HEDGE FUNDS REVIEW
THE VOICE OF THE ALTERNATIVE INVESTMENT INDUSTRY FOR 10 YEARS

The current volatile market environment makes the European event driven opportunity set attractive, discovers Margie Lindsay.

Volatility offers opportunities

Although many people would take one look at Europe and turn away, Simon Davies, head of the event driven division at Cheyne Capital, sees a wealth of opportunities. As one of a team of nine for the European Event-Driven Fund, Davies is surprisingly upbeat about European merger and acquisition (M&A) activity.

"For us, I have always said we have never needed a large-cap M&A boom to be able to make money. Our fund is nimble enough to be able to invest in mid-cap M&A situations and credit as well," he explains.

Performance of the fund, which returned a healthy 20.48% in 2010, is generated mainly by equity mid-cap and credit. While Davies admits M&A volumes are down significantly on pre-crisis levels, that drop in activity is mainly confined to the large-cap sector.

"We are running at around one investable M&A deal a week, which is low by historical standards but it's okay for me. Mid-cap M&A is a sweet spot, much less arbitraged and especially so in today's environment," he says. "On a risk/reward basis, these are the best spreads I have seen in my 11 years of arbitrage and very few are taking advantage."

The reasons for the lack of arbitrage, believes Davies is purely down to uncertainty. "The risk of the deal is that the market is much more uncertain than it was two months ago – you can't argue with that. The amount of return you can make is much more adjusting for the increased rate of risk. Some of these deals in my 16 years of experience are the best, without a doubt."

"I'm not too worried about how bad M&A gets. If in a worst-case scenario M&A does stop in Europe, we will spend more time investing in capital structure."
Simon Davies, Cheyne Capital (pictured)

The mandate for the fund is deceptively simple: every position requires a strong catalyst in the short term that will move the instrument's valuation. Because the team is experienced in investing in all parts of the capital structure, deals can be structured around credit and equity.

Davies points out the fund's ideas are generated by 'hard' events. "Because we're hard event driven, we are driven to events that have been announced or are about to be announced."

In terms of idea generation, Davies and his team tend to respond to announcements. "A lot of our ideas actually come from monitoring what's happening in Europe," he says. "We come in first thing in the morning and there will have been a 7am regulatory news announcement about a stock that has been bid for so we will focus on that." Ideas also come from brokers, bankers, lawyers and a network of contacts throughout Europe.

"Depending on where we are in the cycle, the vast majority of investments don't make it on the book. It more or less depends on the cycle. At present there is a particularly high amount of good-quality situations, so there is a higher hit rate. But maybe that is a little bit unusual because of the current climate."

Team event

The event driven team includes co-manager Michel Massoud as well as Peter Rushton, portfolio manager for the team, and analysts Nick Kroepfl, Joseph Gebran and Anooj Unarket with Deepak Verma as business manager and two on support.

Cheyne, one of Europe's largest portfolio management groups, specialises in investment grade and crossover corporate credit. The event driven team is one of the largest and most experienced operating in Europe. The team invests only in liquid, event driven situations with definite short-term catalysts.

In addition to Davies's own 16 years' experience, 11 of which were spent investing in the event driven sector, co-manager Massoud has 13 years' experience with seven spent investing in this specific sector. The rest of the investment team have combined experience of 24 years. The four senior members of the team have all worked together between six and 11 years. This makes for a solid base of experience coupled with a team that works well together.

Davies says the team tends to work in pairs on the initial work on screening positions. If an idea looks good, it moves through to the next stage.

Depending on what kind of investment it is, the team might need to move quickly to take a position. "You may need to be in a position where you can invest when the market opens, so it is very intense in that initial period when you are making an initial investment," says Davies.

On the other hand, complicated distressed credit deals can take much longer, with a lot of research and analysis needed before the team is ready to act.

"Those are two extremes but that is the spectrum. Throughout the process it becomes pretty clear whether the investment will be made or not."

With such an experienced team, Davies says the group can decide whether the investment is interesting or not and what the potential risk/return might be. For Davies, it is just as important to get this right.

