Building up Barnegat

May 01, 2010

Bob Treue's approach is unconventional, but he proves being quirky and making money are not mutually exclusive.

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Photographs by Dorothy Hong

Two private bankers from Belgium, dressed in impeccable suits & ties, arrived in Hoboken, N.J., one hot summer day a few years ago to check out a promising young hedge fund manager.

The bankers weren't certain they'd arrived at the right address: an office open to the street in a mixed-use building with apartments upstairs. Inside they found a disheveled single room of about 600 square feet, outfitted with furniture from Ikea, and three earnest young men peering into Bloomberg terminals. One of them got up. He was wearing a T-shirt and shorts. The bankers noticed that he was barefoot.

Robert Treue III introduced himself as the founder of Barnegat Fund Management. He had gotten the date of their visit mixed up, and so the bankers got a glimpse of what Bob Treue looks like on a typical summer workday. The bankers were not impressed and took their investment capital elsewhere.

Their loss. In 2009 the Barnegat Fund's fixed-income arbitrage strategy produced an eye-popping 132.68% net return, earning Treue a nomination for AR's fixed-income fund of the year. Barnegat was up another 3.3% through March 2010 and earned an 11.6% gain for the first quarter of the year.

Every day may be casual day at the Barnegat Fund, and Bob Treue may not look the part of the sophisticated Wall Street investor—he rides to work on a bike he bought at Target, for a start—but there's nothing casual about his hunt for profits. "We make money on panic," Treue says.

While that was certainly true in 2009, which followed the rout of 2008, it belies a far more nuanced approach than simply taking advantage of market dislocations. Treue characterizes himself as a long-term investor, and he has designed his fund to withstand major market setbacks so that he can concentrate on finding trading opportunities that the firm can keep holding through tough times.

Despite a punishing year in 2008, when the fund lost 37.62%, Barnegat has churned out an 18.89% compound average annual return since inception in 2001, with a Sharpe ratio of 1.0. The fund had about $487.7 million under management as of March 31, and Treue limits the size to about $500 million. He figures that is the maximum that he can manage effectively without having to expand his tiny firm, which he doesn't want to do. His staff amounts to six people, with three of them working outside his office.

Barnegat's performance is based on Treue's ability to spot anomalies in fixed-income pricing and then strategically place long and short bets in the expectation that prices will eventually revert to a normal pattern. He rounds out his investment strategy with futures and swaps.

The fund focuses on large, long-term quirks in interest rates in the world's fixed-income markets. This focus generally results in a portfolio of about 10 to 15 trades, which are comprised of multiple products—such as yield curve trades that use combinations of futures and swaps of varying maturities, or bonds that are mispriced compared with similar bonds. Unlike many fixed-income arbitrage funds, Barnegat trades infrequently, and his long positions can sometimes take years to play out. But Treue has the patience to wait for his positions to pay off, and he keeps enough reserves to wait out markets that turn against him in the short term, as happened in 2008.

Treue has tried to build an investor base attuned to his long-term investment approach. About 80% of his investors have been with the fund since its first year in 2001. He charges his investors 1% management fees and 15% performance fees, well below the 2-and-20 standard.

Treue uses a mostly low-tech method for spotting opportunities: He reads and studies as much as he can not only about pricing of worldwide government debt issues but also about domestic and global economics and politics, looking for news, events or trends that might influence prices. While some funds employ science and math wizards to construct elaborate computer models that hunt for the sorts of trading opportunities that Barnegat specializes in, Treue relies on his training and instincts. Although he uses his own models, the nugget that triggers a Treue investment can come from just about anywhere.

The tip that led to much of his outsize 2009 performance came from his mother, a former math teacher who monitors government bonds on her own and spotted a pricing anomaly between two types of U.S. issues that Treue turned into a highly profitable investment.

"I really enjoy just sitting at my desk working on the math and valuations of respective bonds," Treue says. "With trading, you also need to include current events and market psychology. My wife always makes fun of me for bringing the Economist and the Financial Times along when we travel as part of my reading list."

But Treue says he doesn't have any game-changing views on the economy, and his firm does not specialize in trying to predict it. Instead, the firm focuses strictly on looking at how bonds are priced relative to one another, and Treue says the field has become less crowded over the last few years as banks have cut back their proprietary trading in the strategy and a number of fixed-income relative value hedge funds folded after the crisis of 2008.

Barnegat covers most large developed countries—including those in North America, Europe and the Pacific Rim—and every day Treue and his team download quotes for all the relevant bonds, swaps, options and related instruments for those countries. They spend most of their time analyzing this data, scouring it for potential mispricings. The team looks to construct trades with at least three components so the fund can take advantage of not only the initial mispricing between two bonds but also the eventual correction of the mispricing.

