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MontLake Fund in Focus: Tosca UCITS Fund

A discussion with Johnny de la Hey from Toscafund

Interview

The Tosca UCITS fund launched on the MontLake UCITS Platform ICAV on the 7th November 2018. The fund largely mirrors the offshore strategy that Johnny de la Hey and his team have managed since December 2008 and looks to provide investors with exposure to the global financial equity sector on a long short basis.

The UCITS fund has daily liquidity and is available in EUR, GBP, USD and CHF.

Kevin Ewer, MontLake's Head of Research sat down with Tosca portfolio manager, Johnny de la Hey to get an update on the strategy and the opportunity set that the market is presenting the investment team with.

Kevin Ewer (KE): Johnny, congratulations on the recent launch of the UCITS fund. It launched into a volatile market in Q4 2018, but you have been emphasising to our team that you believe you have a fantastic opportunity set and I also noticed that the partners of Toscafund increased their investment in the fund in the past few weeks. Do you feel that investors and the market are starting to come around to your point of view?

Johnny De La Hey (JdlH): Thanks Kevin. As you say, we launched into a sharp correction in late 2018 and while financials have rebounded along with the broader markets this year, the sector – by all measures – remains out of favour. However, in the past 10 years since I took over as PM of the offshore fund, we have experienced several episodes of challenging markets and the portfolio actions we have taken on each occasion are what have led to strong future performance. 2016 was a good example of this when financials were impacted by a combination of global growth concerns, geopolitical issues (e.g. Brexit referendum) and idiosyncratic factors (such as Indian demonetization) and was followed by a very strong performance in 2017 (+27.50%). What the team did then, and we have done again in response to the decline in late 2018, was to go through the process of re-underwriting all positions in the portfolio involving company visits, primary research and validation of our proprietary financial models. The importance of this process is to reaffirm, or otherwise, the investment merits of each holding (both long and short) and to reallocate capital to high conviction positions. This recent addition of partner capital and uptick in performance is a validation of this process and we feel confident in the positioning. I would suggest there are signs that investors are starting to think more about financials, but there is still a long way to go if they are to fully come around to our point of view.

KE: Can you drill down into the detail of the current opportunity set? Is there any dominant theme at the moment?

JdlH: There are essentially three broad areas in the portfolio, namely cyclical normalisation, secular growth and an idiosyncratic group of stocks which don't fit neatly into any theme. Bank rehabilitation is the dominant cyclical theme on the portfolio and is actually one we have exploited in various guises over the years, initially with US banks (2009-2011) and then Northern European banks (2012-2016). The key to rehabilitation and the subsequent increase in stock valuations has been the normalisation of balance sheets, facilitating the reduction in non-performing loans and a return to a position of stability growth and profitability. At this point, the cash flow generation can be returned to shareholders through dividends and share buybacks rather than being used for balance sheet repair and restructuring. During the previous iterations of this process we have seen valuations increase from 0.3-0.5 TBV to a more normalised 1.0-1.5 TBV. We are now positioned for this to play out in peripheral European banks where significant capital raises have been followed by large scale disposals of non-performing loans.

KE: What are some of the names you are invested with here and what's the progress on this potential revaluation in stock prices?

JdlH: Our current holdings in this theme include Banco BPM, Banco Sabadell and Creval. All are expected to see significant cash generation in 2019-2021. While this process started well in 2017, the fundamental progress at the micro level was overwhelmed by political noise and macro-economic uncertainty. However, as cash flow generation is delivered, we believe a significant upside rerating of our holdings will be realised. Given we are now approaching the midpoint of 2019, we are close to the point when the market will no longer be able to ignore the fundamentals and investors will be forced to revisit these stocks.

KE: What are some of the other positions you can share with us? Are there any new ideas that are particularly exciting?

