, but there is a “very clear segment of the market” which remains suspicious of an institutional offering. Robinson puts it down to losses suffered by investors when other in-house shops failed amidst internal acrimony. The departure of super-star fund managers, again a symptom of the flagship approach to fund management, has been a wrecking ball for big name banks that have dabbled in hedge funds in the past. Big names, Maldonado feels, have their own liabilities.

A more diverse future

Maldonado is confident that he can add to his portfolio of managers going forwards. He is already planning a technology long/short offering that has been driven by client demand. The other anticipated launch for this year is an emerging markets fund. There is plenty of scope to add other new strategies, but part of the challenge will be finding new talent.

This is something that is occupying a lot of Maldonado’s time at the moment.

Finding the right people to run HSBC hedge funds requires cultivating a number of different potential avenues for recruitment. Sure, there are a lot of people out there looking for a position, and Maldonado finds himself being approached regularly, and is happy to sit down and talk to managers with a competitive proposition. Like Sartmore, HSBC tax found that there is a new wave of managers coming onto the market from existing hedge fund shops, and these can be particularly valuable. But Maldonado also stays close to those prime brokers who pursue an unofficial role as matchmakers for the industry, and who are aware of potential new hedge fund managers developing hefty feet within long-only businesses. He also makes use of a specialised firm of head hunters that only works on hedge fund manager recruitment, and will only take on one or two mandates at a time.

“We also rely a lot on word of mouth.”

Maldonado says. “That is a very powerful part of the recruitment process. We get a lot of people who come to see us for a conversation.”

What attracts hedge fund managers to come and work for HSBC? It is a question that comes up in discussions with investors, who want to be sure they’re not getting second best.

“Our managers are compensated to produce returns - not live off management fees. Their incentive compensation is a linear function of alpha-period. Over and above the comp and economics of scale, the deal is very simple,” Robinson says. “You get started right away.”

A man fond of his complex analogies, he likens it to the ability to get straight into a racing car and turn the key. A great deal of the additional headaches involved with setting up a fund are therefore stripped away: the manager gets on with the managing, and leaves the rest of the infrastructural and operational issues to the firm.

“We’re seeing plenty of potential managers come our way.” Maldonado adds. “I must see two a week, and we have to interview 50-100 managers to find one we want to take. But there is a lot of talent out there. There is some recycling of talent, so those that have tried and not succeeded in one form will come back again, and hopefully they will have learned their lessons. Plus there is the second generation of manager that has grown up in a hedge fund environment. That is a very interesting phenomenon, and quite new here (in Europe).”

HSBC Holdings is one of the world’s largest banks by capital and equity, and its asset management arm oversees around $228 billion in AUM. It has one of the world’s premier private banking businesses with over $14 billion in fund of hedge fund assets (although an HSBC-branded hedge fund would have to compete on its own merits against third party funds to be selected by the private bank). Against such large resource, and with its considerable back office capability taken into consideration, it is surprising that HSBC Alternative Investments only has approximately $350 million in AUM. Ultimately, Maldonado is looking to build a profitable firm that will really matter to the bank. This will be quite some objective, as HSBC Group had gross assets of $660 billion and recorded a pre-tax profit of $39.4 billion for the 12 months to 31 December 2004. A staging post on the way and a medium term goal (2-3 years) is to have 10-12 successful funds operating under the auspices of HSBC Alternatives. Maldonado has said he would read it as successful if half of the funds were closed to new investors at that point, and had utilised half their capacity.

HSBC has the ability to seed funds with up to 50 million, and this has to be another plus factor when it comes to attracting good managers, but Robinson is aware, from where he sits, that simply seeding new funds with in-house capital is not enough. Investors don’t like being the first external money into a fund, he says. It makes them nervous. Luckily, the firm is also tapped into a valuable network of commercial providers of seed capital that it will be able to draw on going forwards, providing it with a crucial coterie of core investors that will be able to support the growth of its product menu.

“The phase we’re in right now is focusing on asset-raising,” Maldonado explains. “I was a bit naive starting out believing that good hedge funds combined with an excellent platform would sell themselves. We were fortunate to get Charles Robinson to come over to help us with asset gathering. We’re starting from a very low base, but we’re well on the way to getting critical mass with some of our funds. We have learned about seeding funds with too little money – it can be a long and painful process for all concerned, as clients want to write chunky tickets these days, so we have to come with $50 million (in seed capital).”

Maldonado does not come across as a man wanting to conquer the hedge fund world overnight. He is more focused on making sure he gets the business formula right while it is still relatively modest, rather than stumble on any nasty surprises further down the road when the firm is running a billion dollars in client money. He has the advantage of having been able to see the problems others in a similar position have run across as money has poured into their businesses, as well as the experience from HSBC’s own first foray into hedge funds. The bank’s global brand and massive back office support, as well as the fact that it is one of the best-capitalised banking institutions around at the moment, are likely to stand HSBC Alternative Investments in good stead over the next couple of years.

Maldonado is at the helm of what is likely to become a very diverse alternative investments business.