



IMAGING: RASHMI

Alpha Romeos

Size may be in question, but hedge funds will continue to thrive – sans leverage – on the back of a few credible fund managers and strategies

V Keshavdev

On the night of December 3, about 650 guests piled on to Nikki Beach on the east side of Manhattan drinking dirty martinis and grooving into the early hours of the morning. Not an unusual sight in New York, except that the party was hosted for the much-battered hedge fund industry.

“For months, all you hear about is lagging numbers, layoffs and huge bailouts. Just for a night, I wanted everyone to forget all that. I think everyone was long overdue for a good time,” says Evan Rapoport, co-founder of HedgeCo Networks and organiser of the event.

While the night out was fun, gloomy days are in store for the hedge fund industry. The global financial tsunami – whose epicentre lay in the troubled US housing market – has wiped out 693 funds till October or nearly 7 per cent of the industry, according to the

Chicago-based Hedge Fund Research, which tracks over 9,000 funds. On an annualised basis, the year is expected to end with more than 920 fund liquidations, exceeding the previous calendar year record of 848 in 2005.

The turmoil in the credit markets and the consequent market reverberations saw edgy investors pull out \$40 billion from hedge funds, which, coupled with the \$115 billion performance-based asset losses, pared the industry’s capital base by \$155 billion by October.

The much-touted alternative asset class – which began the year with around \$1.93 trillion in assets under management – was left with \$1.56 trillion in assets among 9,762 funds by the month-end. Also for the first time since 2003, except for short-bias, macro funds and managed futures, all other strategies yielded negative returns for investors.

Unfortunately, the pain is not yet over for the industry which has capped redemptions by skittish investors such as family offices, pension funds and en-

dowments as the funds head for their biggest annual loss of 23 per cent (as on December 30) since 1990. According to Singapore-based hedge-fund consulting firm GFIA, as on October, 18 per cent of assets (about \$300 billion) managed by 5 per cent of hedge funds was subject to restrictions on withdrawals. Surprisingly, the redemption blues are not just confined to smaller funds but also the best in the business such as Citadel, Tudor Investment, DE Shaw, Farallon Capital Management. Even as the industry battles the crisis of confidence, the regulators are turning the heat on funds to get them regulated. While the jury is still out on who is responsible for the collateral damage, industry experts predict a bitter shakeout in the near future with only a handful of fund managers and strategies making the grade.

The return matrix

Since the credit crisis began in the summer of 2007, financial institutions started deleveraging, that is, selling assets to shrink their balance sheets.

The unwinding resulted in a vicious cycle of selling across financial markets as a fall in asset prices, resulting in additional margin calls, forced long-only mutual funds and hedge funds to offload their liquid positions which triggered further selling pressure. The situation worsened in September following the collapse of Lehman Brothers, resulting in interbank lending almost drying up.

As Andrew W Lo, Harris & Harris Group Professor at MIT Sloan School of Management, aptly put it in his written testimony to the US house: "Leverage has the effect of a magnifying glass, expanding small profit opportunities into larger ones, and also expanding small losses into larger ones. And when adverse changes in market prices reduce the market value of collateral, credit is withdrawn quickly and the subsequent forced liquidation of large positions over short periods of time can lead to widespread financial panic, as we have witnessed over the past several months."

That leverage came back to haunt hedge funds which is evident from the fact that most funds that shut shop had leveraged around 10 times their assets and in some cases, even around 30 times. The subsequent unwinding has seen hedge funds increase their cash holdings and simultaneously decrease their leverage since August 2007.

While hedge funds had managed to sail smoothly in the past five years, a turbulent 2008 only saw a couple of strategies, such as managed futures, macro and short bias, raking in positive returns.

"Financials and commodities were the two big stories of the summer. Frighteningly, the bulk of hedge funds (on a strategy basis) had exposure in this trade as demonstrated by correlation levels in the 0.70 to 0.85 range against the Reuters-Jefferies CRB Index. The ensuing breakdown of this trade hit many hedge funds across all strategies," points out Aureliano Gentilini, global head of hedge fund research, Thomson Reuters Lipper.

Under short bias, fund managers seek to profit from a decline in share prices and borrow a security to sell it in the hope that they can buy it later at a lower price. The HFR Short-Bias index delivered nearly 25 per cent in returns in the 12 months to October 2008 – the best-ever seen in the past five years – despite a temporary ban on short-sales in the US, Europe and some Asian markets. "Short-biased funds typically exhibit a negative beta to equity markets of between -0.8 and -0.9 over time, this is why they have done well," says Ken-

neth J Heinz, president, HFR.

