New Fund Looks to Ride the Volatile Gulf Wave

By Martin de Sa'Pinto, Senior Financial Correspondent – September 17, 2008

DUBAI, United Arab Emirates (HedgeWorld.com)—The Middle East and North Africa markets are slowly gathering traction as an investment destination as, with the BRIC [Brazil, Russia, India and China] nations beginning to look a little frothy, investors look to diversify their emerging markets investments to new and promising areas. Pierre Lavaud, founder of Geneva-based conference organizer Jetfin recently told HedgeWorld that due to popular demand, his firm has organized a Middle East and North Africa [MENA] Hedge Funds conference for autumn next year. Meanwhile, a number of the city's private banks have confirmed that they too are exploring the possibility of investing in the region.

One fund that has already tested the water is Dubai-based Constans Crescent Investment Fund, a long/short equities fund which began trading with proprietary capital in June 2006. The fund, which is managed by Argent Financial Group International LLP, was officially launched in October last year, and managed $28.3 million as of September 1. The fund's main markets are Morocco, Tunisia, Egypt, United Arab Emirates [both Dubai Financial Markets and the Abu Dhabi Securities Markets], Oman, Qatar, Bahrain, Saudi Arabia, Kuwait, Lebanon, Jordan, Turkey and Pakistan. The fund's investment objectives allow it to use leverage up to two times the amount of capital invested in the fund on an annual basis, while the average should be between 0.5 and 1.5 times.

To date one of the main difficulties for long/short equities funds focusing on these countries to date has been the cost and complexity of shorting in what are relatively volatile markets. But managing the downside has been getting easier. In an email to HedgeWorld, O.E. Starnes IV, director of marketing and investor relations at Argent, told how Constans Crescent does it. "We manage downside volatility by shorting ADRs/GDRs [American/Global depositary Receipts] of MENA equities listed in international markets, shorting in futures markets for a couple of countries and using synthetic equity derivatives, where the counterparty is typically an international investment bank," he said.

"Our goal is to manage the downside volatility risk for our investors while still capturing a good portion of the upside potential that exists in these markets over the next five to seven years," he continued. "We have delivered on that mandate to date." According to Mr. Starnes, since trading began in June 2006 Constans Crescent is up 33% while the largest monthly drawdown has been only (0.11%). In the same period, he said, the MSCI Arabian Markets Index is down 4% in the same time period, and has seen significantly higher monthly drawdowns.

The MENA markets offer a very attractive opportunity set, advised Mr. Starnes. First, he said, the markets are relatively untapped by global investors, and the level of foreign participation is fairly low—typically below 20%--especially in the Gulf Cooperation Council markets. "This allows our Fund to find interesting stories that have not become crowded plays with other emerging market funds," he noted. "While foreign participation is increasing, this region still offers some of the last untapped markets for global investors."

Another important factor is that the correlation with other markets, both developed and emerging, is negligible. "Given restrictions on foreign investor participation and the nascent stage of many of the MENA markets, most of the money in the local equity markets is Middle Eastern money," explained Mr. Starnes. "As such, when there are dislocations in global equity markets—for example, subprime fears—and global investors pull their money out of riskier asset classes such as emerging markets, the MENA markets are relatively insulated. A case in point was August 2007, where most emerging markets were down considerably, while the GCC markets were mostly flat to up for the month and the fund was up 2.5%."

A third attraction is the significant economic development and expansion occurring in the MENA region. The Gulf countries have seen GDP growth in excess of 10% per annum. True, this is underpinned by high energy prices, but on the other hand non-oil dependent countries such as Egypt and Morocco are also seeing robust growth.

A further important consideration is that unlike during previous oil booms, a lot of the petrodollars are staying in the region as the chief beneficiaries take advantage of attractive opportunities in their home countries. Since the start of the boom investments in infrastructure, real estate and commercial development have accelerated. “This cycle of development not only fuels growth, but is leading to sector diversification and the spawning of new industries which help to reduce the reliance on oil as the primary contributor to GDP in the Gulf region,” said Mr. Starnes.

“We aim to capture the fundamental economic changes and growth happening in the MENA markets and the untapped opportunities they offer,” continued Mr. Starnes. “Being based in Dubai, we are “on-the-ground” investors, and this supports the fundamental bottoms-up approach that drives our investment process.” Given the limited amount of sell-side research available on companies, he said this local presence gives his firm and edge allowing it to meet and monitor companies.

“The other aspect of our value proposition is our long/short strategy,” he added. “While the fund will retain a long bias, we do use equity derivatives to hedge our exposure. Since retail investors still dominate many of the local markets, there tends to be a lot of volatility in the MENA markets.” In addition, the fund also manages its exposure across the various sub-regions within the MENA markets, since these have limited cross-correlation with one another. Additionally, it uses country, sector and position limits to manage concentration risk.

The fund’s senior portfolio manager is Zeeshan Ali, who joined Argent in late 2005 specifically to launch the fund. Mr. Ali, who has been based in Dubai since early 2006, was previously a manager at a global long/short hedge fund based in the United States and prior to that was at Goldman Sachs. He holds a BA and MBA from Stanford University.

Constans Crescent is domiciled in the Dubai International Financial Centre and requires a minimum investment of $500,000. There is an annual management fee of 1.5% and a performance fee of 20% with a high water mark. Subscriptions and redemptions are monthly, with redemptions requiring a 90-day notice period.

The prime broker is Deutsche Bank, and the auditor is KPMG. Administration services are provided by IDS International, the custodian is HSBC and the legal adviser is Afridi & Angell.