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Prisma's customised angle gives it the edge for institutional investors

A scion of the structure and culture found at Goldmans Sachs, New York-based Prisma Capital has exploited a niche in the market to provide the discipline, dialogue and customisation that institutional clients require

By Claire Makin

New York-based Prisma Capital might have been tailor-made to appeal to institutions in 2009's tricky markets. Investors can check off all the vital ingredients on their wish lists. No gates, no lock-ups, no blowups. Experienced hands-on partners, an incentive structure aligned with clients' interests, a rigorous process, fine-tuned quant tools, and – to prove that it all works – a five-year track record (just achieved) that ranks Prisma in the top decile or quartile against its peers.

"The environment suits Prisma very well," says Girish Reddy, the firm's managing partner and one of its three founders. Following a tough 2008 for the industry, Reddy believes that rigor and discipline are taking the place of promises of access to top managers as funds of funds fight their way back into clients' favour. "Clients are looking for a shift occurring from the access story to the process story," Reddy says.

If this business model sounds as if it were made at Goldman Sachs, that would be partly true. All three of Prisma's founders are former Goldman partners. Reddy, who was born in India and has a masters degree in engineering from Cornell University, was co-head of equity derivatives when he left Goldman. Thomas Healey, who was assistant secretary of the US Treasury under Ronald Reagan, was head of pension services, while Gavyn Davies (ex-BBC chairman, and chairman of Fulcrum Asset Management) had been Goldman's chief economist. Healey and Davies are advisory partners at Prisma.

"We wanted to recreate what we had at Goldman," Reddy says. A big part of that was the structure and the culture it created.



Girish Reddy

Prisma is 40% owned by its employees. A significant portion of senior employees' bonus is deferred, co-invested in Prisma funds and not paid out for up to four years. No-one has left the team in the last three years, and only one member has left since the firm was founded.

Prisma's managers have a similarly long shelf-life. "We are tough to get into, but we do stay with our managers," Reddy says.

Reddy, Healey and Davies set up Prisma Capital in June 2004. They had spotted a niche opening up in the market as institutions grew more interested in hedge funds. But most fund of funds managers still catered largely for wealthy individuals, and so lacked the discipline and the kind of dialogue that institutions wanted. "We felt there was room for customisation

and consultation with clients," Reddy says.

The three men got off to a flying start by buying into an existing operation run by Aegon USA Investment Management, a subsidiary of the big Dutch insurer. This firm's in-house team ran a \$1.3 billion portfolio of hedge funds for its own account, and Prisma took on both the team and the assets.

Today, Prisma Capital runs \$3.5 billion and employs 30 people, 15 of them on the portfolio management side. Prisma's London office opened a year ago to provide on-the-ground market intelligence in Europe, as well as manager research and sales. Aegon USA retains majority profit interest (60%) in Prisma, and is also its largest client, but any potential conflicts of interest are balanced with incentives. Either Aegon or Prisma employees co-invest with other clients in all Prisma's strategies.

Fund Profile

Altogether, employees invest \$60 million in the funds.

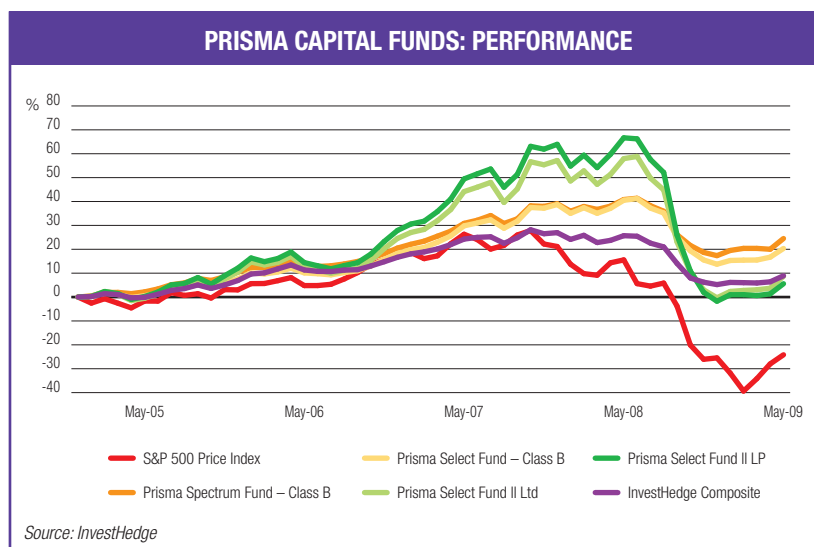
One striking feature of Prisma's business is that 60% of the firm's assets are in customised portfolios, a coveted sector of the market that is usually built up gradually on the back of a well-established fund of funds record. Some 95% of Prisma clients are pension funds, insurers, or foundations. They include the Netherlands' Doctors' Pension Funds Services, Cincinnati-

based Fort Washington Investment Advisors and other names in the US, Europe, Asia, and Australia.

