HedgeFund Intelligence

Double Haven rides Asian credit investing boom

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Asian credit veteran Darryl Flint is positioning his Double Haven firm for sustained growth in the asset class following its acquisition last year of the DragonBack infrastructure platform


Darryl Flint

When Hong Kong-based Double Haven announced in October last year that it was acquiring DragonBack Capital and absorbing it as an internal hedge fund platform, many in the industry saw it as an excellent opportunity for founder and CIO Darryl Flint to secure a prized infrastructure set-up at a time of industry consolidation.

The DragonBack acquisition swelled Double Haven's team to 17 people - six in the investment team and 11 in risk and operations, a clear sign of the group's potential and ambition for growth.

But how far would the move help in developing Double Haven's success as a formidable Asian credit hedge fund shop? Would it give the firm the scale and competitive edge required to succeed in today's rapidly evolving hedge fund industry?

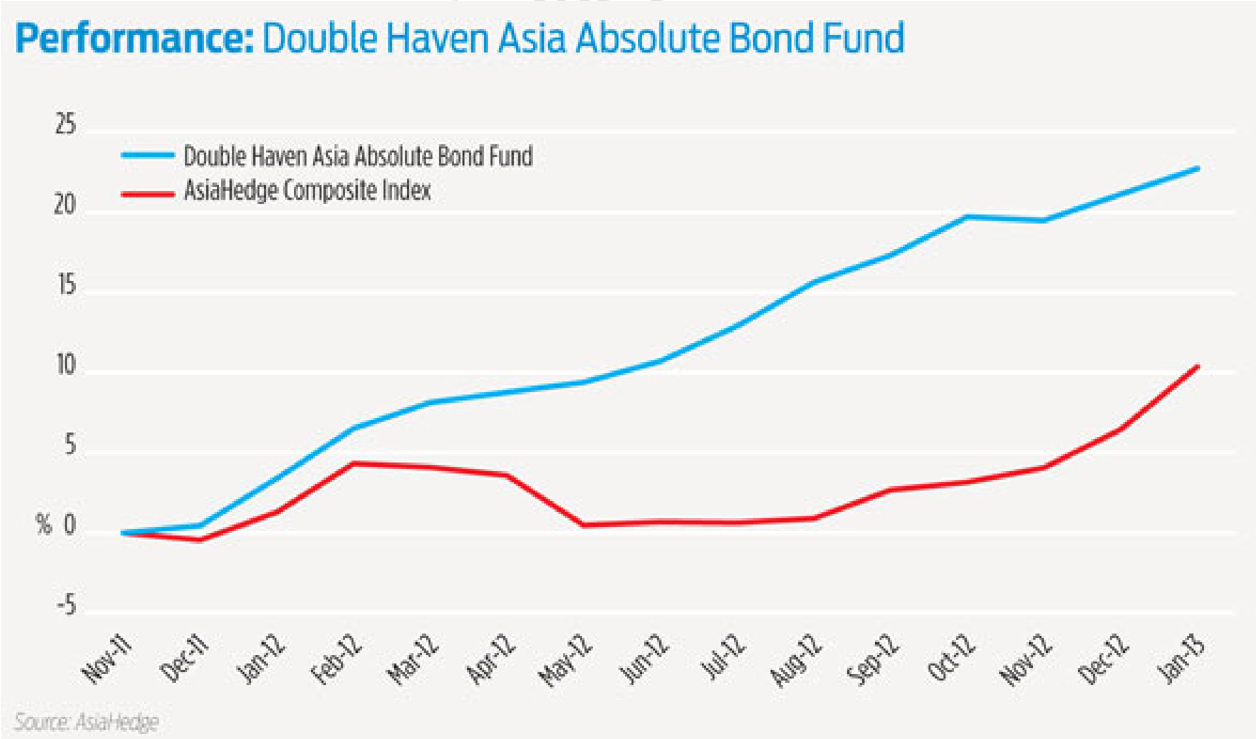
To date, the strategy seems to be working. Last year was a rewarding one for Double Haven as attractive spreads on Asian credits drove strong performance and inflows. Its flagship Double Haven Asia Absolute Bond Fund, a long/short credit fund run by the six-man investment team led by Flint, delivered a robust 20.58% gain despite a challenging macro environment, due in most part to concerns over the European debt crisis.

The fund's performance was solid enough to convince an established European insurance firm to award the team a $200 million mandate for a segregated account pursuing a similar strategy, albeit with a long-only bias and no leverage. The mandate, which came through in December, sent total assets under management to $413 million. For Flint and his team at Double Haven, this is clearly just the start.

Flint, a well-regarded credit manager who was previously the CIO for credit strategies at PMA Investment Advisors - one of Asia's largest hedge fund shops at its peak - believes that Asia's bond market is finally coming of age.

He cites the dramatic increase in the number of bond issues since last year as a key reason, predicting that more big-ticket investors from the US and Europe are preparing themselves to allocate away from developed markets to fast-developing credit markets such as Asia.

"Take, for example, our recently won mandate on the long-only side," says Flint. "This is the first mandate awarded by this investor for long-only exposure in global emerging-market bonds."



Flint notes that while most investors, particularly large allocators, previously tended to hesitate about allocating to emerging-market bonds for fear of illiquidity, the situation is changing in a significant way, with close to $120 billion worth of new US dollar-denominated Asian bonds issued last year alone in Asia ex-Japan.

"The market is not only getting bigger but also becoming more diverse with a significant number of first-time issuers over the last 12 months," Flint says. "Asian credit has become a much more serious asset class and global fixed-income allocators are becoming more comfortable with Asian bonds."