JdlH: I think while getting new ideas in the portfolio is obviously important, our experience shows that the most exciting positions are those which we have established over the past year or two, have been patient with, and are now starting to deliver. These include IWG (global serviced offices), A-living (Chinese property management) and GVC (online gaming software). Similarly on the secular growth side of the portfolio, where companies are typically using technology to disrupt the legacy players and/or are delivering new propositions to an underpenetrated market, Indiabulls Ventures (Indian digital consumer finance), TCS (Russian credit cards & SME business services) and PagSeguro (Brazilian online payment processing) all have considerable upside to price targets. In terms of new ideas, we have added three new payments names in recent months. In two cases this was taking advantage of pullbacks and the third was an IPO of an EM business, which is not only both unique and fast growing. We have also recently initiated a number of new short positions. While these are inevitably idiosyncratic in nature, we have been able to identify a number of positions where there are structural reasons why growth is challenged or credit is deteriorating.

KE: Some of the names you mention in countries like India, Brazil, Russia and China highlight the fact that your team looks all over the world for ideas. How do you think about the overall structure of the portfolio from a regional perspective and how does the team go about sourcing some of the more esoteric ideas in the portfolio?

JdlH: The strategy is driven by proprietary idea generation and fundamental research, so it is clearly important to have significant analytical resource dedicated to the investment process. My team has over 100 years of experience in analysing financials with the five analysts all having sub-sector specialisation. With the exception of a recent addition, the team have been together for the 10+ years that I have been PM of the Fund. This level of resource and expertise facilitates the origination of differentiated ideas as well as the effective proprietary analysis of the stocks selected to the portfolio. We are always mindful of our likely competitive edge and this affects the geographies in which we invest.

Tosca, whilst being a global fund, will typically have around 50% of the exposure in UK/Europe. This is where we have the deepest and most longstanding relationships. Conversely the US, which accounts for around half of the world's financials, typically represents around 25% of exposure as we are disadvantaged in areas such as regional banks. The process works well in Emerging markets which make up the balance of the portfolio as third-party research is patchy at best and there are considerable rewards to travel and diligence. We feel this sets Tosca apart from other global funds, the rationale being that we wish to focus on areas where we can develop an information edge and originate differentiated ideas. To this end I encourage the team to spend significant amounts of time travelling, visiting companies, regulators and in fact anyone that can give us a better insight into potential investments.

KE: The experience and stability of the team that you mention is certainly a key factor that we have identified that investors should put great value on when assessing the fund. How do you ensure that the team remains hungry so that this experience continues to translate into results on the portfolio?

JdlH: Working together for over 10 years has definitely allowed us to develop a consistent and cohesive investment process and the team has built excellent connections with regulators, sell-side analysts and corporates. The team is compensated largely through the performance fee generated by the fund. Individually, analyst's performance-related compensation is based on their success in sourcing ideas which ultimately are selected into the portfolio, and their subsequent performance. In this process greater weighting is placed on the success of short positions. Ultimately its all about alignment of interests for both the team and the firm. Internal capital represents about 15% of the AUM across both the offshore and UCITS funds and as PM I am the 3rd largest investor.

KE: Having a firm and team so closely aligned with the performance of the fund is definitely something investors like to see. What are the other key aspects of the process that help you sleep at night and that investors should take comfort in, even when the fund may go through a period of tough performance?

JdlH: When I took responsibility for the strategy following the GFC, a rigorous portfolio construction and risk management framework was established and remains firmly in place today. This is monitored on a daily basis by our Chief Risk Officer. This framework incorporates hard limits on gross and net exposure, single position concentration and portfolio liquidity. Then, while the fund is unapologetically return seeking, hedging is imbedded in the investment process. FX exposures are hedged across all major currencies and around 1/3 of the short positions are maintained to hedge out unwanted risk.

Whilst there have been periods of drawdown, the annualised volatility of the fund is a respectable 12% with a Sharpe ratio greater than 1%. As mentioned earlier, key to the portfolio management during drawdown periods is the underwriting of all positions in the portfolio to ensure that the investment theses remain intact.

Typically, we would look to concentrate capital in the high conviction positions in drawdowns which historically has served to facilitate strong recoveries in performance from such periods.

KE: You mention the constraints imposed after the GFC in 2008. Were these limits pretty similar to the UCITS limitations and after 6 months of trading in the UCITS fund, how successfully do you feel you have been able to transfer the DNA of the offshore strategy into the regulated framework?