Because of the fund's longer time horizon, Treue sometimes enters into trades too early. He admits that he is frequently wrong in his timing, and this is part of what contributed to the big drawdown in 2008. Treue says the trades that netted big gains in 2009 were the same trades he put on in 2008, but being too early cost him in the short term.

But Treue is willing to be patient when it comes to a good opportunity, and luckily, so are his investors. For Treue, the best opportunities arise when other bond investors are forced to make decisions that are not in their best interests—what he refers to as "noneconomic decisions"—that result in pricing irregularities. "Those are the times we make the most money," he says.

Treue believes more investors will be forced to make these types of decisions today, just as they did after the demise of Long-Term Capital Management in 1998. At the height of the most recent crisis, governments were forced to take steps, such as quantitative easing, that created a lot of pricing anomalies.

For example, the Bank of England bought 25% of all outstanding gilts—the UK equivalent of Treasuries—at the same time the government was issuing huge amounts of debt. "You had an enormous buyer and an enormous seller, and they couldn't trade with each other," says Treue. The Bank of England was buying bonds with durations ranging from five to 25 years, while the U.K. Treasury was issuing bonds throughout the curve. To take advantage of this, Barnegat shorted the five-year to seven-year bonds and bought four-year and 10-year inflation-linked bonds from the U.K. Treasury. This is because the Bank of England was not buying those particular bonds, which made them cheap, while the price of five- to seven-year bonds was inflated because of the buybacks. This way, Barnegat was able to get higher yields and pay lower yields to the Bank of England via the short positions.

Investors who have watched Treue over the years say he maintains an unusual level of intellectual curiosity about bonds and the governments that issue them, but manages to distill the reams of information he reviews into simple, useful tidbits. "Bob looks at markets in a quantitative sense, but he is not trying to take advantage of very complex things happening in markets," says Mike Lozowski, who was with Man Group in London when it provided Barnegat with some of its original investment capital. "His methods are more down-to-earth, more commonsense."

Giles McClelland, another former Man Group executive who worked with Treue, says he was impressed with the depth and breadth of Treue's research. McClelland is now with Revere Capital Advisors, a hedge fund firm in London and New York.

"The attention to detail that he applies to mispricing in the fixed-income world, is, I think, exceptional," McClelland says. Another investor marveled at Treue's ability to recite up-to-date debt ratios and statistics for countries around the globe.

One example of Treue's method was his play on two U.S. bond issues, both due in 2014. One was a plain fixed-rate U.S. Treasury bond due in February, the other a Treasury Inflation-Protected Security (TIPS) bond indexed to inflation due in January. Because of their similarities, the two issues are expected to follow a similar path in pricing: When one goes up, the other should go up proportionately. Treue's mother, a conservative investor, started touting the allure of TIPS, arguing that they were cheap considering the inflation protection they offered.

Treue decided she was onto something. After Lehman Brothers collapsed in September 2008, the fixed-rate 2014 bond dropped, but the TIPS didn't seem to be following, presenting an arbitrage.

Treue went long the TIPS, shorted the fixed-rate bonds and used an inflation swap to lock in the inflation rate on the TIPS. But the Lehman bankruptcy continued to distort markets, and the bet initially looked like a loser. Treue, who admits he put the trade on too early, figured the play would work out, and it did: Within a few months, the TIPS rose, nominal bonds fell and Treue profited handsomely.

"We are not the only people who discovered this trade," Treue readily acknowledges. "But we were in early, and although we lost money initially, we were able to survive and wait for this trade to become profitable."

This is also an example of Treue's fondness for the opportunities that arise when other investors are forced to make bad decisions. "When Lehman went under, the world panicked and sold TIPS feverishly and raced to buy nominal bonds. Panic is a noneconomic decision. That's great for us."

Treue's ability to stick with the TIPS trade through the market turmoil following the Lehman bankruptcy, at a time when margin calls were seriously pinching other funds and forcing some to unwind trades, says almost as much about how he operates as does his ability to find arbitrage opportunities. While Treue exudes confidence in his predictions, he also maintains extra controls in case of severe and unexpected market dislocations like those of 2008. One way he does that is by maintaining oversize cash reserves that he can draw on if he gets hit with big margin calls. Barnegat keeps 40% to 50% of its assets in cash and government bonds.

"The big secret is, when the world blows up, you have to be able to post margin on trades," Treue says. "One reason we survived 2008 was our huge stash of excess collateral. We can meet margin calls without a problem."

