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A London Hedge Fund That Opts for Engineers, Not M.B.A.'s

By HEATHER TIMMONS

LONDON, Aug. 17 — The calmest trading floor in the world might just be at Sugar Quay, a former dock on the north bank of the Thames.

There, in the headquarters of the hedge fund giant Man Group, a small number of traders are quietly handling tens of millions of dollars at a time, around the clock, following directions generated by the fund's black-box trading system, known as AHL.

Hedge funds are sometimes seen as the "smart money," and their managers hailed as market iconoclasts whose quirky, daring trading styles are central to their success. But some of the smartest traders are often beaten by an unlikely foe: the room full of man-high Hewlett-Packard computers that are the brain of AHL, named for the initials of its three founders.

AHL, created by three analysts who studied physics at Oxford and Cambridge Universities, boasts an annualized return of 17.9 percent since December 1990. Total returns during that time are more than 1,000 percent.

Several rows of computers decide the fate of $16 billion in assets, churning out thousands of trading decisions a day in all corners of the futures markets, including stocks, government bonds, energy, metals and foreign exchange. They use historical data to determine which direction markets will travel, and every five minutes spit out orders to be executed by a room of low-key traders.

Black-box trading systems, as they are known, are responsible for a growing percentage of market trading around the globe, including an estimated half of all United States stock trades and a quarter of worldwide currency trades. AHL, as one of the longest-running, most successful programs on the market, has become the backbone of the Man Group's rise to a £7.44 billion ($14 billion) market cap company.

Recent weeks have been a struggle for AHL, but analysts and Man Group executives say that is part of the normal trading fluctuations for the highly volatile system. AHL Diversified Program, AHL's basic performance measure, was down 3 percent in June and 3 percent again in July. Market indecision stymies many an investor and money manager, but it can seriously thwart a black box system like AHL. Automated trading systems rely on long-term momentum in any given market to calculate what the next trade should be, so when markets and prices do not move in a constant way, a system loses money. In June, AHL also suffered because gold had a precipitous one-day drop, and commodities sold off.

"The last six weeks have been a bit of a nightmare for them, or for anyone looking for direction out there," said Michael Sanderson, general financial equity research with Dresdner Kleinwort in London. Mr. Sanderson, who has the company rated a buy, added that there was little cause for alarm.

Man Group executives say they are not concerned.

"Even in times that people have started to get nervous about it, AHL has proven tremendously resilient," said David Browne, the Man Group's head of funding. In April 2001, the net value of the assets managed by AHL dropped 6.3 percent. By year-end, they were up 19.7 percent over 2000.

The question that haunts AHL — and all black-box trading systems — is this: What if something completely unexpected happens that the system doesn't predict?

"Every market has that issue," Mr. Browne said. "The advantage of AHL is that it is uncorrelated" to markets, and "often does quite well in those conditions," he said. The fund expects annual volatility as high as 18 percent, and in many cases penalizes investors for exiting in the first six years, cushioning it from skittish investor movement. For the fiscal year ended March 31, AHL was the largest contributor to the Man Group's $450 million in asset management performance fees, at 23.4 percent.

AHL's founders, Michael Adam, David Harding and Martin Lueck, have been gone from the Man Group for more than 10 years, and have since started up new funds themselves. The program is updated by an even quieter group of employees. They try to improve the AHL system by, for example, finding a better, faster way to conduct trades. Twice a day, analysts look at AHL's risk levels and its portfolio allocation, checking to see that nothing has gone awry.

For those jobs, hedge fund analysts need not apply.

"Typically the research analyst staff come straight from academia," said Tim Wong, head of research for AHL, who is an engineering graduate from Oxford University. "We want people who have quantitative skills, but a very open mind about the market data. If someone comes right from M.B.A. school, you have to get them to unlearn what they've learned about the right way of investing in markets."

"If I have to track the performance of our fund on a day-to-day basis, I do find it hard to be emotion-free," Mr. Wong said. But, he added, "we really have to look at the data, and let the stats speak for themselves."

"Quite a lot of trades will fail, but over all, on average, we do have an edge, it just takes time" for it to become apparent, he said. "People can't sit on the fence forever, and that's the time we will profit: when people are coming back and putting their money on the table."

Analysts caution that the Man Group's trading acumen cannot all be attributed to AHL.

"The computer didn't build itself," said James Longsdon, an analyst with Fitch in London. "Clever minds went into building it."