The HFRI Macro Systematic index delivered the second-best returns of the year at 13.5 per cent. Systematic diversified strategies involve using mathematical, algorithmic and technical models; there is little or no influence of individuals over the portfolio positioning. According to HFR, systematic diversified strategies typically do not allocate more than 35 per cent of their portfolio in either dedicated currency or commodity exposures over a given market cycle. "In macro strategies, systematic has done better as they are agnostic to direction (primarily trend followers), trade in liquid markets and it would be atypical for them to have exposure to corporate credit or financial equities – two of the worst areas of performance during the year," adds Heinz.

According to David Friedland, president of Magnum US Investments and president of the Hedge Fund Association (HFA), "Any opportunistic, short-term trading strategy should be able to profit in this environment. Macro funds and short selling funds fall in this category." The HFA chief feels that the market over the past few months necessitated a short-term, opportunistic trading approach, rather than a long term buy and hold one.

The other index that did well was the HFRI FOF (fund of funds) Market Defensive index, which delivered returns

of 3.6 per cent till October. FOF invests in a portfolio of different hedge funds to provide broad exposure to the hedge fund industry and to diversify the risks associated with a single investment fund. While there are no distinct strategies that FOFs seem to have deployed during the year, analysts feel funds have benefited partly because of their exposure to short-bias funds. "Had the funds primarily invested in short-bias funds, their performance would have been at par," points out an analyst.

Interestingly, in October, short-bias funds delivered the maximum monthly returns of 8 per cent during the year even as the S&P 500 fell 17 per cent during the month. No wonder that over that assets under management of short-bias funds were up 58 per cent over December 2007.

Managed futures had an excellent year too after a relatively muted performance in 2007. The CS/Tremont Investable Managed Futures index gained 11.99 per cent in the year to October 31, making this one of the few hedge fund strategies to come through 2008 in positive territory.

The worst returns of the year were doled out by the fixed-income and emerging market categories at -15.1 per cent and -33.7 per cent till October. The most impacted was the convertible arbitrage strategy which saw negative returns of 33.5 per cent as hedging strategies became less effec-

THE RED SEA

Except for a couple of strategies, most hedge funds ended up losers in 2008

| HF indices returns in % | 2003 | 2004 | 2005 | 2006 | 2007 | 2008* |
|----------------------------------|--------|-------|-------|-------|-------|--------|
| HFRI Equity Hedge | 20.54 | 7.68 | 10.60 | 11.71 | 10.48 | -23.60 |
| CS/Tremont All Funds | 15.44 | 9.64 | 7.61 | 13.86 | 12.56 | -15.54 |
| HFRI Event-Driven | 25.33 | 15.01 | 7.29 | 15.33 | 6.61 | -17.57 |
| CS/Tremont Event Driven | 20.02 | 14.47 | 8.95 | 15.73 | 13.20 | -13.92 |
| HFRI Macro | 21.42 | 4.63 | 6.79 | 8.15 | 11.11 | 3.25 |
| CS/Tremont Global Macro | 17.99 | 8.49 | 9.25 | 13.53 | 17.36 | -7.10 |
| HFRI Short Bias | -21.78 | -3.83 | 7.28 | -2.65 | 4.72 | 24.71 |
| CS/Tremont Long/Short Equity | 17.27 | 11.56 | 9.68 | 14.38 | 13.66 | -19.46 |
| HFRI Energy/Basic Materials | 28.83 | 34.91 | 23.40 | 16.13 | 16.40 | -35.57 |
| HFRI Relative Value | 9.72 | 5.58 | 6.02 | 12.37 | 8.94 | -15.06 |
| HFRI Convertible Arbitrage | 9.93 | 1.18 | -1.86 | 12.17 | 5.33 | -33.54 |
| CS/Tremont Convertible Arbitrage | 12.90 | 1.98 | -2.55 | 14.30 | 5.17 | -29.59 |
| HFRI Emerging Markets | 39.36 | 18.42 | 21.04 | 24.26 | 24.92 | -33.73 |
| CS/Tremont Emerging Markets | 28.75 | 12.49 | 17.39 | 20.49 | 20.26 | -29.24 |
| CS/Tremont Managed Futures | 14.13 | 5.97 | -0.11 | 8.05 | 6.01 | 11.99 |
| HFRI Equity Market Neutral | 2.44 | 4.15 | 6.22 | 7.32 | 5.29 | -3.49 |
| CS/Tremont Equity Market Neutral | 7.07 | 6.48 | 6.14 | 11.15 | 9.27 | -0.19 |

Source: Hedge Fund Research; Lipper TASS *Returns till October 2008

tive as correlations broke down following the re-pricing of fixed-income assets. This impacted market liquidity and the evaluation of a range of financial instruments.

