



## Determined K2 holds course

By Michael Pascoe



**PORTFOLIO POINT:** Campbell Neal says being able to go long or short on stocks will help K2 achieve its target of a 15% return after fees.

The K2 absolute return funds have the freedom to go short or long equities as they pursue an average 15% return after fees over three to five years. One great short opportunity they've missed this year is K2 itself: the management company floated at \$1.05 late last year and now trades around 30¢.

Co-founder and managing director Campbell Neal is unbowed: the stock is 94% owned by K2 directors and principals and he says they're not selling. And they're definitely not lending out their shares for anyone else to go short.

K2's three publicly offered hedge themselves happily borrow stock to go short when they believe a share price is going to fall. Neal says it's an ability that should give an absolute fund an edge in volatile markets when long-only funds are limited by their nature to only one side of market. As the financial year is being ruled off, the K2 funds have outperformed the market, but are still negative. (To analyse the performance of K2's long/short funds against its peers in the Australian marketplace, see the table below from hedge fund advisers Hatfield Liptak)

### Australian long/short equity fund performance

Fund name	Returns currency	Last month	Last 12 months	Last 24 months	Annualised compound return %pa	Annualised standard deviation	Last reporting month
Agora Absolute	(AUD)	1.70%	-4.78%	8.40%	8.50%	6.35%	Apr-08

Return Fund								
Agora Absolute Return Fund - Leveraged	(AUD)	1.59%	n/a	n/a	-7.42%	6.05%		Apr-08
BGI Australian Alpha Advantage Equity Fund	(AUD)	4.89%	n/a	n/a	-3.60%	20.10%		Apr-08
BGI Equitised Long Short Fund	(AUD)	4.42%	2.53%	35.71%	25.51%	11.76%		Apr-08
BGI International - Alpha Advantage Equity Fund	(AUD)	1.51%	n/a	n/a	-22.44%	12.16%		Apr-08
Blue Mountain Australian Absolute Return Fund Ltd	(USD)	-2.85%	-14.20%	4.59%	11.70%	9.11%		Apr-08
Blue Sky Japan	(USD)	-3.31%	-40.79%	-46.67%	9.07%	27.13%		Apr-08
Cadence Capital Fund	(AUD)	2.29%	-19.30%	1.08%	15.46%	13.56%		Apr-08
Cadence Capital Limited	(AUD)	1.33%	-13.17%	16.48%	16.90%	15.52%		Apr-08
Cadence Cayman Fund	(AUD)	1.44%	-12.17%	n/a	-5.05%	14.63%		Apr-08
Five Oceans World Fund	(AUD)	-1.38%	7.90%	n/a	14.40%	10.55%		Apr-08
H3 Japan Fund	(USD)	-0.73%	3.19%	10.23%	12.63%	5.54%		Apr-08
H3 Japan Fund Class B	(USD)	-0.73%	3.19%	n/a	3.97%	4.33%		Apr-08
H3 Japan Fund Class D	(JPY)	-0.63%	-0.80%	n/a	0.00%	4.00%		Apr-08
Hayberry Australian Equity Fund	(AUD)	2.68%	-3.13%	0.62%	19.01%	8.37%		Apr-08
Herschel Absolute Return Fund	(AUD)	1.93%	9.33%	52.98%	23.68%	9.05%		Apr-08
Herschel	(AUD)	1.93%	9.31%	52.90%	19.97%	9.19%		Apr-08
Intercept Capital Fund (AUD Class)	(AUD)	-3.91%	12.69%	18.52%	9.77%	10.18%		Apr-08
Jaguar Australian Leaders Long Short Fund Limited	(USD)	1.08%	27.47%	13.98%	11.07%	9.56%		Apr-08
K2 Asian Absolute Return Fund	(USD)	3.11%	5.45%	23.01%	15.22%	16.27%		Apr-08
K2 Australian Absolute Return Fund	(USD)	1.58%	-7.08%	14.18%	15.75%	13.38%		Apr-08
K2 Select International Absolute Return Fund	(USD)	2.98%	-0.97%	21.46%	18.01%	9.73%		Apr-08
Macquarie Alpha Opps (130/30)	(AUD)	-5.45%	-2.02%	19.15%	16.00%	13.49%		Mar-08
Macquarie Asia Pac Long Short Segregated portfolio	(AUD)	-4.18%	7.06%	n/a	11.73%	10.22%		Mar-08
Macquarie Long Short (200/100)	(AUD)	-6.77%	2.15%	20.21%	20.16%	12.82%		Mar-08
MIR Absolute Return Fund Class A (AUD)	(AUD)	4.78%	-5.33%	3.58%	12.45%	12.61%		Apr-08
MIR Australian Absolute Return Fund Ltd Class A	(USD)	7.94%	4.35%	23.19%	16.12%	16.47%		Apr-08