Reddy attributes the firm's success in this area to the smartness of its people and the quant tools they have devised, which help them to understand the needs of institutional investors in the context of their other investments, come up with a solution, and make it work. Prisma has custom-built portfolios with strategy constraints, beta constraints, specific strategy biases, and all kinds of other parameters, Reddy says.

Reddy himself has a passion for academic research, and he and his colleagues delve into topics in enough depth to write research papers in response to clients' concerns. One asked recently: "Why should we buy hedge funds when beta is so cheap?". Prisma's answer, based on data going back to 1990, is because hedge funds bounce back just as strongly if not more so than equities, and timing the bottom is not so critical.

Research into another topic produced surprising results that Prisma applied directly to its portfolios. This is the longstanding debate about why managers tend to have stronger returns earlier in their lifecycles. Prisma found that equity long/short is the only space where early stage managers continue to produce alpha



for up to three or four years, and came to the controversial conclusion that time rather than size is the critical factor in the debate.

Reddy's theory is that managers launch funds when their particular style is doing well, so they benefit from a strong 'strategy tailwind' for two or three years, before this fades away. Long/short equities tend to have more consistent alpha, perhaps because the strategy offers more themes

to play out for longer, he says.

For regulatory reasons, Prisma says it is not permitted to disclose details of its funds or performance. But according to *InvestHedge* and other published sources, the Prisma Genesis Fund was launched on the basis of this research in August 2007. All 10 to 16 managers are early stage managers who run equity long/short related strategies. They are moved into Prisma's other products or let go after a certain amount of time.

The firm's main products also form the basis for its separate accounts. All were launched in 2005 except Prisma Select, which was rolled out in late 2004. The flagship Prisma Spectrum is a multi-strategy, lower volatility fund. Prisma Select is a higher risk, moderate volatility product with more directionality, and Prisma runs a leveraged version of this fund as well. Prisma also runs a long/short equity portfolio with a good four year track record, and an enhanced fixed-income fund which was launched in 2005.

According to the *InvestHedge* Database, Prisma Spectrum was down 15.6% in 2008, compared with a negative 17.34% for the *InvestHedge* multi-strategy composite. Over the five years through May, the fund has returned on average a little

WHAT PRICE LOCKUPS?

How much extra return should you expect from your hedge fund manager in return for letting him lock up your money for a year or more? After all, this privilege should come with a price attached, because it prevents you from investing your money in other ways. Emanuel Derman, Prisma's head of risk, set out to discover the answer, working with Prisma colleagues.

The firm found that investors should expect a premium of about 83 basis points from a fund with 10% volatility and a two-year lockup over a similar fund with a one-year lockup. For a 20% volatility fund the premium increases to over 200 basis points. The longer the lockup, the higher the additional return investors should look for, up to a whopping 3.33% extra a year for a fund with a very long lockup – say 10 years or more. The more volatile the fund, the larger the

premium investors should expect to compensate for the lockup.

Prisma arrived at these conclusions by creating a 'Markov' model built on various assumptions. Among these assumptions are that hedge fund returns are persistent because they depend on manager skill, and that hedge funds can be in one of three states: Good, Sick or Dead. This assumption was included because returns depend in part on whether you are able to redeem from a Sick or Dead fund and reinvest your money in a Good one.

Given the influence of its managing partner Girish Reddy in academic circles, Prisma might expect its conclusions to send a chill down the spine of many hedge fund managers.

more than 5% a year net of all fees.

The Prisma team is split into operational due diligence, risk and portfolio management. Each team head has more than 20 years experience, and each group has power of veto over hiring a manager. This is becoming industry standard, but Reddy points out that Aegon took this approach 10 years ago.

“People say ‘That’s great, but how does it help the client?’,” he adds. The answer is that it has helped Prisma avoid the headline manager blow ups that can torpedo a fund of fund portfolio, he says.