Managers make money by buying convertible bonds – which can be converted into stock at a certain price – and then hedging the investment by shorting the underlying stock. According to Jeremy Howard of UK-based Aspiration Capital Research, the two factors which destroyed convertible valuations in 2008 were the brief ban on short sales and a general collapse in the prime brokerage model which saw investment banks extend high levels of leverage to convertible hedge funds. “In my ten years in the product, I never once heard an investor or trader speculate on the effect of a temporary ban on short selling. It just never occurred to anyone that it could happen,” points out Howard in a report on the convertible market. “All convertible valuation models relied on the fundamental ‘long bond/short stock’ portfolio to work. Take away the latter and you have nothing. So on 19 September when the SEC and the UK’s FSA regulators co-announced a temporary ban on short sales on a range of ‘financial’ stocks, the sky fell in on convertibles. Financial convertibles were rendered virtually untradeable in the US and everywhere convertible premiums were marked down sharply to ascribe a probability to further such bans occurring in the future.” As capital began to contract, major prime brokerages (which have hedge funds as their clients) hastily drafted rules which substantially increased the amount of collateral required to hold convertible positions. “The withdrawal and re-pricing of leverage to convertible arbitrage funds has probably done as much to destroy the market as the short-selling ban,” adds Howard.

The other big casualty in the hedge fund industry was emerging market funds. The HFRI Emerging Markets index fell nearly 29 per cent during the four months to October 2008 and was down 33.7 for the 10 months of calendar 2008. The worst-hit were funds and strategies that focused on Russia and Eastern Europe. The Russian stock market, which is down nearly 70 per cent this year, has resulted in a nearly 50 per cent drop in returns for hedge funds. According to HFR, investors pulled out \$5.2 billion from emerging market funds over the four-month period. The overall assets under management of emerging market funds fell by 20 per cent to \$91,357 million till October, as per data from Lipper TASS,

which tracks over 8,300 hedge funds.

Event-driven or special-situations funds, which often bet on pending mergers and acquisitions, fared miserably as M&A deals worth \$699 billion (Thomson Reuters) fell apart during the year following the credit squeeze. The renowned Kenneth C Griffin-owned Citadel Investment Group closed its special situations group after the fund lost hundreds of millions wagering on the takeover of Huntsman Corporation by Hexion Specialty Chemicals. Hexion terminated its \$6.5 billion bid, citing Huntsman’s deteriorating finances. According to reports, Citadel owned 18.6 million shares of Huntsman as on October 26.

While wrong bets may have taken the wind off some hedge fund strategies, the market consensus is that the alternative investment vehicle will continue to chug along on the back of select few strategies.

What’s in, what’s out

While hedge funds have proved to be a let-down for alpha-smitten investors, Ros Altmann, a pensions advisor to British ex-prime minister Tony Blair and now an independent policy expert, feels the industry is all tarred with the same brush which is not really appropriate. “Some strategies have been a disaster and some managers have

failed abysmally, but there are still many who have performed relatively well and certainly far better than many long-only managers,” she adds.

While Altman feels arbitrage funds won’t survive, Friedland of HFA expects opportunistic trading funds (macro, short-term trading-oriented equity traders and similar funds) to do well. “At some stage, once confidence and credit returns to the system, convertible bond arbitrage and distressed should do well, but over the long term, I think investors now realise the cyclical nature of convertible arbitrage funds.”

According to GFIA, managers of equity long-short funds and macro funds attract investors. Managers of credit strategies may also outperform because a dearth of available credit from banks will create a niche opportunity, Peter Douglas, also the chairman of the Asia chapter of the Alternative Investment Management Association, was quoted by Bloomberg.

