Hedge Fund Report: SG Energy Equity Long Short

August, 2024

Summary

SG Energy Equity Long-short (SGELS) is the flagship fund of SG, launched in 2020 by two portfolio managers from respected major institutions. SG has US$1.2 bn assets under management (AUM), with roughly $600 mm in SGELS and $600 mm in managed accounts. Using a fundamental bottom-up investment strategy and low net exposure, SGELS has produced a net annualized return of 28.8% and a Sharpe Ratio of 1.05 since its inception, compared to that of 12.7% and 0.39 respectively of the S&P 500 total return index (SPX) during the same period.

SGELS has a capable portfolio manager supported by seasoned research and support teams. It has quality custodian, brokerage, accounting, legal, and other service providers, and sound regulatory compliance. SGELS will likely continue to generate attractive absolute and risk-adjusted returns and investors should consider an allocation, certain caveats and the need for due diligence notwithstanding.

This report examines the history, team, strategy, risk control, service providers, operations, governance, performance, and terms before providing an assessment of SGELS.

History and Overview

Partner1 and partner2 co-founded SGELS in 2000, with Partner1 being the CIO. Partner1 has an MBA degree from the University1, and worked as a partner and portfolio manager (PM) of energy and industrial long short portfolios at firm1, and as an equity analyst and PM at firm2. Partner2 is a graduate of University2 and worked as an equity long short analyst and portfolio manager at several firms, including firm3. Firm1, firm2, and firm3 are all well-known major asset managers. Both partners have been investing in equities for over 20 years.

Headquartered in city1, SGELS has an 8-person investment team and a 5-person operation and client team, with a bottom-up fundamental strategy. It invests in the traditional and alternative energy space, roughly 80% in USA and 20% internationally.

SGELS is a master-feeder fund, with a Delaware vehicle for US on-shore investors and a Cayman off-shore feeder, subject to the oversight of SEC (the US Securities and Exchange Commission) and CIMA (the Cayman Islands Monetary Authority). It has an independent Board of Directors and uses independent service providers to handle investor money, calculate returns, and keep records, adding layers of protection to investors.

Team

SGELS investment team includes the CIO and 7 analysts. Among them, the five senior analysts have 8 to 20 years, and the two analysts have 3 to 5 years of experience investing in energy related stocks. Its 5-person support team includes a COO, a client service director, a risk manager/trader, an accountant, and an associate. Most of investment and support staff have worked at well-known firms. New hires are subject to background checks, and SGELS reviews staff performance annually with ongoing informal feedback. Large portion of staff compensation is tired to SGELS investment returns. Trading in personal account is not allowed on SGELS restricted securities, or otherwise requires approval of SGELS' external compliance consultant.

SGELS organizes research by sub-sectors and its investment team covers the entire traditional and renewable energy space that includes exploration, production, refining and service, infrastructure, alternative fuels and renewables, electric batteries and minerals, et al. Over the last 24 month, one EU utility analyst left (due to small allocation to the region/sector) and one renewable analyst was replaced for better fit. The traditional energy team is very stable, currently representing 95% of the portfolio, as SGELS building out its renewable book. Investments from SG staff represents 15% of the total firm AUM.

Investment Strategy and Process

SGELS uses bottom-up fundamental research to cover about 300 names, investing 80% of its AUM in the US and Canada and 20% worldwide. It normally uses gross exposure of 1.5x to 2.5x, but maintains a low net exposure within +/-20% by pairing individual stock longs and shorts. Its portfolio usually contains 40-60 longs and shorts, with an average position size of 3-7%. SGELS may exit positions in as little as 2 weeks or hold them for as long as 2 years.

Each analyst, specializing in the sub-sector he/she covers with deep domain expertise and industry contacts, ranks his/her long and short candidates. The investment team is in constant contact, discussing candidates and the latest developments. The CIO, who knows all the names SGELS covers, consolidates ideas from analysts and decides on allocations within its portfolio risk parameters. SGELS trading desk then executes the authorized trades, if any, to rebalance the portfolio.

While having its twists, SGELS generally follows a common strategy and investment process that has worked well. However, by using a low net exposure, prioritizing businesses that do not fluctuate widely through commodity cycles, SGELS aims to reduce its performance correlation with the equity market and the oil price.