He noted that in the past, Asian corporates typically relied more on the loan market rather than bonds to raise capital - but that the situation completely reversed in 2012. "It was the first year when the bond market issuance exceeded that of the loan market in Asia," he says.

"This increased bond market penetration is a result of loans becoming more costly and less available from the banks. European banks have reduced their exposure to the region and local banks are curbing lending growth in line with the decline in deposits growth."

That Asian credits have proved highly rewarding to investors over the years is no less important a factor, he adds. "The risk-weighted returns from both local and hard-currency Asian bonds have significantly outperformed Asian equities, and that's a key reason why Asia-focused investors have begun reducing their exposure to that asset class and are allocating more to credit strategies," Flint notes.

Double Haven's goal is to deliver consistent, robust performance year after year for the group's long/short strategy, which adopts a bottom-up approach to Asian credits and invests mostly in high-grade Asian bonds.

The strategy in the public markets was evolved over three years ago as a managed account for a US institution, which now stands at $120 million. It is the same strategy that Flint's team ran at PMA Investment Advisors (PMA was later acquired by the Sparx Group of Japan, from where Double Haven spun off in October 2011).

Double Haven's focus of allocating more to investment-grade credits as opposed to high-yield credits has not changed over this period - unlike most credit managers based in the region, who tend to focus more on the high-yield sector.

Investment-grade credits comprise as much as 70 to 80% of the long/short portfolio at Double Haven, with the rest going to long and short positions in high-yield bonds. "We believe there is better risk/reward from employing moderate leverage on investment-grade credits, which gets you close to high-yield returns - without the illiquidity, jurisdictional and default risks associated with high-yield bonds."

With the heavy weighting towards investment-grade credit, the strategy is able to effectively hedge much of the market risk, given the liquidity in investment-grade CDS (primarily indices) - something that is not available in high-yield credit.

As a result, there is significant correlation between the portfolio's short and long books as the fund does not take on any non-Asian basis risk or non-credit basis risk. The cautious approach has paid off, with the portfolio experiencing volatility of just 3.35% last year. The strategy also fully hedges all interest-rate risk associated with the investment-grade bonds, shorting US Treasuries on a duration-weighted basis.

While spreads for high-grade credits have tightened considerably since last year, Double Haven opted nonetheless to continue raising its exposure to them. "As yields on Asian credits have fallen some people thought that it would force us down the credit curve in search of yield, but in fact our portfolio has gone the other way and the exposure to high-grade credit is now at its highest that it has ever been," says Flint. "Broadly speaking, we believe high-yield credit offers less value than investment-grade when moderate leverage is applied to investment-grade names."

Based on JP Morgan Asian credit indices, Asian high-grade credit gained 11.1% last year, after the spreads tightened by 72 bps from 296 bps to 224 bps and as declines in risk-free rates provided further uplift. A Nikko Asset Management report says that Asian high-yield bonds gained 24.5% as spreads in the non-investment-grade area experienced a more significant compression of 311 bps from 841 bps to 530 bps.

"The key to our success is picking the right longs and identifying the names which we believe have a low risk of default and which the market is mispricing, either because they are non-rated and are trading at wide spreads, or because people are just not focused on them," comments Flint. "This asset class is still very much under-researched. With a portfolio of these names, we then hedge the mark-to market volatility using the right hedging tool."

A key strength of Double Haven is that most of the members of its investment team have worked together for at least eight to 10 years. Flint sees the newly-awarded segregated account as a clear vote of confidence in the business. Besides him, the other members of the investment team at Double Haven are Thomas Doud, Arun Vaswani, Richard McDade, Stanley Kwok and Kunal Saha.

Flint says by now having its own in-house infrastructure suite, Double Haven has gained the capability to provide more products and also to respond better to customers' needs.

Aside from establishing segregated accounts for potential investors, Double Haven is also looking to launch a fund focused on private lending. It is understood that the new fund will primarily target the natural resource and infrastructure sectors, and will focus on lending to Indonesian corporates, given the already well-established links and contacts of the investment team there.

The fund will be populated primarily by self-sourced deals or club deals where it will hold a controlling position. The team is drawing from their existing experience - from 2004 to 2008, Sparx/PMA's private lending strategy lent nearly $1.7 billion in the region, with a focus on companies in Indonesia.

Flint says that the opportunity for private lending across the region now looks even better than it did five to eight years ago, citing the tightening access to liquidity and funding that is being faced by corporates around the region.

Banking reforms in the West, together with the European debt crisis, are restricting the amount of available capital from Western banks - while local banks in the region often struggle to lend into structures that fall outside their traditional limited universe of borrowers.

Flint describes the ability of most banks in the region to look at credit and to consider cashflow lending instead of asset-based lending as still very limited, resulting in a liquidity shortfall. If investors wish to get exposure to the "high-yield risk" countries within the region, they are better off doing so through a structured, secured loan rather than an unsecured public bond, he adds.

"As European banks restructure their operations around the region in the aftermath of the European debt crisis, many companies are finding it more difficult to raise funds that are required for capital expansion and growth," says Flint. "The rising loan-to deposit ratios of banks in the region will also hamper their ability to expand lending capacity to corporates in the future."

While credit remains a fledgling asset class in Asia compared to equities, he believes Asian-focused credit strategies provide excellent opportunities to investors - with credit set to continue to grow and develop into a more meaningful asset class as Asia develops, and as corporate balance sheets evolve. "We will continue to be an active player in this dynamic environment, and will expand and strengthen our position," concludes Flint.

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