The slide in global stock prices will also present opportunities for managers of so-called long-short funds, who bet on rising and falling stock prices, feels Douglas. Long-short funds with assets between \$200 million to \$400 million in Asia are the best placed to take advantage of these opportunities. Macro-fund managers, who wager on trends in stocks, bonds and currencies worldwide, are also set to gain. As per Lipper TASS, the assets under management of macro funds have increased 30 per cent to \$158,868 million during the year, whereas assets under long-short were up marginally at 2.3 per cent to \$433,275 million.

According to the Tokyo-based alternative investment consultant, Veryan Allen, “If a fund needs fine conditions to make money, there is little point in having it in a portfolio. We can get ‘good economy’ return sources from traditional funds.

A true hedge fund should offer something different. That’s why they are called alternative investments. If it is dependent on underlying risk factors, it is not a hedge fund.” But Altmann feels it won’t be easy for hedge funds grappling with lack of liquidity, investor redemptions and unavailability of credit for leverage – the mainstay of some strategies.

Redemption blues

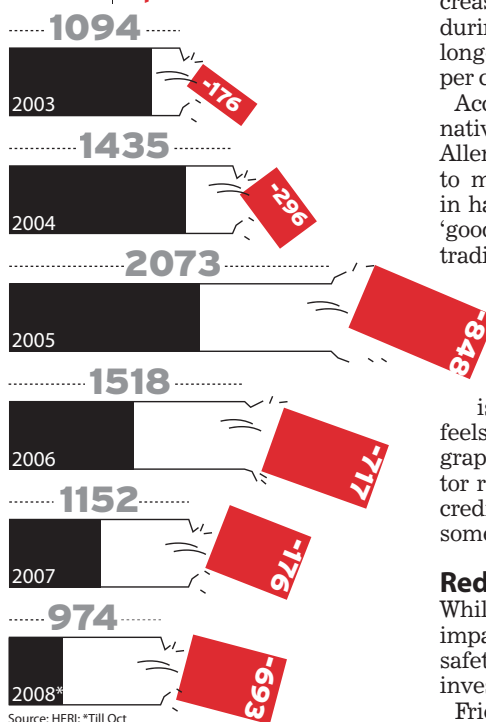
While the stock market turbulence has impacted hedge funds, the flight to safety has accentuated the crisis with investors pulling out funds.

Friedland of HFA feels that hedge

BREAKDOWN

Estimated number of funds

Launches | Liquidations



Source: HFR; *Till Oct

funds were being sold, rather than selling on their own terms, which exacerbated the crisis. "The same can be said for the mutual fund industry and, frankly, the severe decline in stock markets can largely be attributable to mass mutual fund selling which control far more of the daily market volume than hedge funds," he says.

Altmann agrees. "Definitely, forced selling has been a major problem as investors demand money back often from hedge funds that have performed well, just because they are desperate for some liquidity or to lock in gains they have."

According to Heinz of HFR, "Anecdotally, redemption requests are likely to have limited the ability of the industry to act aggressively as a liquidity provider as it has previously." No surprise then that fund managers reacted to the crisis by halting redemptions. GFIA estimates that about \$300 billion is being locked up against investors' will. In fact, Cayman Islands – home to 80 per cent of the world's hedge funds – passed a law in the first week of December that suspends the payment of redemption proceeds in respect of extant or pre-existing redemption requests. While fund managers feel it is in the interest of investors, research shows that halting redemptions will do more damage than good in restoring confidence.

According to a study by the Tennessee-based Vanderbilt Owen Graduate School of Management, raising restrictions on hedge fund withdrawals can erode investor value by as much as 15 per cent. Nicolas P B Bollen, E Bronson Ingram professor in finance at the Owen School, believes an investor who deposits \$1 million in hedge funds – a relatively modest allocation for such financial products – is essentially paying a fee of as much as \$150,000 if his/her



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DAVID FRIEDLAND

PRESIDENT, HEDGE FUND ASSOCIATION



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KENNETH J HEINZ

PRESIDENT, HEDGE FUND RESEARCH INC

ability to exit is eliminated through future suspension of redemptions.

"Hedge funds have historically been attractive because of their potential for high returns," says Bollen. "What we are now seeing is that, in a serious downturn, investors can face heavy penalties and even be prevented from retrieving their capital should they seek to liquidate their investments, and the implied cost of these restrictions can significantly reduce the return that should be expected from funds."

But despite the overarching concerns and losses, institutional investors – the lifeline of the hedge fund industry – are not in hurry to pull the plug – yet.