"You can be pretty quick to understand whether the investment is interesting or not based on what the risks are and what the potential return is measured against what you can lose if it's wrong."

The next step is to decide if the team is comfortable with the risks. "The risk/reward may be very good, but if those risks are really unfathomable, we're not going to invest. We're going to have to take a knowledgeable view on the outcome and whether those risks are manageable. If it is not, it won't happen."

Relaxed at turmoil

Despite the turmoil in Europe, and in particular in the eurozone, Davies is not worried about how much M&A activity there will be. The current environment actually favours Cheyne to some extent. Even in the current environment Davies believes there are enough small caps with enough cash to make strategic M&As where it makes sense, especially if the board of the buyer thinks the economy is headed towards a double-dip recession.

"I'm not too worried about how bad M&A gets. If in a worst-case scenario M&A does stop in Europe, we will spend more time investing in capital structure. This is an area I last really invested in 2003-04. It is very profitable," he says, adding, "It is almost an environment now where those investments would start to make sense again. We're not quite there yet, but I think we could be over the next few months, especially if we go to that other extreme where volatility is extremely high across Europe and M&A is off the table. Then the dislocation between credit and equity will only get worse and I think we will be investing in credit versus equity trades."

While Davies is adamant that he is not in the habit of making forecasts, he does need to have a view as to where markets are in a cycle. "I think there is a very high risk that we are in a bear market," he finally admits. "This is event driven, so we don't express views on the medium term outlook of markets but if you look at our book today, we have a series of investments that have minimal beta so whether we are in a bear market or not, I try to minimise the effect of that."

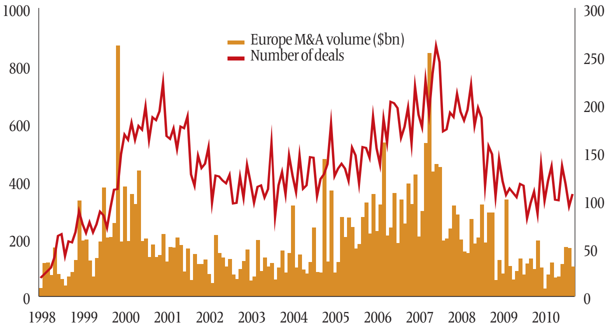
At present, not surprisingly, Davies has no exposure to financials and "absolutely no exposure to peripheral sovereigns". He does not like to express views on where Europe is heading. The fund is keeping investments "very tight and deliberately very short dated in duration" as it is such a volatile environment.

However, Davies does concede that he believes things will get worse before they get better and sees the outlook as extremely uncertain.

At present, if the portfolio does not re-invest, it will be 100% cash by the end of January. This is because all the deals are contractually announced and, as long as they close, the investment plus profit is returned. "That's perfect for me in this environment. I am not sitting on a portfolio of investments that have suffered some mark-to-market loss."

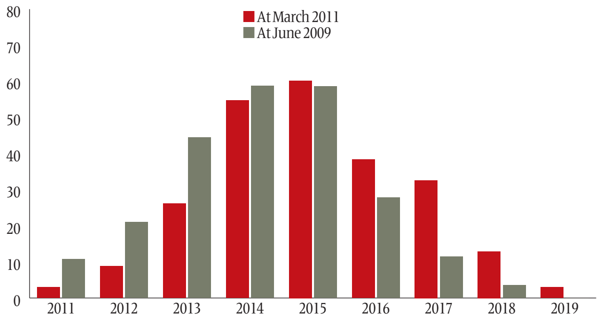
Unlike some strategies where it is difficult to take advantage of investment opportunities or leverage is needed to finance

Evolution of European M&A activity



SOURCE: Datastream, MSCI, Bloomberg via JP Morgan Cazenove

European sub-investment-grade debt maturities (€ billion)



Source: S&P LCD, JP Morgan, Deutsche Bank. Includes European leveraged loans and high-yield bonds.