Treue further minimizes the impact of margin calls by substituting some of his own collateral terms for the standard ones used in most counterparty agreements with hedge funds. If a trading strategy nosedives, standard agreements allow for the forced unwinding of a trade when a fund's assets drop 15% in one month, 25% in three months or 35% in 12 months. Barnegat's contracts set those triggers at 20%, 30% or 40%, respectively, which gives Treue a little more breathing room.

But even more important is what happens when a trigger is reached. A prime broker in most agreements has the right to close out a fund's position at what amounts to the low point in the trade, which is very good for the broker but can be disastrous for the fund; The drain on capital from a big trade that must be closed out can be enough to force a fund to shut down. Treue inserts language into his collateral agreements that requires pricing each trade at its midpoint, which is far more favorable to the fund during a serious market drop and can often deter a counterparty from closing out the trade.

That came in handy when Lehman Brothers collapsed in September 2008 and many funds found themselves forced to liquidate positions at fire sale prices. Barnegat was able to maintain most of its positions and in some cases, like the TIPS play, add to them while waiting for the recovery. Barnegat did lose money and hit the 30% trigger in late 2008, so it had to post additional collateral. But none of its brokers forced it to liquidate positions. Treue says that he was later told by one of his prime brokers, which has a sizable hedge fund business, that Barnegat was one of only two funds to negotiate contracts of that type.

Treue says he underestimated how bad things would get in 2008 and never imagined that he could lose as much as he did that year with all the safety measures he had put into place. In the end, though, those measures kept his fund in business and in position to profit on the turnaround.

He adds that the reason the firm negotiated those agreements, and the reason it maintains a high balance of cash and government bonds, is partly because he and the other firm partners constitute the

second largest investment in the fund. "It's not, 'Heads, we win, tails, the investor loses,'?" he says. "We're locked in for the long haul."

The investment strategy Treue pursues is not much different from what powered Long-Term Capital Management into one of the world's largest hedge funds—and one of its most spectacular blowups. John Meriwether's LTCM was stocked with Nobel Prize winners, but the fund couldn't weather a market downturn in 2008 that widened rather than narrowed spreads. Treue likes to compare himself to LTCM, pointing out two key differences: There are no Nobel Prize winners in his fund, and he is savvy enough to insure against major market disruptions.

McClelland says that Treue's delight in discussing the similarities—and differences—between his firm and LTCM says a lot about what makes him distinctive. The analogy underscores his understanding not only of the investment process but also of the precautions necessary to survive tough times. Still, comparing himself to one of the most infamous hedge fund blowups underscores just how clueless Treue is about marketing.

"Maybe a sharp marketer wouldn't draw parallels with LTCM," McClelland says. "He does."

Treue claims marketing and sales have never been his forte. Although he is sociable, with a wide circle of longtime friends and acquaintances, he says he has difficulty charming would-be investors. It took him years to land his first investor, with a pitch so low-key and wonky that it invariably fell flat.

"I thought I would be able to go out, show investors the arbitrage opportunities, and they would trip over themselves trying to get into my fund," Treue says. "The opposite happened. I went two years with no income."

For a while during that period, he lived in a tiny room barely larger than a closet in the apartment of Jennifer Rochon, a New York lawyer who was a friend from college. She was at the time living in a small Manhattan apartment with the man she has since married. Each morning Treue would leave for the New York Public Library and queue up for an hour of time at one of three public-access Bloomberg terminals. He would copy bond prices by hand and later enter them into a spreadsheet on his computer. At night he would return to his nook in Rochon's apartment.

"It was a tiny space, maybe four feet by six feet," she says. "He had every piece of his belongings in there. He had a kind of futon, mattressy-thing pushed up against the wall. I don't know how he fit in there. But his stuff all stayed in that room and never leaked out. He wasn't any trouble, and you just enjoyed being with him."

How Treue wound up living in what amounted to a friend's closet-size extra room, and how he got out, is a tale of Midwestern pluck, investing talent and an ambition to succeed in his chosen specialty.

Treue, who is now 41, grew up in the suburbs of Detroit, Mich., in the 1970s and 1980s. His father was a computer engineer who worked for General Motors for 35 years. Treue and his sister lived what he describes as a carefree, middle-class life reminiscent of "Leave It to Beaver" and indicative of the final glory days of the U.S. automotive industry.

He showed an early aptitude for math, competing in the Michigan statewide math competition for eighth graders and finishing 17th, a distinction he cites on his personal bio. Treue enrolled in the University of Michigan at Ann Arbor as a math major, then considered engineering but finally settled on business. He had started scanning stock pages and real estate listings while in high school and thought he might enjoy a career where he could use his math ability to help him analyze and trade securities.