Risk control is rigorous, as you would expect from an institutional process. “We never got into the business of building a giant risk machine like RiskMetrics because that is a never-ending task,” Reddy notes. Instead, Prisma has built an arsenal of quant tools to ensure that risk is built into its portfolios (on the basis of micro-analysing each managers’ risk characteristics, for instance) and monitored afterwards. This is not to say that the human dimension takes second place. “We need a discipline, but I believe that portfolio management is a strong combination of art and science,” he says.

Many fund of funds managers were spooked by 2008’s wild price swings, and concluded that their correlation analysis needed a radical rethink. Prisma disagrees. Reddy points out that asset classes only became correlated during a three-month period within a 19 year span. Even if you assume that the environment has changed permanently and that there is more downside risk, hedge funds have not lost their appeal, he says. Under a fat left tail scenario, Prisma’s optimiser continues to prefer a 10% allocation to hedge funds at the expense of equities, he points out.

Prisma thinks of portfolios in two dimensions: strategies and managers. Davies leads an allocation discussion every quarter, and the firm’s perspective is unusually long and very macro, with strategy decisions taken on an 18 to 24 month view. “We don’t think we can move our portfolios more dynamically than that,” Reddy says. Prisma then ‘peoples’ the strategy buckets with best-of-breed managers.

Reddy says that Prisma pays “an enormous amount of attention” to sizing managers within a portfolio. The team’s portfolio construction tools take into account managers’ own risk processes as well as their correlation to other managers in the same fund. Typically a portfolio invests with 35 underlying managers, who may account for up to 5% to 6% of NAV, although the average position size is 3%. Only two or three managers have 4% to 5% positions at present.

Prisma values its manager relationships. “Managers like to talk to us. We’re a good source of information,” Reddy notes. Portfolio team members have on average more than 20 years of experience, and see contact with managers as a dialogue of equals. This contrasts with procedures at some funds of funds, where less senior people may not understand the significance of what they are being told about a manager’s exposures.

“We may say ‘Listen, your top five positions are not that unique,’” Reddy says. This scenario occurred last year, when sev-

eral managers built up long positions in Visa and Mastercard. “Everyone thought they had a unique story” when in fact it was becoming a consensus trade, Reddy points out.

One of Prisma’s best calls was its short sub-prime bet in 2007. This originated not with a top down strategy view, but in a dialogue with managers, Reddy notes. Prisma’s analytics picked up a manager who was putting on a short sub-prime trade. “The cost of carry was high, and they were still putting it on,” he recalls. Prisma partners picked up the phone and researched the opportunity by talking to managers, traders, and other market participants. “We realised [the sector] was significantly overpriced,” Reddy says. As a result, Prisma searched for and hired managers with this exposure and ended up 10% to 12% short subprime.

But it is macro judgements that lie behind most of Prisma’s key decisions. Reddy notes that there have been two cycle turns over the past five years. At the beginning of 2004, when Prisma took over from Aegon, the portfolio contained a lot of relative value-type exposure. But Prisma felt that spreads on mortgages and credit were way too tight. “Providers of capital were not being compensated for the risk they were taking,” he points out.

So Prisma shifted its emphasis from providers to borrowers of capital, such as event-driven, activist and restructuring managers. Prisma’s exposure to event-driven managers peaked at 18% in 2007 and has since been slashed to 6%, he says.

The next big opportunity was sub-prime in 2007, with problems spilling over into credit, and strategies reliant on borrowed capital. But earlier this year, Prisma started to see opportunities in fixed-income and credit, and took the plunge into residential mortgage backed securities. “They are now too cheap and there is too much bad news,” Reddy notes. It is now possible to find RMBS paying the equivalent of 6% a month, he says. “Even if it doesn’t rally, we are okay as long as we can collect those coupons,” he says.

He believes that providers of capital are once again being rewarded for risks taken. This has led Prisma into sectors

where capacity has shrunk, such as re-insurance, or stat arb. Prisma also likes very short-duration convertibles, and niche strategies that are “agnostic to economic recovery”. The firm has 6% of its portfolios invested in strategies such as insurance, volatility arb, and shipping, which has an unusual return dynamic.

Looking ahead, Reddy believes that Prisma is well positioned as the hedge fund sector starts to bounce back. The firm recently added to its staff with six new hires, three of them senior, in portfolio management, operational due diligence, and marketing.

Reddy notes that Prisma was cash flow positive in 2008 – one of very few fund of fund managers to be in this position – and that four or five clients have topped up their investments this year. He believes that institutional investors will be a stabilising force in the industry, but warns that they are tough customers.

“Institutional clients are more sophisticated. They want to have a relationship with managers who can provide more than just a commingled fund product,” he says.

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