> "I think there is a very high risk that we are in a bear market. This is event driven, so we don't express views on the medium term outlook of markets but if you look at our book today, we have a series of investments that have minimal beta so whether we are in a bear market or not, I try to minimise the effect of that.
>
> **Simon Davies, Cheyne Capital**

deals, Cheyne's fund is able and ready to pounce at the right moment. "We have a balance sheet that is very strong because of this unleveraged profile. So when we see these amazing investment opportunities out there, we can be very opportunistic and take advantage of them."

Because most of his positions in the portfolio are announced M&A deals, he is confident of completion. "If they are announcing it in the current environment, that's already a big tick for me because they know the world is extremely uncertain and they are willing to pay this amount of money for this company."

For Davies, the backdrop on most deals is positive, although he admits some deals can be stressed in the short term, particularly in the eurozone. "I have to hedge these positions. So I run hedges both at the position level and at the portfolio level to mitigate any market to market losses on the way. I do that through the use of put options in equities and through credit default swap protection in credit."

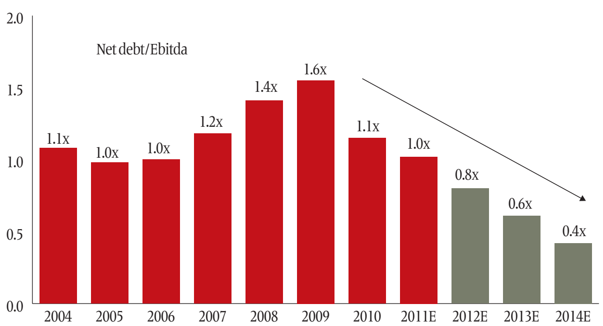
While many investors may think of event-driven as a relatively slow-paced strategy once a position is taken, the Cheyne portfolio is a lively one. Davies says he tries to be as active an investor as possible. While the actual event – the credit or arbitrage has a life of its own – he thinks it would be dangerous to sit back and let a position ride without close monitoring and re-visiting assumptions and the preliminary analysis.

"We have to continuously update those assumptions because things change, especially in this environment. Worst case, the buyer may change their mind," he explains. "But reanalysing every day and changing the position sizing to adjust for changes in view is essential. We always like to leave room to add more if it trades off, even if you love that investment, especially in this environment." The reverse is also true, says Davies. "If we make gains quicker than we would have thought, we're not afraid to size a position down as well."

While the fund is finding it hard to match the strong performance in 2010, Davies is confident the portfolio will end the year in positive territory. Relative to the competition, he believes the fund is outperforming and is certainly doing better than cash.

"I'm here for the long term, trying to build a long track record. If I can make good money in more stable conditions and not lose money in the current conditions, I think our investors and I will be happy with that." ■

Build-up of debt capacity



Source: UBS research estimates, August 2011.

Fund facts

Full name of fund:	Cheyne European Event Driven Fund
Portfolio managers:	Simon Davies and Michel Massoud
Name of investment/management company:	Cheyne Capital Management (UK)
Contact information:	Stornoway House, 13 Cleveland Row, London SW1A 1DH (+44 (0)20 7968 7450; info@cheynecapital.com; www.cheynecapital.com)
Launch date:	October 2009
Assets under management:	$405 million (September 2011)
Net cumulative performance since inception:	26.33% (at September 30, 2011)
Year-to-date return:	1.38% (at September 30, 2011)
Annualised volatility:	5.13% (at September 30, 2011)
Annualised return:	12.40% (at September 30, 2011)
Sharpe ratio:	2.27 (since inception)
Strategy:	event driven
Share classes:	euro, US dollar and sterling
Administrator:	Citi Hedge Funds Services (Ireland)
Auditor:	Ernst & Young
Prime brokers:	Deutsche Bank, UBS, Morgan Stanley
Legal counsel:	Mourant Ozannes (Cayman Islands law); Dechert (UK/US law)
Domicile:	Cayman Islands
Management fee:	2%
Performance fee:	20%
Minimum investment:	€/$/£100,000
Lock-in:	none
Redemption/liquidity terms:	monthly with 60 days' notice