Stirred but not shaken

There's little doubt that institutional clients such as family offices, endowments and pension funds have been battered by the meltdown. According to Prequin, the UK-based research and consultancy firm focusing on alternative asset classes, public pension plans and endowments have a total exposure of \$148 billion and \$66.3 billion to hedge funds.

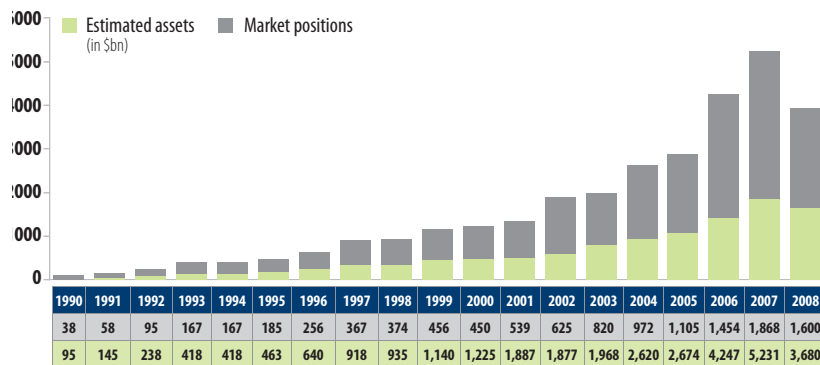
According to reports, Harvard University's endowment has lost \$8 billion, while the University of Virginia Investment Management Co has lost nearly \$1 billion, or 18 per cent, of its endowment over the four-month period, reducing it to \$4.2 billion. Altmann fears the losses could climb higher. "Marking to market will be very ugly and I'm sure that some funds will show losses of 30 per cent or more."

But despite the losses, institutions are keeping the faith with hedge funds. According to a new Prequin survey of 300 institutions, though around 75 per cent investors acknowledged that their hedge fund returns had fallen short of original expectations, more than half (53 per cent) were satisfied with their hedge fund returns. Around 5 per cent of institutional investors, however, are going ahead with redemptions.

Amy Bensted, senior research analyst at Prequin, however, feels it's hard to predict how much capital will be flowing into hedge funds in 2009. "Currently there is a polarised opinion among

WEIGHT LOSS

After a significant build-up in hedge-fund assets from 1990, there was a sharp decline in assets and leverage in 2008



Source: Q3 2008 - HFR Industry report. Q4 2008 projections - based on Credit Suisse analysis; percentage growth y-o-y

THE LONG AND SHORT OF IT

Managed futures and short strategies saw the maximum gain in assets under management

| AUM (\$ mn) | 2003 | 2004 | 2005 | 2006 | 2007 | 2008* | % chg over Dec 07 |
|-------------------------|---------|---------|---------|-----------|-----------|-----------|-------------------|
| Convertible Arbitrage | 40,699 | 41,330 | 24,760 | 33,393 | 38,789 | 28,653 | -26% |
| Dedicated Short Bias | 893 | 1,587 | 2,426 | 2,892 | 3,826 | 6,030 | 58% |
| Emerging Markets | 17,045 | 29,785 | 46,767 | 71,722 | 114,776 | 91,357 | -20% |
| Equity market neutral | 33,037 | 36,623 | 38,188 | 52,876 | 71,504 | 64,177 | -10% |
| Event Driven | 83,811 | 126,897 | 170,793 | 224,245 | 318,199 | 245,140 | -23% |
| Fixed Income Arbitrage | 35,576 | 47,579 | 56,618 | 64,171 | 59,156 | 82,461 | 39% |
| Global Macro | 51,724 | 67,706 | 67,610 | 94,079 | 122,129 | 158,868 | 30% |
| Long/Short Equity Hedge | 161,757 | 218,915 | 262,128 | 326,552 | 423,649 | 433,275 | 2% |
| Managed Futures | 23,189 | 35,119 | 34,427 | 45,530 | 56,796 | 132,778 | 134% |
| Multi-Strategy | 41,795 | 68,307 | 109,110 | 135,017 | 181,174 | 271,464 | 50% |
| All Funds | 489,528 | 673,848 | 812,826 | 1,050,478 | 1,389,998 | 1,514,203 | 9% |

AUM as on 31 December for each year; * till September 2008. Source: Lipper TASS (Funds of Funds are excluded from the calculation)

investors – with some getting out of the asset class completely and others increasing their investments because HFs have outperformed all other areas of their portfolios.”

