

The canny investor

Investing in safe assets with cash flows enables fund manager Stephen Diggle to also take on higher risks elsewhere

By GENEVIEVE CUA

IN the aftermath of the 2008 financial crisis, tales of canny fund managers who made a fortune out of the collapse of US sub-prime mortgages and the subsequent market meltdown have become legend. But few may know that Singapore had its own “hot hands” in Artradis Fund Management, a hedge fund set up jointly by Stephen Diggle and Richard Magides, which ballooned from seed capital of US\$5 million in 2002 to an astonishing US\$5 billion at its peak in 2008.

Today, the affable Stephen Diggle runs his own family office. He also heads Vulpes Investment Management, the latest incarnation of Artradis, whose flagship fund Baracuda and its leveraged sibling AB2 were wound down in 2010 and their capital returned to investors. Mr Diggle and Mr Magides have also parted ways.

Says Mr Diggle: “Richard and I like to joke – it’s half a joke – that the best decision we made was to form Artradis. The second best decision was to close it.” Artradis traded in volatility options on indices and securities.

“Richard and I didn’t start Artradis because we wanted or expected to become very wealthy. It just happened that we ran a good hedge fund over the years; we had all our money invested in it and it did very well. We woke up in 2008 when the dust settled and realised – we were rich! Which is great, but it brings a lot of challenges.”

Today, most of his family’s money is invested in Vulpes funds – which invest in a mix of real estate, agricultural land, gold, public equities and private equity. Vulpes has around US\$300 million in assets under management, of which a proportion comprises third-party funds.

When Vulpes began investing in 2011, Mr Diggle firmly believed that the massive quantitative easing (QE) measures undertaken by central banks would unleash “elevated inflation”, which bodes ill for financial assets. Today, his views have “morphed”, he says, as inflation remains relatively tame despite QE intervention.

“Milton Friedman said inflation was always and ever a monetary phenomenon. Using that as a starting point, we were concerned that with the creation of massive amounts of money, we’d have a period of sustained and elevated inflation, at the same time as you had very low interest rates and government bond rates.”

Since 2009, however, while financial assets and bond prices have risen, as have real estate in selected locations, prices and wages in general have not risen. “I think the

principal reason (inflation) didn’t happen was that none of that money ever in any meaningful way leaked into the real economy. So you had a gigantic QE, and all they really did was buy government bonds and mortgage-backed securities from the financial system...

“On the other hand, the phenomenon of financial repression – the suppression of interest rates and bond rates – meant that it was impossible to get a decent return from traditional low-risk investments.

“The problem for wealth, for anyone trying to live off capital rather than labour, is the same – how to get a return on capital. Our focus has changed in a nuanced way. We’re less concerned about inflation; we hold less raw land, less gold. But where we are focusing more intensely is where we can get a reasonable return – a cash flow return, not capital gain. That’s the critical thing.

“What we look for is a real return on capital, not in terms of what someone else will pay for it next year or the next two seconds, but in terms of where we can get a cash-on-cash yield. For the bond market, unless you take an extraordinary amount of credit risk, (the yield) is very poor indeed.”

Today, real assets takes up about half of Vulpes’ investments and the other half is invested in financial assets. “Think of it as a barbell. Half of our money is in what we describe as safe assets, protected from inflation with a significant yield such as agricultural land and real estate, and gold. That’s our safe haven. On the other side, we don’t go for blue-chip stocks. We go for things with a high degree of risk such as biotechnology, early-stage technology and frontier markets. Done properly, they can produce very high returns.”

Robust returns

So far, he has fared handsomely in public securities. Specifically, investments in three UK-listed biotech companies – positions that the family has held for over a decade – have generated returns of 70 per cent year to date. The largest holding is Oxford Biomedica, a pioneer in gene and cell therapy of which the firm owns 17.7 per cent. A second company is life sciences firm Proteome Sciences, which specialises in biomarker services. Brother Martin Diggle heads the firm’s Life Sciences Fund and sits on the board of a listed and a private company in the portfolio.

“Our biotechnology fund is volatile with a high degree of risk. If it comes out right, you can make proper money rather than grinding it out for 8 to 10 per cent which is con-



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sidered the new excellent. I don’t see that as particularly excellent. I don’t want to bad-mouth my hedge fund peers, but there was a time when those guys were a little more daring. You didn’t invest in hedge funds to get 5 to 8 per cent return; you did it to double your money.

“To a certain extent, we try to go back to an earlier age of proper hedge fund returns – as in we make a great deal of money. We do take a fair amount of risk. Our thinking is the core (should) remain stable and highly cash-generative, and continue to give us as a family and business the income we can live off and do things we want like philanthropy. Most of all, it gives us the lifeblood to invest in new things that are risky.”

Investors’ risk appetite in general has ratcheted downwards, he says, and he blames the “unintended consequences” of QE. “Because investors don’t have income, their risk appetite has gone down very low indeed, partly because if they put money in risk, they don’t have anything to restore that. We have assets giving positive cash flow on a regular basis that allows us to take somewhat outsized but potentially highly remunerative risks like biotech,

early-stage technology and frontier markets. We see a lot of opportunities in those areas despite the fact that one of the things lacking in the world now is growth. Generally speaking, those investments are places you can get a leveraged bet on growth.”

Activist investors

The going, however, is often tough particularly in the emerging markets, due to generally poor corporate governance and uncertainty with regard to the rule of law, among other factors. The need to protect one’s own investments has spurred Vulpes to take on an activist role.

A case in point is Russia, and Mr Diggle bursts into laughter when queried about how he navigates the notorious corporate governance issues. “The answer is, you don’t. We clearly wouldn’t have started a Russia fund if we had envisaged how difficult things would become. But when you find yourself in a situation where things are difficult but not impossible, you have to work with what you have to become a better investor. That’s why we’ve become activist investors. It wasn’t by choice. We felt it was a necessity.”

Corporate governance in Russia, he says, is very poor and has steadily worsened. “There are some fairly egregious things going on. What would surprise most people is that the Russian legal system is not hopelessly corrupt or a pawn of the state or the oligarchs. It actually operates reasonably independently and in an uncorrupt way.”

The Russian legal system is, however, powerless, he says. “We have a specific example where we own a meaningful but small stake in a company. We won an injunction against Gazprom in the Supreme Court. Gazprom said, ‘We understand the court ruled against us, but we don’t agree with the judgement, so we’re not going to do anything ...’ This is a Russian company significantly owned by the state, refusing to comply with a judgement which would have significantly compensated us for our losses.

“How do you navigate this? You do the best you can. Clearly the best way to avoid this is not to be in the situation in the first place. Anyone who says they have a crystal ball that says which markets will work and become a great investment is fooling himself or others. The reason fron-

tier markets are dangerous is that you don’t know what path they’re on.”

Vulpes’ Russian Opportunities Fund, which invests in Russian stocks, isn’t “disastrous”, he says. “From the time we’ve operated, the Russian market has halved and we’re about par. It’s not a huge triumph after eight years, but better than losing half your money. We want to use our experience and expertise to make money in places where we think there are great opportunities.”

The firm has private equity investments in frontier markets such as Ukraine and parts of Africa. “We’re very picky about who we partner with. The critical way to mitigate your risk in these places is to choose partners carefully. It’s almost more important than getting the country and industry right ... So we spend an inordinate amount of time doing due diligence on our partners.”