"I thought about what would be the best jobs that I would want," Treue recalls. "Number one was rock star. Two was pro athlete. Obviously those things were not open to me. The most realistic joI wanted was to be a trader and investor."

After his junior year, he landed an internship with what was then Shearson Lehman. He spent the summer making cold calls on potential retail customers and hated it.

On the final day of class in his senior year, an instructor offered a lecture on life lessons and learning that made a lasting impression and continues to influence how Treue operates his fund. The lecture was based around an excerpt from the 1909 book "The Autobiography of Nathaniel Southgate Shaler," in which the Harvard sciences professor tells of a seemingly inscrutable method of teaching that his mentor imposed. Shaler is presented with a dead fish on a tin pan and ordered to study it with no outside help of any kind and then to report back with his findings. Hours become days and confusion gives way to insight as Shaler pores over the fish, eventually becoming a self-taught expert.

Treue still hands out copies of the book excerpt today and made his associates read it. "The teacher just leaves this guy alone with a fish for days on end," Treue says. "The guy studies the fish so much that he knows everything possible about fish. It's the concept of self-driven study. What we do here all day is look at bonds, swaps, derivatives around the world, looking at pricing. The idea is to study it until you know it like the back of your hand."

Treue graduated in 1991 with a bachelor's degree in business and landed a joas an entry-level trading analyst for the currency options trader O'Connor & Associates in Philadelphia (the company has since merged with UBS). A year later he jumped to Watermark Group in Princeton, N.J., a fixed-income relative value fund, where he learned the essence of the strategy that he would later apply to his own fund.

In January 1998 Treue left Watermark for Litchfield Capital Management in London, one of Donald Sussman's Paloma Funds at the time, to run a fixed-income relative value strategy. He was just getting started when LTCM blew up after its fixed-income arbitrage strategy got sideswiped by Russia's bond default, wiping out billions in capital over a few weeks.

Treue took some initial losses in his new position at Litchfield in the turmoil following the LTCM collapse, but he also saw an opportunity. LTCM had been such a big player in fixed-income arbitrage that its demise left room for others to jump in. Treue also felt LTCM's collapse caused such significant price dislocations that arbitrage opportunities would be plentiful.

Treue left Litchfield in July 1999 and launched Barnegat Fund Management with $400,000 of his own money, living and working out of his friend Rochon's spare room. He chose the name of a New Jersey bay for his fund simply because he liked the way it sounded. Treue eventually found a roommate and moved into an apartment in Hoboken, where he continued to run his fund with his own money as he searched for investors. He posted returns of 34.1% in 1999 and 11.2% in 2000, but that was not enough to convince investors.

"People would ask me how many Nobel Prize winners I had," Treue recalls. "I would say, 'I don't have any.' And they would say, well, these guys at Long Term Capital have two, and they just blew through billions of dollars."

In 2000 Man Group was looking to fund a new fixed-income relative value manager. Someone at Man knew someone at Watermark, who suggested Treue. After examining his work, Man agreed to provide some initial capital and help him develop his operating systems. Treue flew to London and spent several months working out of an office in Man's headquarters, then returned to Hoboken, ready to debut his new fund.

The Barnegat Fund launched on January 1, 2001 with $25 million. That year Treue posted a 13.52% gain, and his assets grew to $75 million. He did even better in 2002: Barnegat assets rose to $286 million, and he recorded a 55.9% return. He continued to post positive annual returns for the next few years. Assets hit a peak of $613 million in 2005—more than Treue wanted to manage, so he gave money back to investors. By 2005 he was back down to $386.9 million. His assets rose back up to $480 million by 2007 before dropping to $275 million in 2008, when he recorded his first loss, the 37.62% decline. But his assets were back up to $476 million by the end of 2009, bolstered by his 132.68% gain.

Along the way, Treue began collecting accolades. He was a finalist for AR's fixed-income fund of the year in 2009, and Bloomberg named Barnegat the top fixed-income fund in the world in 2002 and 2009.

While Treue's stature in the fixed-income arbitrage world has risen, his personal style has remained largely unchanged. He lives in the same brownstone apartment he has occupied since shortly after starting his fund. He doesn't own a car—although his wife does—and he has made few lifestyle adjustments to reflect his increasing personal wealth. He spends his days reading and researching, making trades only rarely. Barnegat has 10 to 20 positions at any given moment and usually holds trades for 12 to 24 months. That means Barnegat trades only about once or twice per month.

That leaves plenty of time for Treue to spend in his modest Hoboken office reading about bonds and government debt. And every now and then he might actually place a trade. "There is not that much going on here," Treue says. "It is just us sitting here studying the market, looking for mispricing." And sometimes quietly making piles of money.

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