(USD)								
MQ Asia Long Short Fund	(USD)	0.93%	6.14%	n/a	13.21%	6.74%	Apr-08	
MQ Special Events Fund	(USD)	1.32%	2.83%	18.14%	10.05%	3.66%	Apr-08	
Naos Absolute Return Fund	(AUD)	5.56%	-7.40%	16.00%	12.60%	10.40%	Apr-08	
Naos Small Companies Fund	(AUD)	10.28%	-18.18%	18.40%	11.12%	17.01%	Apr-08	
Optimal Japan Fund	(USD)	5.79%	-14.45%	-9.96%	10.26%	12.43%	Apr-08	
Peak Asian Absolute Return Fund Ltd.	(USD)	3.32%	5.57%	24.72%	11.15%	16.85%	Apr-08	
Pengana Australian Equities Long Short (Onshore) Fund	(AUD)	7.01%	3.62%	19.69%	16.15%	7.73%	Apr-08	
Pengana Global Resources Fund	(AUD)	5.29%	44.06%	n/a	44.42%	21.50%	Apr-08	
Perpetual's QI Long Short Fund	(AUD)	7.08%	-1.68%	20.92%	17.39%	14.01%	Apr-08	
Platypus Australian Long/Short Fund	(USD)	3.35%	4.76%	21.49%	12.05%	7.26%	Apr-08	
PM CAPITAL Absolute Performance Fund Ltd	(USD)	4.34%	-17.41%	-5.82%	13.81%	20.60%	Apr-08	
PM CAPITAL Australian Opportunities Fund Ltd	(USD)	-0.56%	-18.25%	-0.82%	10.39%	12.43%	Apr-08	
Regal Zambezi Absolute Return Fund	(USD)	4.44%	-8.43%	17.79%	32.55%	28.57%	Apr-08	
Saltbush Amalg Fund (Onshore Class D AUD)	(AUD)	0.63%	3.96%	14.05%	9.69%	4.69%	Mar-08	
SHC Ailsa Fund	(AUD)	-1.16%	1.81%	20.10%	12.52%	5.46%	Apr-08	
SHC Arran Fund	(USD)	-1.43%	3.11%	22.92%	7.89%	5.79%	Apr-08	
Summit Master Water Equity Fund, L.P.	(USD)	1.83%	4.59%	17.22%	12.95%	10.48%	Apr-08	

**Source: The Australian Hedge Newsletter**

The latest published fund **reports** show the K2 Australian Absolute Return Fund 53.7% long, 11.9% short at the end of May. To see how and why K2 is thus positioned and what Campbell Neal thinks of his own share price, read on:

## **The interview**

**Michael Pascoe: It's an interesting time in the markets for everyone. Should absolute return funds be doing better than just long only?**

Campbell Neal: You'd expect so. Once the initial shock (of this year's sharemarket fall) has taken place and you get volatility in the market, both on the upside and the downside, that does lend itself for absolute return managers or long/short managers like ourselves to be able to outperform given that the long-only managers can't do much on the short side.

**There's a temptation to label long/short managers hedge funds. Is that a fair call?**

As good a definition as I've seen was from (research house) Lonsec recently: anyone that can short is now in their hedge fund basket. It's fairly wide but a hedge fund is hardly a generic product.

**While in theory long/short funds and hedge funds have more upside in difficult times, it seems they're a bit on the nose at the moment. Is that true?**

Are you saying they're on the nose with investors or that the actual performance has not been as good as it should be?

**I suppose both. Let's take investors first.**

I think everyone's on the nose at the moment. I don't see much in the way of inflows really to any equity product of any significance. I'm not sure that absolute return or hedge funds are really doing any worse than long-only managers in terms of inflows. However, if you look the performances of some of the boutiques or hedge funds, they probably under-performed a little more than what the investor would have expected. But given that there are so many hedge funds now with different strategies, you can't really compare one directly against another because of their diversity. There are a few people that have blown up, who are creating a bad taste for the others.

**Overall performance?**

There are a lot of hedge funds that take on enormous amounts of risk and, to me, risk is undue leverage or excessive leverage. There's also the problem of not looking at the liquidity of your portfolio, so you don't overlap other levels of risk that other people might take on. They are the two things we try to avoid. We spend a lot of time looking at the liquidity of our portfolio, particularly in bad periods, because of what happens to some of the hedge funds and

long-only managers for that matter. Say you're a long-only manager with 5% cash but you get 10% redemptions, it puts enormous amount on the stocks you need to sell and if there are only a few that are liquid, they might be good ones because they are liquid, it puts pressure on your portfolio and hence performance. It's a combination of those two things, the leverage that's been used and the liquidity of the portfolio, that's created a great deal of the problems.

**Being short has become somewhat questionable since Opes Prime blew up. By going short are you borrowing shares and how do you look after that part of your book?**

Yes, we borrow from our prime broker, Morgan Stanley, then we sell the stock into the market and then, when we buy the stock back, we return the borrow to Morgan Stanley and the transaction's cancelled. That's the way we short.

