No plain vanilla portfolios here

K2 chooses unique investments for its fund of funds

By Joel Chernoff

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Movie rights. Weather derivatives. Natural catastrophe insurance. Carbon dioxide emissions credits.

It's not your typical portfolio. But hedge funds are going where few investors have gone before.

The beauty of any of these markets is that they not only offer the potential for chunky returns, but they also have virtually zero correlation to domestic stock and bond markets — and to other hedge fund portfolios as well.

K2 Advisors LLC, a Stamford, Conn.-based hedge fund-of-funds firm with $5 billion in assets under management, is bundling a host of those esoteric investment strategies into a single fund of funds now being touted to institutional investors.

So far, the $13.5 billion New Mexico State Investment Council, Santa Fe, has invested $50 million in the low-volatility fund K2 Alternative Strategies LLC. An investment by an unnamed family office and internal allocations bring the fund to $133 million in assets.

New Mexico's investment stems from an effort by Chief Investment Officer Gary Bland this spring to provide downside protection in case equity markets go south.

"I think there's a general fear among managers everywhere, not just here, that the market is doing some squirrelly things, and we didn't want to get caught with our pants down," said Adam Levine, deputy state investment officer for the New Mexico fund.

The $50 million investment is part of a $200 million allocation by the fund to absolute-return strategies designed to reduce the impact of falling markets. (The fund's overall absolute-return allocation is $1.3 billion.)

3 existing managers

New Mexico officials leveraged relationships with three existing managers. Besides K2, EIM Group, New York, was awarded $50 million and Hunt Financial Ventures' HFV Asset Management L.P., Dallas, was allocated $100 million.

Allan Martin, partner at New England Pension Consultants' Redwood City, Calif., office, which advises the New Mexico fund, said K2 is "one of the most technologically advanced in terms of risk control tools." He also praised K2's transparency and analytics.

K2 has structured the portfolio into three major divisions. At the lower end of the risk spectrum, highly collateralized structured loans that kick off a 15% to 17% yield constitute about 40% of the portfolio.

Weather derivatives and insurance risks — both somewhat riskier investments — each comprise about 10% of assets. And a coterie of more opportunistic investments such as commodities; private investments in public equities, or PIPEs (securities issued for small-cap companies); royalties; carbon emissions; and currencies make up the remainder of the portfolio.

The fund returned 6% in the last 11 months of 2005 (the fund started investing Feb. 1, 2005), even though one-fifth of the portfolio was invested in insurance derivatives whose value was dragged down by hurricanes Katrina and Rita. A benchmark of LIBOR plus three percentage points used by the New Mexico fund returned 6.2% during the period. In the first six months of 2006, the fund returned 8.2% vs. 4% for the benchmark.

It's not easy finding qualified managers in such unusual investments. Kelsey Biggers, a managing director at K2, said it typically takes nine months to select a manager for the fund, two or three times as long as it takes to pick a long-short equity manager.

"You really have to kiss a lot of frogs to find the prince," said Marc Stern, director and co-portfolio manager of the alternative strategies fund. K2 invested assets with 16 managers after examining 200 firms.

Among the princes is Dune Capital Management LP, New York, an asset-backed lender that spun out of Soros Fund Management in 2005. Dune's $1.8 billion multistrategy hedge fund invests 75% of its assets in liquid securities, but reserves one-quarter for less liquid investments such as movie royalties. Early this year, in a deal with Fox Filmed Entertainment, Los Angeles, Dune invested $350 million for a 35% stake in 28 films, including "Walk the Line," "X-Men: The Last Stand" and "The Devil Wears Prada."

"We think of it as a securitization strategy," explained Charles B. "Chip" Selig Jr., managing director at Dune. Essentially, the firm has bought the future rights to a film library before it has been produced, he said. Fox has a stable management team and keeps costs down, while the entertainment industry as a whole can generate unlevered returns around 11%-12% a year, he said.

Similarly, in May, Dune officials teamed with Soros Strategic Partners LP to purchase DreamWorks SKG's film library for $900 million.

Elsewhere, K2 has invested 10% of assets in covering risk of natural catastrophes — events likely to occur only once every 50 or 100 years, explained Charles Flynn, a K2 portfolio manager.

One insurance manager chosen is Nephila Capital Ltd., Hamilton, Bermuda, formerly known as Willis Asset Management. Investors such as Nephila are taking a small stake of

the $200 billion reinsurance business as some leading reinsurers have exited the business.

Nephila — named after a spider that Bermuda folklore says weaves its web close to the ground when a hurricane is approaching — is paid a premium for taking on insurance risk, explained Barney Schauble, principal. The bonds are rated around BB, similar to high-yield bonds, while returns range from 5% to 15% percentage points over U.S. Treasuries, he said.

K2 also has invested in the nascent carbon dioxide emissions market, spawned by the Kyoto Protocol curbing global emissions. In January 2005, the European Union formed the EU Emission Trading Scheme, a secondary trading market for carbon dioxide and other greenhouse gases.

Basically, Western European companies can meet caps on emissions by purchasing credits from sellers in other countries — typically from India, China, Brazil and Eastern Europe, explained Andrew Pearson, chief operating officer for markets at Climate Change Capital Ltd., London, which manages a portfolio for K2.

But the markets can be very volatile. In late April, data from Western European governments suggested emissions might fall well below projected levels — meaning the emission credits were worth far less than valued. In the space of five trading days, the value of credits plunged more than 70% from e31 per ton ($24.20), Mr. Pearson said. Prices since have rebounded to around e16.

While Mr. Pearson declined to provide performance data, he said company officials expect the strategy to return more than 20% a year over the long term.