Risk Control

SGELS manages risks by using domain expertise and focused research to know its investment candidates well, paring individual long and short trades to reduce net exposure, and imposing limits so that its investment portfolio is diversified and not overly leveraged.

SGELS limits its max gross exposure to 250%, max net at +/-20%, max allocation to a long position at 15%, max allocation to a short position at 10%. It does not use stop losses, but a decline of 5% in a position prompt reviews, and a drop of 10% would trigger a reduction in position size. SGELS imposes these restrictions in constructing and rebalancing its portfolio. Its CIO and risk manager continuously monitoring and enforcing these risk parameters. SGELS maintains a liquid portfolio. It can be liquidate 95% of its portfolio in 5 days if necessary, using 20% of the average daily trading volume.

Service Providers

SGELS uses Goldman and Merrill Lynch as its custodians and prime brokers. It auditor is RSM US, LLP and its legal advisors are Vedder Price, and Maples and Calder. UMB Fund Service is its fund administrator, and Davis Powers Inc. is its system administrator and IT consultant. All of them are independent and respected firms in the industry.

Operations

SGELS outsources its back-end functions to service providers, as is customary in the industry. It conducts research and investing, manages client relations and service providers, and ensures compliance.

The client relation director markets SGELS and ensures that investor inquiries are handled promptly. She works with the fund administrator to ensure client subscription and redemption are handled properly and monthly NAV (Net Asset Value) reports are delivered on time.

The COO maintains internal control, works with a third-party consultant to ensure compliance, and coordinates legal advisors to prepare AWL (anti-money laundering) reports and filings in various jurisdictions. The accountant and associate track client and SGELS accounts independently of the fund administrator. The team works with its IT consultant to maintain and secure SGELS systems that house accounts, records, research, trading systems, et al. They are also responsible for coordinating outside auditors, lawyers, and the administrator to prepare monthly reports, annual audits, tax returns and filings.

Governance

SGELS' governing document, the PPM (Private Placement Memorandum), sets out its structure, strategy, risk parameters, fee levels, rights of the manager and investors, and other details. The document contains a wealth of information. Investors should review this document carefully before investing in SGELS.

SGELS has an independent Board of Directors (2 outsiders, and the COO of SGELS). The Board delegates investment and business operations to investment manager (SG) and its service providers. The Board reviews and approves annual audit and regulatory filings. It also holds quarterly meetings to review and discuss presentations from SG and its service providers as necessary, to ensure investor money is safely kept and proper accounting, legal, and regulatory procedures are followed.

Performance

SGELS has produced a net annualized return of 28.8% and a Sharpe Ratio of 1.05, using a risk-free rate of 5%, since its inception in September 2020 to August 2024. During the same period, the annualized return and Sharpe Ratio of the SPX were 12.7% and 0.39 respectively. The max drawdown during the period was 19.8% for SGELS and 24.8% for the SPX. Table 1 shows the monthly returns of SGELS, and Chart 1 compares its equity curve with SPX. The correlation between the monthly returns of SGELS and SPX is 0.01. Chart 2 contains the scatter plot of the two monthly returns series, confirming the low correlation between the two.

Table 1: SGELS monthly returns since inception

	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
2024	(4.58)	(2.22)	2.79	0.35	0.68	0.15	(1.98)	(4.04)					(8.73)
2023	4.86	5.63	0.31	1.91	2.64	(1.08)	2.84	4.05	0.44	(1.53)	(1.53)	1.48	21.58
2022	6.97	11.10	0.39	1.10	7.27	(7.18)	3.56	3.29	3.95	10.66	1.35	6.19	59.06
2021	(19.84)	25.61	(2.59)	3.32	18.91	6.19	(4.55)	4.60	8.13	(1.17)	(1.04)	5.03	41.88
2020									0.79	(0.15)	7.10	2.02	9.95