Most investors seem to be waiting until the second quarter of 2009 to begin investing again, so assuming some stability returns by then, there should be fairly large inflows of capital into hedge funds from June onwards, adds Bensted. Besides, Prequin has identified 160 institutional investors that

are poised to make their first investments in hedge funds over the next 12 to 18 months. “With some hedge fund strategies disappearing altogether in the wake of the credit crisis and new strategies emerging as a result of a different financial climate, institutional investors will overhaul their approach to hedge fund investments,” points out Bensted.

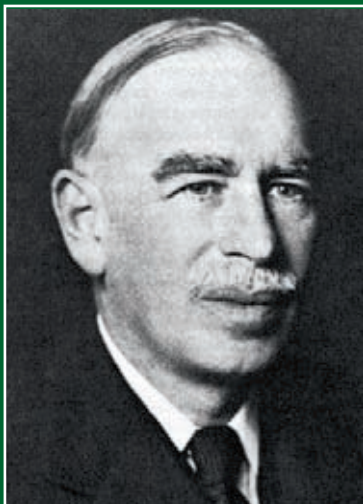
Future tense

Even before the credit crisis dust set-

tlings down, the fate of the hedge fund industry has already been decided. George Soros of Soros Fund Management told the US Congress in November “the bubble has now burst, and hedge funds will be decimated. I would guess that the amount of money they manage will shrink by between 50 per cent and 75 per cent.”

Add to it the recent Madoff ponzi scheme and the big canvas is all but red. Market losses and rolling redemptions, according to Morgan Stanley, are

Keynes over the hedge



JOHN MAYNARD KEYNES
UK ECONOMIST (1883–1946)

We all know him well for The General Theory of Employment, Interest and Money, but few are aware that famed economist John Maynard Keynes was the earliest hedge fund manager, much before Alfred W Jones came in the picture. While Jones mastered the long-short selling strategy, Keynes ran a macro fund which dabbled in stocks, bonds, currencies and commodities in the 1920s. In 1927, Keynes was appointed as manager of the Chest Fund at King's College in Cambridge.

Though his strategy of speculating in the stock market was opposed by many, Keynes's view was that he would rather be a ‘speculator’ in an asset that had a daily price quotation and was liquid enough to be bought and sold than an ‘investor’ in something whose price was largely unknown. From an initial capital of £30,000, the fund had grown to £380,000 – an annual compound rate of over 12 per cent – by the time Keynes died in 1946.

On the face of it while the growth may not sound phenomenal, it came during a period that encompassed both the crash of 1929 and the build-up to World War Two, both of which proved disastrous for British stocks as the market fell 15 per cent. The interesting aspect was that the growth in the value of the Chest Fund was entirely due to capital appreciation as Keynes spent all of the dividends to fund the college's needs.

According to noted US economist, Mark Skousen, in 1933, at the depth of the Great Depression, Keynes took a contrarian position by acquiring the preferred shares of utility holding companies in the US. National Power & Light, one of Keynes picks, was yielding 15 per cent and had huge cash reserves. His preferred stocks doubled and tripled in value over the next few years.

Keynes believed in going contrary to popular opinion. In 1937, he wrote, “It is the one sphere of life and activity where victory, security and success are always to the minority and never to the majority. When you find any one agreeing with you, change your mind. When I can persuade the board of my insurance company to buy a share, that, I am

expected to reduce hedge fund assets by nearly half from their peak to between \$900 billion and \$1.6 trillion by the end of 2009, depending on the timing of a recovery.

But what will really hurt the industry is the shrinking leverage pipe. According to Robert McAdie, global head of credit strategy, Barclays Capital, funding for investment grade bond collateral early this year was relatively easy to obtain and the haircuts (initial margins) were 3-5 per cent. "In contrast, lenders today are very selective about providing funding. Leverage has declined from 20-30 per cent to 4-6 times. In addition, funding costs are about 200-400 basis points higher than in January 2008," he adds.

Concurs Gentilini of Lipper TASS, "The cheap borrowing, the availability of stock lending and other attributes that have characterised the hedge fund industry may no longer be forthcoming in the new era of tighter credit. The industry will continue shrinking in the first (possibly the first two) quarters, hit by shutdowns of some hedge fund businesses."