**If there was a crackdown on borrowing, what would that do to your business?**

That would create some sort of problem but they've been talking about this for a long time. I don't actually believe ASIC is really going to abolish this type of shorting. I just think you'll need to disclose your shorts a little bit more than what's been done in the past. At the moment we effectively don't have to disclose our shorts in any way shape or form, so without pre-empting what ASIC or the ASX bring into force, maybe more levels of disclosure are going to be required.

**Has it become harder to borrow lately?**

No, not in the least. We've never been rejected on any borrow we've been looking for and that's over 9½ years or so. Now in saying that, we're not your standard hedge fund with what I call "trendy trades" or arbitrage in stocks – the takeover stocks and things like that where there is a great deal of demand to short particular names. We don't do that by and large; we find our shorts a different way so we're a bit of a lone ranger when we start looking for our shorts and I suppose that's evident in the fact that we've never had a problem in borrowing.

**Could you give me an example then of the sort of long/short strategy you use?**

Well, at K2 we don't do pair trades; for example, you might like the resources sector but you think BHP will outperform Rio, so you buy BHP and short Rio. Rather, we try to find fundamental shorts and what we mean by that is find a reason why we think a particular stock is going to underperform the market in the short to medium term. We might think an industry's under pressure and there's a result coming up that may disappoint; it's those types of shorts that we look for. They come about mostly by our own absolute proprietary information because we find that trying to be led to shorting ideas through brokers is a little bit tough because brokers by and large are not good at shorting.

**You have three funds on public offer: the Select International, the Asia and the Australian Absolute. They're all absolute funds. Looking at your May report, the most recently published, you were short financials by 7.1% and long financials 6.5%. They're individual calls on stocks?**

They are. Financials is a very wide basket, as you will appreciate. You have investment banks, you have real banks, you have a number of different entities within there, so we were short quite aggressively the major banks and that was the body of our short but we thought some other financials had probably done their pain and were probably oversold.

**On performance, with June still to be counted, all three funds are negative for the year, the Asia fund only just.**

Yes. The international fund only just I suppose and the Aussie fund will be down as well. We'll be better than the index but we will be down and this will be our first financial year down since inception on any of the funds. But we've always said in all our documentation, we've been seeking a 15% per annum return over a three to five year cycle because you will get times like what's happened here, very late in the year you get a situation like this or in January and you just haven't enough time to trade your way back into positive territory by the end of the financial year. You'll see that our returns over three to five years and out to seven years and now out to nine years are all around a positive, of the 15%-plus mark.

**By the nature of the fund there's a fair bit of trading going on. Does that create tax bills that are pretty hefty on the real bottom-line performance for investors?**

Because we are active in our portfolio management it does lend much to the capital account and, yes, we are traders. Given that these are trusts, all the realised gains minus the realised losses have to be paid out as dividend and that is taxable in the hands of the unit holder.

**So in assessing the performance, some extra allowance should be made for that?**

I don't know whether extra allowance should be made. If you put your money in the bank and it gives you an 8.4% return then you know you're paying tax on the 8.4% return and so I think that's the way you look at a thing like this – that if you have a distribution of realised gains minus realised losses then that's a fact that has to be brought into account. There are other people who do other things but our way of getting a positive return is to be very active on the portfolio turnover and to take advantage of the ups and the downs. That's what you can do with a fund like ours that's not particularly large.

**What's your outlook for the new financial year?**

If I had to call it, maybe flat to marginally up, but hopefully a long/short fund can generate a bit better returns than that by capturing a bit of the volatility.

**Your management company, K2 Asset Management Holdings, listed late last year just in time for the financial sector to be slammed. Has anyone been shorting K2?**

They'd be brave if they did, given that 94% of it is tied up with the principals and the directors and we don't loan our stock out. I think the whole sector is a bit on the nose at the moment and probably rightly so given the year we've just had. However, if you look forward and you say equities are a longer-term game, then you would probably approach a stock like ours a bit like a call option over the market, but you know that's not for me to overlay my views on how people view our share price.

**Coming on a bit above a dollar ... it's now down to 30¢. That's got to be painful, hasn't it?**

It's only painful if you're going to sell it and we've never been sellers

but we did want to list the company. We were going to list the company in August last year at \$1.60 and then we had that first subprime setback that really put a lot of pressure on the sector. When the dust settled in late October we repriced it because we didn't want people to lose money and we were really only trying to get a spread of shareholders; we were doing less than 10% of the stock to get the spread of shareholders. We thought we were doing it at a fairly good price at \$1.05 in November. However, January did come upon us and it changed the whole spectrum. The point is that none of the principals in here are sellers and we're very committed to the business and hopefully can continue to grow the funds under management and get the performance on track over the next three to five years.

I've always been a believer that managing directors and boards really shouldn't focus too much on their share price because if they just concentrate on their earnings per share and concentrate on the business, the share price will look after itself. Yes, I can see it at 30¢ but I'm not a seller so it's a bit like the property correction: if you're not selling your house then it doesn't really matter what the local estate agent's valuing it at.