Chart 1: SGELS Portfolio vs SPX

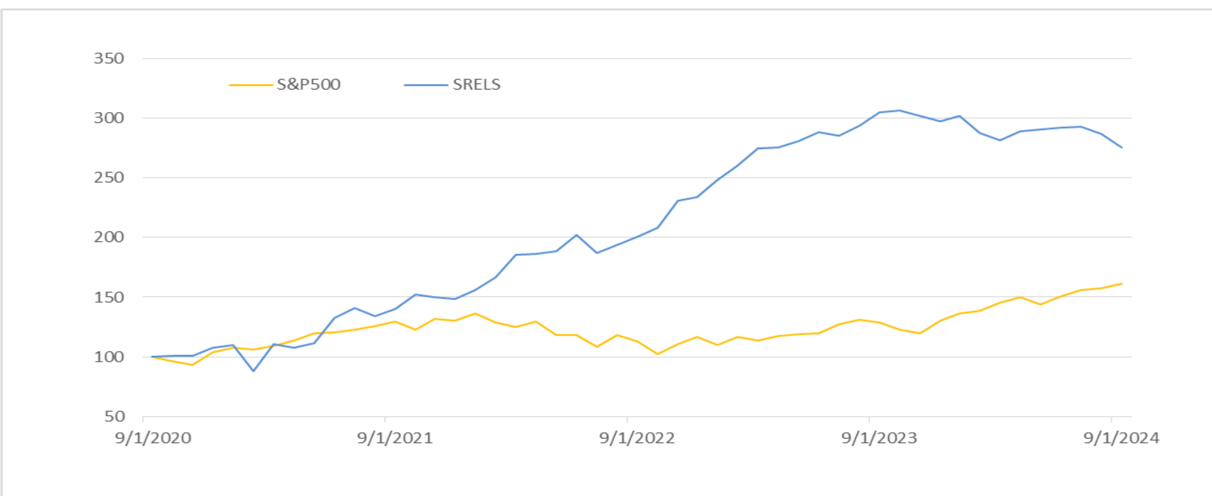
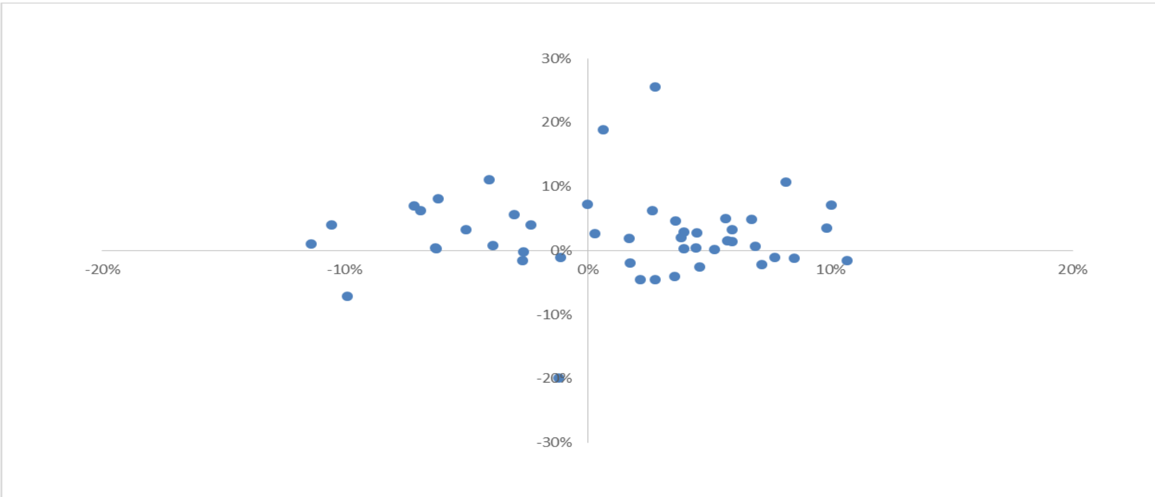


Chart 2: Scatter Plot of Monthly Returns, SGELS (vertical axis) vs SPX (horizontal axis)



Terms & Facts

1. Currency	US$
2. Domicile	Cayman Islands
3. Fund Administrator	UMB Fund Services
4. Custodian	Goldman Sachs, Bank of America/Merrill Lynch
5. Prime Brokers	Goldman Sachs, Bank of America/Merrill Lynch
6. Auditor	RSM US, LLP
7. Legal Advisors	Vedder Price, Maples and Calder
8. Min Subscription	US$1,000,000
9. Management fee	1.5% per annum
10. Performance fee	20%
11. High watermark	Yes
12. Hurdle rate	No
13. Subscription	Monthly
14. Redemption	Quarterly, with 65-day notice
15. Lock up	One-year soft lock up, with 5% early withdrawal fee in the 1st year

Assessment

SGELS has a capable investment team with deep domain expertise, a tested investment strategy and process, and a straightforward but effective risk control, producing attractive absolute and risk-adjusted returns since inception. Its support and compliance functions appear to work well, and it has well-respected independent service providers and an independent board of directors.