But Gentilini believes the hedge fund crisis is not a merely cyclical performance setback. "There is indeed something secular going on. Part of the issue has been the cost structure of the hedge fund business, especially for so-called mid-tier firms that

have high overheads and are on the verge of getting sizeable institutional investor allocations."

While the party is over for hedge funds, the industry is expected to survive as institutional investors like pension funds will continue to chase absolute returns and park funds with hedge funds. Altmann feels institutions will continue to look at hedge funds as no other asset class provides the ability to reduce losses and still provide significant upside. "Hedge funds should still be a core part of long-term portfolios, but it is vital to distinguish between good and bad. There are good managers out there and I think there it will continue to be. A shake-out of the weakest managers and weaker strategies is healthy."

Indeed, Connecticut State Treasurer Denise Nappier is proceeding with a plan to invest 8 per cent of its \$20 billion in hedge funds after market turmoil wiped out \$5 billion worth of pension assets. "This is the time to position our portfolio for the long term and I need that exposure as a diversifier," she says. CalPERS staff have also recommended increasing the target allocation to its alternative investment managers, including private equity and hedge funds, to 18 per cent from 13 per cent. While there is a school of thought (read Warren Buffett) that favours direct investment in equities

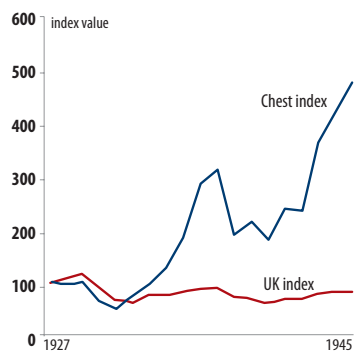
learning from experience, is the right moment for selling it."

But according to William T Ziemba, the alumni professor of financial modeling and stochastic optimisation in the Sauder School of Business, University of British Columbia, Keynes' aggressive approach caught up with him as Britain prepared for World War II in 1938-40 with his Chest index falling to 179.9 in 1940 from 315 in 1937.

But then, during the actual war, 1941-45, Keynes had a strong record. According to Skousen, Keynes, did lose big money during the 1929 crash and subsequent bear market. But surprisingly he took the bear market in a positive stride. "I feel no shame at being found still owning a share when the bottom of the market comes," he said. "I would go much further than that. I should say that it is from time to time the duty of a serious investor to accept the depreciation of his holdings with equanimity and without reproaching himself. Any other policy is anti-social, destructive of confidence and incompatible with the working of the economic system. An investor...should be aiming primarily at

CHARTBUSTER

The Keynes-run Chest fund managed to outperform the underlying index by a huge margin during the crisis period

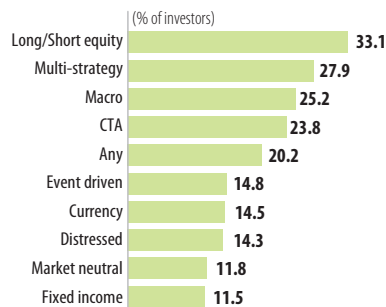


Source: A 2004 study by William T Ziemba, alumni professor of Sauder School of Business

long-period results, and should be solely judged by these." What Keynes has pioneered has resulted in the creation of the so-called alternative investments 'hedge fund' industry, but the jury is still out on whether fund managers have learnt their history lessons well. □

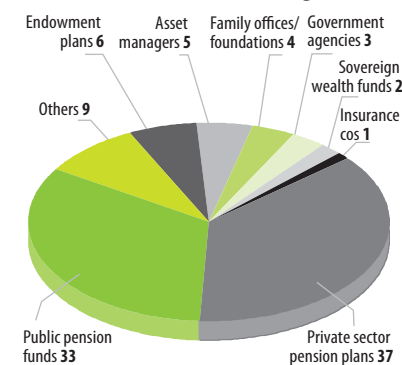
HOT FAVOURITE

Long/short equity continues to be the most preferred investment strategy among hedge fund investors



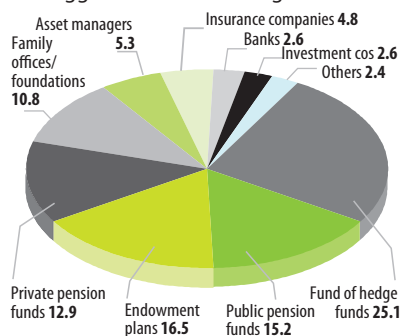
CHECKING IN

Private sector pension plans are looking at first time investments in hedge funds