JdlH: Since 2008, the offshore fund has generally been compliant with UCITS regulations as a result of those self-imposed hard limits. Therefore, we felt confident that we could manage Tosca UCITS on a broadly pari passu basis. This has been validated by the close tracking of the offshore fund with the UCITS vehicle in the period since launch in November 2018. As at the end of April 2019, the YTD performance of Tosca is +5.45% and Tosca UCITS +5.62%.

KE: I think that's a very important characteristic to note as ultimately what you are saying is that UCITS investors are getting a product that reflects the long-term track record of the strategy and is not a watered-down version. Just returning to the opportunity set, dispersion between winners and losers is something key to good returns in a long short strategy. The financial sector has traditionally been one of the sectors with the highest dispersion in the market. What has this been like recently?

JdlH: Banks in particular have historically demonstrated a wide dispersion between winners and losers. Given the inherent financial and operational leverage in banking businesses, weaker business models and/or mismanagement are typically exposed by the market. A case in point is the comparison of JP Morgan and Deutsche Bank, where optically they have similar universal banking businesses but have diverged over the past ten years such that one trades at 2x TBV and the other at 0.3x TBV. Last year dispersion was less than usual as the macro dominated over the micro. This has occurred before but, in our experience, these environments are limited in time and come to an end, at which point the rewards to well-founded analysis are substantial. Whatever the noise, fundamentals do matter, and the offshore fund's track record contains many examples of exactly this.

KE: Finally, for those sceptical investors out there, what are the main risks that you see possibly impacting the wider financials sector and how do you plan to mitigate these?

JdlH: Since the GFC, banks in particular have faced a number of consequential challenges such as litigation, regulatory and capital adequacy directives. These have largely abated, and the process of rehabilitation has largely been completed in many geographies. Undoubtedly the key market risks which now could impact the broader financial sector are of a political and macroeconomic nature. Clearly a global economic slowdown and/or recession in key global developed markets would provide a more challenging environment for the Fund. Analysis of such risks are integral to the positioning and risk management aspects of the investment process and increase the emphasis on exposure management, diversification and hedging overlays. However, as a fundamental bottom up stock picking process, we firmly believe that the universe we cover provides sufficient opportunities to identify idiosyncratic and secular growth companies which will deliver alpha over time irrespective of macro related volatility. Equally, short opportunities will become more prevalent in such circumstances.

KE: Johnny, thank you for your time. We at MontLake look forward to a long and successful partnership with Toscafund and strongly believe that investors will be rewarded with solid, high alpha returns from the fund in the future.

Biographies

Kevin Ewer

Head of Research

Kevin is the Head of Research at MontLake. Kevin began his career in South Africa at Sanlam Asset Management in 1998, before departing in 2000 to co-fund RisCura Solutions, one of South Africa's leading risk and asset consulting firms. Having established a business servicing the risk management requirements of the hedge fund industry, he moved to Blue Ink Investments in 2006 to manage their range of award-winning fund of hedge fund portfolios. Following corporate action which saw Blue Ink bought by Sanlam Investment Management, Kevin was asked by the Sanlam group to move to London in 2010 and re-establish their institutional asset management presence. As a director of Sanlam International Investments, he managed both fund of hedge fund portfolios and global balanced portfolios for the group. He also worked for Skybound Capital as a portfolio manager prior to joining MontLake. Kevin holds a degree in Finance, Accounting and Computer Science from the University of Natal and is a CAIA charter holder.

Johnny De La Hey

Portfolio Manager

TOSCAFUND

Johnny de la Hey is the Portfolio Manager for Tosca and is a co-founder of Toscafund. Johnny has been a Portfolio Manager since 2008 and has 25+ years' experience as a bank analyst. Johnny joined Toscafund in 2000 and contributed to the portfolio management of several of Toscafund's products, being responsible for many of the firm's financial sector related investments. From 1997 to 2000, Johnny was a financials specialist at Tiger Management. Before joining Tiger, he worked at Credit Lyonnais (1996-97) and Société Générale Securities (1992-96). He graduated with a first-class honours degree in Geography from University College, University of London, England in 1992.

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