While it has a relatively short history, SGELS has demonstrated its ability to generate impressive absolute and risk adjusted returns with a low net exposure in both up and down markets. We all prefer funds of high returns, battle-tested with severe market dislocations. But these funds often become too large to maintain their performance. SGELS is relatively new and smallish. With its low net exposure and a seasoned investment team that had gone through major market dislocations in their previous roles, SGELS could be a unique find.

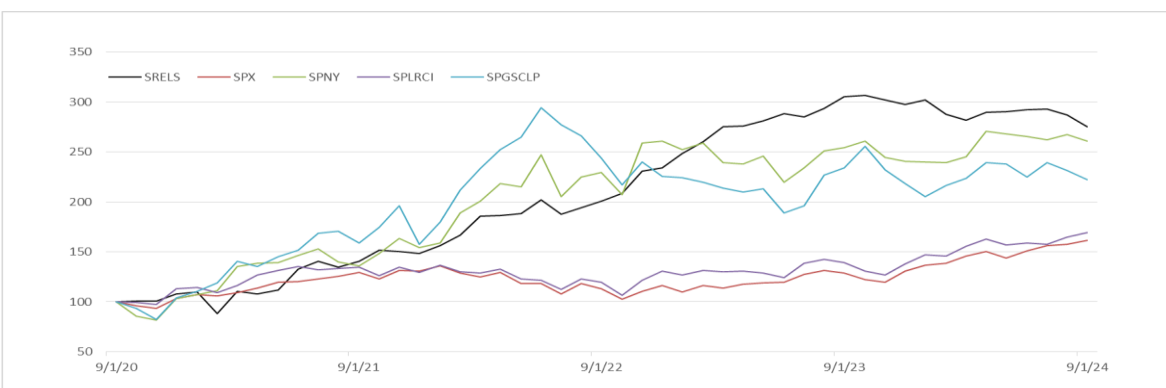
The initial screen suggests that SGELS should be a candidate for consideration, based on public information and materials provided by the fund, with the following caveats:

- ***Risk management, again***: Fundamental equity strategies could be volatile, especially for a leveraged sector fund. While SGELS had a smaller max drawdown than its benchmarks, investors need to diversify their allocations among assets and strategies.

- ***Strategy details***: SGELS may hold its positions for as brief as 2 weeks. Are these positions part of same fundamental stock selections or part of a short-term trading program? SGELS provided little information. Also, SGELS has underperformed the market recently, is that just a normal fluctuation or a harbinger of potential issues? Investors need to find out during their due diligence.

- ***Fund vs managed accounts***: investors need to digger deeper into how SG allocates opportunities to SGELS vs its managed accounts, and whether majority of its staff invest in SGELS or in managed accounts.

- ***Beta or alpha:*** While SGELS has low correlations with SPX (0.01) and its industrial sub-index SPLRCI (0.01), the correlation between SGELS and the oil (SPGSLP) and energy sub-index (SPNY) is 0.35 and 0.47 respectively. Investors should probe why the low net exposure of SGELS had not reduced these correlations further, and how it managed to capture the entire gain of these two indices with low correlations. The following chart compares SGELS with SPX and its energy (SPNY), industrial (SPLRCI), and crude oil Sub-indices (SPGSLP).



- ***Due diligence:*** This report is based on public info from reputable sources and materials provided by SGELS, which we assume to be reliable given the intense regulatory scrutiny in the Dodd-Frank era. We validate facts and data mainly in our due diligence stage of the fund selection. Also in our effort to distill hundreds of pages down, omissions and subjective selections are inevitable and possible errors are likely. Investors investing on their own must conduct a thorough due diligence before their investment decisions.