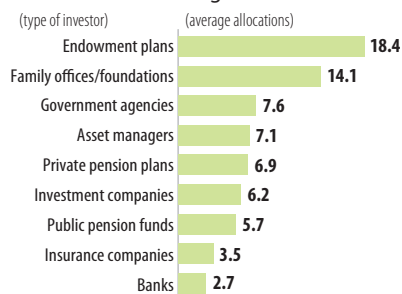
THE FAITHFULS

Family offices, endowments and PFs are the biggest investors in hedge funds



AGGRESSIVE

Endowments have the highest allocation of funds towards hedge funds



Source: Preqin Hedge fund report



Hedge funds have historically been attractive because of their potential for high returns. But the implied cost of these restrictions can significantly reduce the returns

NICOLAS P B BOLLEN

PROFESSOR OF FINANCE, THE OWEN SCHOOL



If a fund needs fine conditions to make money, there is little point in having it in a portfolio. We can get 'good economy' return sources from traditional funds

VERYAN ALLEN

TOKYO-BASED ALTERNATIVE INVESTMENT PROFESSIONAL



Forced selling has been a major problem as investors demand money back from hedge funds just because they are desperate for some liquidity

ROS ALTMANN

UK PENSION POLICY EXPERT

over investing in hedge funds, Mike Howard, head of the Europe-based Ermitage's Long Short Equity, thinks otherwise. "One of the old investment management mantras is that equity markets trend up through time. But try telling that to the Japanese whose markets recently hit a 27-year low. The S&P 500 also hit a 11½ year low in November and European indices are in a similar position. We are not saying that developed markets are likely to suffer a Japanese-style malaise, but clearly it is not always a safe assumption that the long-term trend will bail you out. We believe the a hedged approach is just a more efficient way of compounding returns through equity market investing over the longer term, with significantly lower risk," he says.

To prove his point, Howard says investors tracking the MSCI Europe index since December 1, 1999, will see an annualised loss of -2.6 per cent on their original investment over the term against Ermitage's European Absolute Fund, which has returned 7.9 per cent (annualised) over the same period with approximately one-third the volatility of the MSCI European index.

According to Man Investments, one of the largest hedge fund managers with over \$71 billion in assets under management, given the size of current dislocations (and volatility) in equity and credit markets, hedge funds can potentially capture out-sized returns

without leverage in certain strategies. "Overall, we think the global macro managers are well positioned for 2009 as they have reduced equity market exposure to almost zero. They also do not have credit exposure and the de-leveraging is negligible for the vast majority of macro managers. We see the best opportunities in currencies and fixed income. Most macro managers are positioned for further rate cuts, e.g. in the Eurozone, UK, Australia. This is normally implemented by being long the short end of the yield curve or by multiple positions at various maturities to express a more nuanced view," says Thomas Della Casa, head of research, strategy and analysis group at Man Investments and co-author of the Outlook 2009 report.

While the selection of strategies will be paramount, industry observers believe that recent events will unavoidably lead to a re-evaluation of the hedge fund model. Investors and asset allocators are likely to take a critical look at the alignment of interest between investors and fund managers. Some funds are cutting their management fee to 1.2 per cent from 2 per cent and performance fee to 10 per cent from 20 per cent from October 1, 2008, through 2010.

In certain cases, investors who agree

to a new two-year lockup are being offered a 5 per cent reduction in performance fee and those who invest additional money will pay no incentive fees at all on the new investment until the beginning of 2010. Friedland of HFA feels the crisis will result in fewer assets, fewer managers, and more opportunities. Gentilini of Lipper echoes that sentiment. "I am convinced talented and skilled managers will survive in a new business model, where marketing and distribution policies, investor

disclosure and tighter regulation, and penetration of new business segments/geographies will be key drivers," he says.

Vellan, too believes history has vindicated the belief that come what may, hedge funds will eventually survive. "It is worth recalling that hedge fund managers like Benjamin Graham, John Maynard Keynes, Karl Karsten, Philip Fisher

and Gerald Loeb performed very well during the 1930s," he says.

"The more hedge funds that shut down, the better the opportunity set for talented managers. The money redeemed will simply be reinvested in firms that know how to generate alpha (higher returns) instead of weaker names that were just repackaging beta (benchmarked returns)." □

Preqin has identified 160 institutional investors that are poised to make their first investments in hedge funds over the next 12 to 18 months